CCFs and Asset Pooling

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Background to Asset Pooling

In the context of investment fund products, asset pooling is not a new concept. For many years asset managers have been offering pooled investment products to their clients, such products including US mutual funds, European UCITS, UK OEICs, etc, as a means whereby investors of varying types and sizes could invest on a collective basis in a pool of underlying assets with the aim of benefiting from centralised, professional asset management services and specialist fund administration and custody services with the perceived additional benefits of cost savings across these various services as a result of economies of scale.

In addition, certain investors consider they obtain a higher standard of governance for their portfolios through investment in pooled schemes as well as a consistency of approach and, additionally, depending on the type of scheme chosen, may benefit from relevant regulatory protections applicable to the pooled structure and its service providers.

One drawback, however, of many pooled structures has been how they have been treated from a tax perspective. Take, for example, a small pension fund which decides to invest unilaterally and directly (i.e. not through a pooled scheme). In such a case it may be able to access double tax treaties benefiting from, for example, a reduction or absence of withholding tax on distributions from the investments acquired.

In the case of a pooled scheme, the capacity for the investor to obtain directly or indirectly the benefit of the reduced rate of withholding tax has generally been absent as the pooled vehicle may, due to its legal nature, be treated as an opaque vehicle where the assets are assets of the vehicle itself. It is this issue which the CCF has sought to address.

The central rationale therefore for establishing a CCF is the capacity to provide participants with a tax transparent vehicle, where participants should be treated as investing directly in the pool of assets, and which benefits from all of the advantages of investing via a pooled arrangement including:

- economies of scale:

- / larger pools are able to negotiate lower custody fees
- / larger pools increases capacity to net flows and reduce transaction costs
- / large pools reduce administration costs

- centralised investment approach
- centralised deal placing
- centralised risk management/compliance.

It is important to appreciate that the CCF can be considered to be an *entity pool* rather than being a *virtual pool*, the principal difference between the two being that entity pooling makes use of legal entities (either opaque or transparent) such as collective investment schemes to deliver the pooling mechanism whereas virtual pooling operates through the use of IT systems to facilitate pooled co- management of the participating investors without actually constituting the pool as a legal entity.

Central to the CCF offering is that it is more than just entity pooling, it is *transparent* entity pooling, the CCF having been designed with a number of features to support transparent treatment quite apart from express provisions of Irish tax law.

What is the CCF?

The CCF is a tax-transparent contractual arrangement similar to the FCP (fonds commun de placement) structures in other European jurisdictions, notably Luxembourg and France and the Dutch FGR (fonds voor gemene rekening) enabling the assets held on behalf of investors to be managed through a single pool in proportion to the assets or cash subscribed to the pool.

CCFs are constructed as regulated collective investment schemes, either UCITS or non-UCITS. The UCITS CCF is authorised by the Irish Financial Regulator under the European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003 ("Irish UCITS Regulations") which define in Regulation 2(i) a “common contractual fund” as a “collective investment undertaking being an unincorporated body established by a management company under which the participants by contractual arrangement participate and share in the property of the collective investment undertaking as co-owners”.

The Non-UCITS version of the CCF is constituted under the Investment Funds, Companies and Miscellaneous Provisions Act 2005 and again authorised by the Irish Financial Regulator.

Whilst the Non- UCITS CCF opens up opportunities for a tax transparent structure to be utilised in conjunction with real estate, private equity and other more alternative products portfolios, the principal focus to date has been on the UCITS type CCF. The reason for this lies in the fact that UCITS is the harmonised European “gold standard” for collective investment schemes, is widely accepted by the European investment community (including pension fund trustees, life companies and asset managers) and has also been recognized as a highly regulated product outside of the EU including in jurisdictions such as Switzerland, Hong Kong and Japan.

It also has to be recognized that, as a product, UCITS has undergone quite a dramatic evolution over the last five years, principally in terms of the types of portfolios that may be constructed within a UCITS. The implementation of the UCITS III Product Directive and the recent (March 2007) Eligible Assets Directive and subsequent pronouncements from CESR has broadened UCITS from their original long bond and equity focus to now include:

- fund of funds
- index trackers
- long/short exposures
- derivatives funds, and
- cash funds

More recently the green light has been given to UCITS investing in derivatives on hedge fund indices.

Whilst these strategies may not all benefit from a CCF type tax transparent pooling arrangement and whilst UCITS are of course subject to strict UCITS investment, borrowing and leverage restrictions, it is clear that UCITS is not only an internationally recognised product but also a dynamic one.

How is a CCF constituted?

A CCF is constituted under contract law by means of a deed of constitution (“deed”) executed under seal by a management company (“Manager”).

The deed provides for the safekeeping of assets of the CCF by a custodian (“Custodian”) - who is also a party to the deed – and specifies the fiduciary responsibilities of the Custodian which are equivalent to those of custodians/trustees of other UCITS schemes The deed also provides that the Custodian will be appointed on the terms of a custodian agreement to be entered into by the Manager and Custodian.

Importantly, the CCF is an unincorporated body and does not have legal personality. Because a CCF does not have legal personality, it may act only through the Manager (or investment manager, if authority is delegated to an investment manager).

Participants in the CCF hold their participation as co-owners and each participant holds an undivided co-ownership interest as “tenant in common” with other participants. A "tenancy in common" is a form of co-ownership in which the joint owner (the "tenant in common") has a distinct but undivided interest or share in the property the subject of the co-ownership and there is no right of survivorship (e.g. on death of one co-owner) in favour of any of the other joint owners (tenants in common).

This form of co-ownership may be distinguished from a "joint tenancy" which is characterised by certain features including (a)a right of survivorship in favour of the other co-owners (on death of a joint tenant) and (b)the same interest being held by all co-owners in the property.

The standard deed will provide that the Manager establishes the Fund as a CCF “being an unincorporated body under which the Unitholders participate and share in the property of the Fund, including without limitation, income arising thereon and profits derived therefrom as such income and profits arise, *as co-owners in accordance with the terms of this Deed*…..”. It will also provide that “Each Unit represents an undivided co-ownership interest of a Unitholder as tenant in common with the other Unitholders in the assets of a Portfolio. No Unit shall confer any interest or share in any particular part of the asset of a Portfolio. Units in a Portfolio are not “shares” but serve to determine the proportion of the underlying assets of a Portfolio to which each Unitholder is beneficially entitled.”

In other words, investors do not have any beneficial entitlement to any particular asset, rather a proportional beneficial entitlement to an interest in the underlying pool of assets.

As apparent from the above, the ownership interest of participants are constituted as “units” which are issued and redeemed and in respect of which a register is maintained by the Manager in a manner similar to a unit trust.

What is the Tax Treatment of a CCF?

To enable participants access double taxation treaty ("DTA") benefits, the CCF must be treated as a fiscally transparent entity for tax purposes. In practical terms this means that:

- the CCF itself must not suffer tax in Ireland;
- the character and source of the income or gains received by the CCF should not be "recategorised" on distribution to participants. Such income and gains should be subject to the same tax treatment in the hands of the participants as if it had been received directly by them, rather than through the CCF. Participants in the CCF must be taxed on a current basis on any income derived through the CCF i.e. the income and gains will be treated as arising or accruing to each participant in the CCF in proportion to the units owned by them;
- the tax authorities in the jurisdictions in which the individual pension schemes are established must be satisfied that they will be able to certify any DTA claims made by the CCF participants, notwithstanding that the income for which DTA relief is claimed is derived through the CCF. (Our understanding is that the CCF structure will enable such certification);
- the source country tax authorities (i.e. the country of issue of the relevant security) must grant double tax treaty relief to the CCF participant (not the pooled vehicle) in respect of income or gains.

Tax transparency from an Irish perspective is provided under Section 739(I)(2)(b) of the Taxes Consolidation Act, 1997 (as amended) (the "TCA") which provides: "For the purposes of the Tax Acts, relevant income and relevant gains in relation to a common contractual fund shall be treated as arising, or as the case may be, accruing, to each unitholder of the common contractual fund in proportion to the value of the units beneficially owned by the unitholder, as if the relevant income and relevant gains had arisen or, as the case may be, accrued, to the unitholders in the common contractual fund without passing through the hands of the common contractual fund".

In order to protect the tax transparency of the CCF, unitholders in a CCF will typically be either trustees or custodians of pension schemes who will hold the units issued on trust for the employee beneficiaries of the individual pension scheme or institutional investors who are able to provide the necessary tax declarations and certifications to the Manager.

Currently natural persons cannot invest in a CCF without negatively affecting its Irish tax transparent status. This may change in the future.

Legal Features of a CCF required to facilitate Tax Transparency

To assist in achieving tax transparency (these characteristics differentiate a CCF from a corporate body which is not tax transparent), a CCF should have the following characteristics:

- income derived through the pooling vehicle should generally be distributed annually, pro rata to each participant's investment in the CCF. This ensures that the income is both accounted for and taxed on an "arising"/ current basis. Nevertheless, it is possible in certain circumstances to have non-distributing (accumulating) unitclasses in a CCF without jeopardising the tax transparency of the Vehicle;

- the CCF participant should be provided with an annual breakdown of income on investments by type and source;

- no redemption charge should be levied on participants;

- no "investor" meetings (i.e. meetings similar to shareholder meetings) should be permitted;

- the Irish tax authorities must view a CCF as a transparent vehicle for Irish tax purposes;

- holdings/units in a CCF should not be freely transferable but are redeemable. It has however been accepted that units may be transferred in limited circumstances, i.e. with the prior consent of 100% of unitholders and the Manager;

- a CCF should not be a separate legal entity having its own legal capacity/personality. (Factors influencing the CCF's legal status will include the CCF's capacity to (a) acquire rights and assume obligations (b) hold assets and liabilities and (c) enter into agreements.);

- assets should be jointly held by participants pro-rata to their investment.

Care therefore needs to be taken to ensure that commercial negotiation or legal redrafting does not water down these important provisions.

How is the CCF viewed in other jurisdictions?

As you will appreciate, the overriding question is whether the tax authorities in the investor's jurisdiction and the tax authorities in the jurisdiction where the assets are located will accept the transparency of the CCF thereby entitling the participating pension funds access the DTA between their home jurisdiction and that of the jurisdiction where the assets are located.

Determining how a CCF would be viewed by such foreign tax authorities has taken two principal forms. Firstly, in certain cases rulings have been obtained from tax authorities (such as in the UK, US and Netherlands), whereas in other cases reliance is placed principally on tax opinions from local tax advisers.

Whilst sponsors of CCFs will need to obtain rulings and/or tax opinions in relation to their own CCF products, we understand that the tax transparency of the CCF should be viewed positively in North America, in Australia and by most Northern European states whereas certain Southern European countries have appeared to adopt a quite negative position on CCF tax transparency. Notably, however, certain southern European jurisdictions such as Italy have taken a positive stance to CCF tax transparency.

Similarly we understand that Japanese tax advisers have indicated that they do not think that the CCF should be treated as tax transparent there.

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