OPCVM IV

# Tax Issues

The UCITS IV Directive includes new provisions whereby management companies will be able:

- To carry out their activities in another Member State of the EU,
- To conduct cross border fund mergers more easily,
- To make use of cross border master-feeder structures.

While the UCITS IV Directive harmonizes legal rules across the EU Member States, fiscal regimes remain within the competence of national regulators.

As a result, the setting up of new organizations and mechanisms as available under the Directive might be jeopardized in some Member States by tax obstacles: double taxation, withholding taxes, capital gain tax, wiich could thus restrict the interest lying in this opportunity.

Yet, France represents an attractive location as regards taxation rules whether they relate to:

- Cross border fund mergers,
- Setting up of master funds,
- Setting up of UCITS managed from abroad (or vice versa).

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## Cross border mergers of UCITS are tax neutral in France

The first tax issue arising from a merger relates to ensuring the tax neutrality of the transaction as regards direct taxation of the UCITS at stake.
In France, UCITS are not subject to income tax (a SICAV being exempt of corporate income tax and a FCP being regarded as tax transparent). Hence, there is no tax consequence at the level of the merged vehicles, contrarily to what happens in some EU countries e.g. Italy or Sweden.

The second issue relates to tax neutrality for investors. Indeed, an exchange of shares or units (shares or units of the merged vehicle in exchange for shares or units of the absorbing vehicle) often triggers taxation of the capital gain recognized upon the merger.
Some countries grant a specific regime which allows for non taxation. However, such a regime is sometimes restricted to domestic operations only[1] as this is the case in Germany, Luxembourg and Italy.

In France, as a general rule, institutional investors are taxed on the valuation differential of the units/shares (except for equity vehicles): therefore the issue relates mainly to individual investors.
**The *Direction de la Législation Fiscale* (DLF) (Tax Department of the French Ministry of Finance) confirmed with the AFG that mergers which will be realized according to the UCITS IV Directive will benefit from a tax neutral regime: investors will not be taxed upon the merger.**

Finally, one must take care of the tax costs which may appear in the situation where a French UCITS is absorbed by a foreign UCITS:

- Post merger, management fees may be subject to VAT, while this is not the case according to French rules which provide for VAT exemption;

[1] This raises the question about tax discrimination in the Member States when the latter restrict tax neutrality to domestic transactions (cf ECJ case Schumacher dated 14.02.95).

## Key points for transactions out of France

It will be worth considering the tax impact before any transaction is carried out of France.

Indeed, <u>for transactions carried out of France</u>:

- The tax neutrality of mergers is often restricted to domestic operations ,
- The place of residence of the management company may have an impact on the « residence »of the fund.

Eventually, a withholding tax may apply on the dividend paid by a master vehicle to a feeder fund located in another Member State .

- the location of the UCITS may imply additional withholding taxes on income from the portfolio ;
- Finally, the situation of the investor may be modified in respect of tax credits, tax reporting obligations ...

## Master-feeder structures: minor withholding tax impact on distribution from French master vehicles

Using cross border master-feeder structures is a way to keep investors in a domestic vehicle and thus not to modify his tax regime.

In France, the tax system results in a favourable tax treatment of the conversion: unlike other Member States, the conversion of an existing UCITS into a feeder vehicle (involving a transfer of the portfolio to the master vehicle) is not a taxable event. Similarly, the investor benefits from a tax neutral regime upon the transformation (i.e. on the exchange of shares or units taking place at his level).

The only issue relates to the case where the master vehicle and the feeder vehicle are located in different countries: the distributions between both vehicles may be subject to withholding taxes.

In France, the AFG highlighted the need for a reform in order to promote Paris as a center for master vehicles: in this respect, the AFG requested that the tax regime of income distributed by a SICAV to its non resident investors be aligned with the rules applying to FCP.
The DLF responded positively to this request in the tax regulation n° 4K-1-11: whether the distribution is made by a SICAV or by a FCP, the withholding tax will only apply to the portion of the coupon composed of French sourced dividend (after deduction of any management fees): foreign source income**, interest from bonds and French negotiable securities, etc. are exempt from withholding tax in France.**

It is worth noting that when a Luxembourg UCITS redistributes a French sourced dividend, such a dividend incurs a withholding tax strictly similar to the above.

## Management Company Passport: attention must be paid to VAT and withholding tax abroad

The new Management Company passport will allow management companies to carry out their activities in other EU Member States using one of the following techniques:

- o By setting up a branch which will carry out all or part of their management activities,
- o By setting up investment vehicles domiciled abroad.

1. Setting up of a branch

In order to mitigate tax risks, the main issue in France will relate to the definition of a transfer pricing policy whereby the branch will be compensated for its role according to the arm's length principles.

In addition, VAT aspects will need to be considered notably in relation to the following points:

- The transactions between the head office and the branch are no recognized for VAT purposes; they impact the recovery rights of the branch which may be defined by reference to the head office VAT position.
- The so called « VAT package» provides for attractiveness rules which may require a branch to collect VAT on transactions performed by its head-office and/or vice-versa.

2. Setting up of investment vehicles abroad

Some Member States determine the « tax residence » of a UCITS based on its place of registration or on the place where it is managed from. Thus, a UCITS may be subject to the tax regime defined by the State where its management company is located. As an example, a German vehicle which is managed by a French management company might be considered for tax purposes in Germany as a foreign fund; this could trigger potential issues on inconvenient tax reporting obligations.

**The French approach is much easier since UCITS established in France are simply considered as non taxable.**

From a practical point of view, managers will need to take into account these very different considerations in order to assess potential withholding tax costs on income derived from the portfolio of the funds they manage. In this respect, a French vehicle, in particular if invested in French or European securities often proves better value than a foreign vehicle.


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