THE ASSOCIATION OF GLOBAL CUSTODIANS

BNY MELLON
BROWN BROTHERS HARRIMAN
CITIBANK, N.A.
DEUTSCHE BANK
HSBC SECURITIES SERVICES
J.P. MORGAN
NORTHERN TRUST
RBC INVESTOR & TREASURY SERVICES
SKANDINAVISKA ENSKILDA BANKEN
STANDARD CHARTERED BANK
STATE STREET BANK AND TRUST COMPANY

COUNSEL AND SECRETARIAT TO THE ASSOCIATION:
BAKER & MCKENZIE LLP

EUROPE
ATT: ARUN SRIVASTAVA
100 NEW BRIDGE STREET
LONDON EC4V 6JA, ENGLAND
INT'L TEL: 44 20 7919 1000

GLOBAL
ATT: ROBIN TRUESDALE
815 CONNECTICUT AVENUE, N.W.
WASHINGTON, D.C. 20006
TEL: 202 452 7000
FAX: 202 452 7074

WWW.THEAGC.COM

September 11, 2015

VIA E-MAIL

Ms. Danielle E. Rolfes
International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220
danielle.rolfes@treasury.gov

Re: Comments on Draft Provisions for the U.S. Model Income Tax Treaty

Dear Danielle:

This letter is submitted on behalf of the members of the Association of Global Custodians ("AGC" or "Association") to provide you with comments on the draft provisions for the U.S. Model Income Tax Treaty ("U.S. Model") released by Treasury on May 20, 2015.

The Association is an informal group of 11 member banks that provide securities safekeeping and asset serving functions to cross-border institutional investors worldwide, including investment funds, pension funds, and insurance companies.

In providing global custody services, AGC members routinely seek appropriate tax treaty withholding tax relief on behalf of custody clients. The members typically collectively process millions of such relief claims each year, affecting substantial amounts of cross-border portfolio investment flows in and out of countries worldwide. A significant portion of the income for which the members process treaty relief claims is income received by institutional investors. As such, the AGC members experience on a daily basis the costs, inefficiencies, and excessive withholding that arises when the procedures for claiming lawful relief are unduly burdensome or complicated for the investors involved, or when the standards for entitlement to treaty relief are too unclear or complicated to effectively accommodate treaty relief claims, whether at source or by refund.

The Association believes that several of the proposals for changes to the U.S. Model may have the unintended effect of making it more difficult for U.S. institutional investors that are validly entitled to treaty benefits to obtain those benefits in practice from foreign treaty partners. The purpose of our comments is to explain those potential problems and to suggest, where possible, changes to alleviate them. Our comments are attached in the

Annex. The members very much appreciate the opportunity to comment on these draft proposals and would welcome the chance to discuss their concerns with you. I will contact you separately about the possibility of setting up a meeting with Association representatives for this purpose.

Sincerely yours on behalf of the Association,

Mary C. Bennett
Baker & McKenzie LLP
Counsel to the Association

Annex

Cc: Mark Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury

Robert Stack
Deputy Assistant Secretary (International Tax Affairs)
Department of the Treasury

Henry Louie
Deputy International Tax Counsel
Department of the Treasury

Quyen Huynh
Associate International Tax Counsel
Department of the Treasury

Steven Musher
Associate Chief Counsel (International)
Internal Revenue Service

David W. Horton
Acting Deputy Commissioner (International), LB&I
Internal Revenue Service

ANNEX

AGC Comments on the May 20, 2015 Proposed Provisions for Inclusion in the U.S. Model

General Comments on the Proposed Provisions

The over-arching concern the Association has in connection with the proposed provisions is that their implementation in practice could result in inappropriate loss of treaty benefits to legitimately entitled investors, at least in the absence of very clear standards and pragmatic approaches to procedural requirements. This concern relates primarily to the U.S. Model's proposed (and current) Limitation on Benefits (LOB) provision, but it also applies to some extent to the other proposals as well.

In their capacity as custodian banks, the members of the Association process millions of treaty relief claims each year on behalf of their customers, affecting billions of dollars of cross-border portfolio investment income flows. The AGC notes that the United States has now been following a policy for several decades of including LOB provisions in its treaties, and such provisions can now be found in almost all U.S. treaties in force. As a procedural matter, such provisions have typically not operated to block legitimately entitled foreign portfolio investors from obtaining U.S. treaty benefits. This is largely attributable to the fact that U.S. law allows treaty country residents to obtain treaty relief at source by providing a self-certification (Form W-8) of treaty entitlement to the U.S. withholding agent, and allows the withholding agent to rely upon that self-certification in applying relief at source unless the agent knows or has reason to know that the self-certification is incorrect.

This approach of granting treaty relief based on self-certification is consistent with the recommendations made (with strong support from the United States) in the context of the OECD's projects on treaty relief for Collective Investment Vehicles (CIVs) and on the Treaty Relief and Compliance Enhancement (TRACE) program.[1] Indeed, the OECD Model Tax Convention itself now incorporates guidance recommending against onerous procedural requirements for funds that pose a low risk of treaty shopping.[2]

It is the experience of AGC members, however, that, increasingly in recent years, foreign treaty partners of the United States are imposing burdensome procedural requirements on

---

[1] See the January 2009 Informal Consultative Group report on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors, the February 2010 Pilot Group report on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors: Implementation Package, and the January 2013 TRACE Implementation Package for the adoption of the Authorised Intermediary System, all available at http://www.oecd.org/ctp/exchange-of-tax-information/treatyreliefandcomplianceenhancementtrace.htm.

[2] See, e.g., paragraph 6.30 of the Commentary on Article 1 of the OECD Model Tax Convention ("For example, in many countries the CIV industry is largely domestic, with an overwhelming percentage of investors resident in the country in which the CIV is established. *In some cases, tax rules discourage foreign investment by imposing a withholding tax on distributions, or securities laws may severely restrict offerings to non-residents. Governments should consider whether these or other circumstances provide adequate protection against investment by non-treaty-eligible residents of third countries. It may be appropriate, for example, to assume that a CIV is owned by residents of the State in which it is established if the CIV has limited distribution of its shares or units to the State in which the CIV is established* or to other States that provide for similar benefits in their treaties with the source State." (Emphasis added)).

U.S. institutional investors, and that those requirements are effectively blocking such investors from obtaining the treaty relief to which they are legitimately entitled. These procedural hurdles are often imposed in the name of enforcing LOB-type requirements in the treaties. These procedural requirements fly in the face of the recommendations set forth in the OECD documents referenced above, which call for assessing the treaty-shopping risk posed by different types of collective funds and developing pragmatic approaches to the design of procedural requirements applicable to such funds, taking into account the risk assessment.

The result of these foreign procedural burdens is that treaty-based withholding tax relief to which U.S. institutional investors (e.g. mutual funds and pension funds) are legitimately entitled is being effectively denied. This is a serious and growing problem, and Association members estimate that the foreign taxes inappropriately being withheld from U.S. funds now total in the billions of dollars. This situation is obviously placing a huge and growing burden on the U.S. fisc (through foreign tax credit claims) and on U.S. investors (through reduced returns) which U.S. treaties are supposed to prevent. There is a strong risk that this problem will continue to grow, especially now that the OECD's project on Base Erosion and Profit Shifting (BEPS) has focused the attention of many governments, both within and beyond the OECD membership, on preventing "treaty abuse".

Thus, our comments below are primarily focused on urging Treasury to consider carefully the situation of U.S. institutional investors in relation to treaty benefits and how provisions included in the U.S. Model could affect their ability in practice to obtain the treaty benefits the U.S. treaty negotiators intend and expect them to have.

<u>The Proposed LOB Provision</u>

Treatment of U.S. mutual funds. The Association notes that under the proposed LOB provision, as under the current LOB provision found in most U.S. treaties, a U.S. mutual fund (i.e., a regulated investment company or "RIC") will be able to qualify for benefits only by satisfying the "ownership / base erosion" safe harbor of paragraph 2(f). This effectively means that, "on at least half the days of the taxable period that includes the time when the benefit would be accorded", the RIC must be at least 50 percent directly or indirectly owned by certain categories of U.S. residents and that less than 50 percent of its gross income can be paid in the form of deductible payments to certain non-qualifying persons.

It does not take much familiarity with U.S. mutual funds to recognize that all, or virtually all of them, meet these tests in reality. Non-U.S. residents are very unlikely to invest in U.S. mutual funds, particularly for purposes of deriving income from investments in third States. This is due in large part to the fact that such an investment is not tax-efficient from a foreign person's point of view, both because the United States would impose a withholding tax on dividends paid by a RIC to foreign investors and because the RIC regime effectively requires the RIC to distribute its income annually to investors, rather than accumulating it. Moreover, if a foreign investor receives dividends from a RIC that has realized capital gains, those dividends are likely to be subject to ordinary tax rates in the investor's country, whereas capital gains realized directly would often be eligible for preferential rates in the investor's country. In addition, securities laws severely restrict the extent to which U.S. RIC shares can be offered for sale outside the United States.

These are exactly the types of factors that caused the OECD, with the United States' urging, to include the suggestion in the Commentary on the OECD Model Tax Convention cited above that such an entity should be "assumed" to be owned by residents of its own State, without having to be subject to special LOB-type provisions as a condition for treaty entitlement.

In practice, however, foreign treaty partners of the United States are imposing procedural requirements on U.S. RICs seeking entitlement under the LOB provision that are impossible or cost-prohibitive for the RICs to meet, with the result that treaty benefits are effectively being denied.[3] The above-referenced OECD reports resulting from the CIV project provide detailed background on the typical ownership structure of CIVs and the reasons for the conclusion that overly exacting procedural requirements can lead to widespread inappropriate denial of access to treaty benefits. The Association regularly meets with the IRS's competent authority staff to advise them of these types of barriers being erected by foreign governments and to urge them to seek agreements with treaty partners on streamlined procedures, and the members would be pleased to meet with Treasury staff to provide similar background information.

The Association therefore respectfully suggests that it should be the policy of the United States to include in any LOB provision a safe harbor specifically for U.S. RICs, in order to avoid exactly this problem of unnecessarily burdensome procedural obstacles. Such an outright safe harbor for U.S. RICs would be fully consistent with the suggestions developed by the OECD in its CIV work. This does not necessarily mean that such an outright safe harbor would have to be provided to the treaty partner's CIVs: the OECD explicitly recognized that different requirements might have to be imposed on the two Contracting States' respective CIVs in recognition of their different characteristics. Thus, the outright safe harbor for U.S. RICs should be part of the U.S. Model LOB provision. As a fallback, however, if that result is not achievable with a particular treaty partner, the Association recommends that it should be the strict policy of the United States, whenever it concludes a treaty that subjects U.S. RICs to the potential need to qualify under an ownership / base erosion safe harbor, to simultaneously enter into a Memorandum of Understanding with the treaty partner that will confirm the ability of U.S. RICs to obtain relief at source based on a self-certification of their qualification under that test, without the need to provide detailed information or documentation about their underlying investors. In effect this would ensure reciprocal procedural treatment of U.S. and treaty country mutual funds.

Treatment of pension funds. Similar issues arise with respect to U.S. pension funds, including in particular Revenue Ruling 81-100 group trusts. Paragraph 2(e) of the proposed LOB provision, like the current U.S. Model's LOB provision, provides that a pension fund will qualify for treaty benefits only if more than 50 percent of the fund's beneficiaries, members or participants are individuals resident in either Contracting State. As in the case of U.S. RICs, the practical reality of U.S. pension funds is that their participants or beneficiaries are overwhelmingly U.S. residents. Non-U.S. residents are unlikely to want to participate in U.S.

[3] For example, Japan requires U.S. entities claiming entitlement under the ownership / base erosion test to provide the name, location, status, and number of shares owned by each shareholder. Switzerland has recently begun to impose similar requirements on U.S. RICs.

pension funds, either because they are resident in countries with tax systems that do not give tax relief for participation in non-local funds or because they are resident in countries without tax systems and hence they have no need for their retirement savings to be in tax-efficient form.

In practice, however, foreign treaty partners have begun to impose procedural requirements that are impossible or cost-prohibitive for U.S. pension funds to satisfy in order to demonstrate their LOB qualification.[4] Satisfying such requirements could require soliciting and obtaining documentation from thousands or even hundreds of thousands of individual plan participants. These procedures are even more daunting for 81-100 group trusts, which can have dozens or even thousands of participating pension plans.[5] Thus, what may appear to be a reasonable, easy-to-satisfy entitlement criterion for U.S. pension funds becomes an insurmountable barrier to obtaining benefits when procedural demands become too onerous.

The Association therefore respectfully suggests that, as for the case of U.S. RICs, it should be the policy of the United States to include in any LOB provision a safe harbor specifically for U.S. pension funds (including group trusts), in order to avoid exactly this problem of unnecessarily burdensome procedural obstacles. As a fallback, however, if that result is not achievable with a particular treaty partner, the Association recommends that it should be the strict policy of the United States, whenever it concludes a treaty that subjects U.S. pension funds to the potential need to qualify under a test based on residence of the majority of individual participants, to simultaneously enter into a Memorandum of Understanding with the treaty partner that will confirm the ability of U.S. pension funds (including group trusts) to obtain relief at source based on a self-certification of their qualification under that test, without the need to provide detailed information or documentation about their underlying individual participants.

Other LOB issues. The AGC believes that some other aspects of the proposed LOB provision could operate to inappropriately deny treaty benefits to U.S. portfolio investors. These include:

- The addition of a base erosion test to the requirements for qualifying for benefits as a subsidiary of a publicly traded entity – this addition could be particularly troublesome for members of a U.S. consolidated group that may need to make significant deductible payments (e.g., interest or royalties) to other members of the group, other than the common parent, since those other members are not treated as "good" payees for this purpose;
- The tightness with which the newly proposed derivative benefits safe harbor is drawn, including:
    - The requirement that at least 95 percent "good" ownership be concentrated in 7 or fewer investors;

[4] For example, Japan requires U.S. pension funds to disclose the specific number of members and precise percentage of members that are U.S. residents.

[5] An additional problem faced by 81-100 group trusts is that some foreign treaty partners wrongly refuse to recognize them as opaque entities entitled to claim treaty benefits in their own right, and instead insist on granting benefits only at the level of the participating pension plans.

- The significant restrictions on the status of intermediate owners (including the requirement that they be resident in a country that has a treaty with the source State that includes a "special tax regime" provision).

The Proposed Special Tax Regime Provision

The Association notes that this provision would deny withholding tax relief on interest, royalties, and (Article 21) other income in cases of payments from "related persons" where the recipient benefits from a special tax regime in its country of residence. Without commenting on the policy considerations underlying this proposal, the Association suggests that Treasury should provide a definition of "related person" for this purpose. In particular, it would be helpful to clarify that this provision would not typically affect umbrella fund or fund of funds structures. Also, it is our understanding that the provision is not intended to catch the U.S. tax regimes applicable to RICs, REITs, or pension funds, but it will be important to confirm that specifically with any treaty partner with which the United States negotiates the inclusion of this provision.

The Proposed Subsequent Change in Law Provision

The Association understands that this provision would deny withholding tax relief on dividends, interest, royalties, and (Article 21) other income when the recipient's country changes its domestic law after concluding the treaty to reduce its highest marginal tax rate below 15 percent or to exempt all or substantially all foreign source income. The proposal calls for the State invoking the provision to notify the other State that it will cease to apply the withholding tax relief six months after the notification. In order to ensure that taxpayers (and their withholding agents) have adequate notice of the change in treatment of withholdable payments and are able to introduce the necessary programming adjustments to reflect that change, the Association recommends that the effective date of the change be for payments made on or after the January 1 which follows the expiration of the 6-month period beginning on the date when the State invoking the provision makes public the notice given to the other State.

The Proposed Expatriated Entity Provision

The Association understands that this provision would deny U.S. withholding tax relief on dividends, interest, royalties, and (Article 21) other income payments made by an "expatriated entity" as defined in the Internal Revenue Code (i.e., U.S. surviving members of a group that has undergone a corporate inversion). In order to avoid the possibility that this provision could apply to payments to recipients that are not aware of the status of the payor as an expatriated entity, the Association suggests that consideration should be given to limiting the effect of this provision to related party payments.