Trends in Global Pension Funds: The Irish Common Contractual Fund

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PRÉCIS

Les caisses de retraite ont souvent recours à un instrument de placement collectif pour structurer leurs placements. Le regroupement d'actifs peut se traduire par des économies d'échelle et une réduction des coûts ainsi que par une diversification accrue des placements et une gestion efficace de la politique de placement de la caisse. Bien que l'instrument de placement collectif puisse être utilisé pour les placements transfrontaliers, la préservation de la neutralité fiscale pour la caisse de retraite demeure l'un des défis que pose la mondialisation des placements. Dans un tel contexte mondial, la retenue d'impôt constitue le problème fiscal le plus important. La retenue d'impôt représente un coût absolu pour le rendement des investissements de la caisse de retraite. L'interposition d'un instrument de placement collectif mondial entre la caisse de retraite et le placement peut compliquer le problème de la retenue d'impôt et entraîner des coûts fiscaux additionnels.

Comme les caisses de retraite font l'objet de pressions accrues depuis les dernières années, elles manifestent un intérêt renouvelé pour l'utilisation d'instruments de placement collectifs mondiaux fiscalement efficaces pour structurer leurs placements. L'un de ces instruments est le « *common contractual fund* » (CCF) irlandais. Cet article porte sur les caractéristiques du CCF irlandais dans le contexte des problèmes actuels qui se posent aux caisses de retraite mondiales, le traitement fiscal réservé au CCF selon la Loi de l'impôt sur le revenu au Canada et la pertinence de cet instrument de placement pour les caisses de retraite canadiennes.

ABSTRACT

Pension funds often use a pooled vehicle to structure their investments. Pooling of assets can lead to economies of scale and reduced costs, as well as the opportunity for greater investment diversification and effective management of the fund's investment policy. While a pooled vehicle can be used for cross-border investments, one of the challenges of global pooling is the preservation of tax neutrality to the pension fund. In the global environment, the key tax issue is withholding taxes. Withholding taxes represent an absolute cost to the pension fund's return on investment. The interposition

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of a global pooling vehicle between the pension fund and the investment can complicate the withholding tax issue and lead to additional tax costs.

As pension funds have come under increasing pressure in recent years, there has been renewed interest in the use of tax-effective global pooling vehicles to structure pension fund investments. One vehicle being promoted is the Irish common contractual fund (CCF). This article discusses the characteristics of the Irish CCF in the context of current issues faced by global pension funds, the tax treatment of a CCF under Canada's Income Tax Act, and the suitability of this pooling vehicle for Canadian pension funds.

KEYWORDS: INTERNATIONAL TAXATION ■ PENSION FUNDS ■ PENSION PLANS ■ PENSIONS ■ RETIREMENT PLANS

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INTRODUCTION

The use of pooled vehicles is a common method for structuring the investments of pension funds.[1] "Pooling" refers to arrangements for the collective management of assets. The collective management of assets of several small pension funds can lead to economies of scale, resulting in reduced costs, as well as the opportunity for greater investment diversification and effective management of the fund's investment policy.

1 For example, in 2003, mutual fund investments accounted for 36.7 percent of the assets of Canadian pension funds: *Pension Markets in Focus*, issue 2 (Paris: Organisation for Economic

Pension funds also use pooled vehicles to structure cross-border investments. However, one of the challenges in using a pooled vehicle on a global basis is preserving tax neutrality for the pension fund. In the global environment, the key tax issue is withholding taxes. Withholding taxes represent an absolute cost to the pension fund's return on investment. The applicable withholding tax rate will depend upon the nature of the investment income (for example, capital gains, dividends, or interest) and the provisions of the tax treaty between the country in which the investment is made and the country in which the pension fund is located. Further, under some tax treaties, investments by pension funds that meet certain conditions may be either subject to reduced withholding rates or entirely exempt.

The interposition of a pooled vehicle between the pension fund and the investment can create additional withholding tax issues. First, because the pooled vehicle that is used is typically not located in the same country as the pension fund, the investment may be subject to the withholding tax rules of a third country and its applicable tax treaties. Second, the pooled vehicle may not be eligible to claim treaty benefits; for example, it may not be a person that is liable to tax under the applicable treaty. Third, the legal form of the pooled vehicle may not be recognized by the country in which the investment is made. As a result, the use of a pooled vehicle to make global investments can result in greater tax withholding costs than if the pension fund had made the investment directly.

Traditionally, pension funds have viewed the potential benefits of pooling as outweighing the potential tax costs.[2] Recently, however, the tax cost of pooling has faced greater scrutiny. In the last few years, pension funds have faced enormous funding issues as a result of the decline in equity markets and interest rates, coupled with changes to financial accounting standards. At the same time, the general workforce is reaching the peak retirement age, putting additional demands on pension funds and employers to satisfy pension obligations. A further trend is greater international investment diversification by pension funds.

As a result, there has been renewed interest in the development of a tax-effective global pooled vehicle.[3] Luxembourg and Ireland have been leaders in this area: both countries have developed "tax-transparent" pooled vehicles that are being marketed to global pension funds. The Luxembourg vehicle is the "fonds commun de placement"

Co-operation and Development, December 2005), 6. Statistics Canada has reported (without providing published data) that a large proportion of foreign holdings of trusteed pension funds are in pooled funds: Statistics Canada, *Quarterly Estimates of Trusteed Pension Funds: First Quarter 2002*, catalogue no. 74-001-XIB, 11. The term "pension fund" in this article refers to private arrangements funded by employer and/or employee contributions. It excludes public (government-funded) pension funds, such as the Canada Pension Plan, and retirement savings arrangements that are funded exclusively by employee or individual contributions (such as registered retirement savings plans).

2 Deloitte & Touche LLP, *Pension Pooling Survey for Multinationals: An Increasing Appetite* (Deloitte & Touche, November 2005).

3 Ibid. See also Jayne Jung, "Buy the Pool" (2006) vol. 19, no. 2 *Risk Magazine*.

(FCP) and the Irish vehicle is the "common contractual fund" (CCF).[4] Both are structured as contractual arrangements under which each investor is a co-owner of the assets. More recently, the Netherlands has launched the tax-transparent "fund for joint account" (FJA) to compete with the Luxembourg and Irish vehicles.[5]

The use of FCPs and CCFs by European and US pension funds is growing in popularity.[6] In Canada, the CCF structure was the subject of two recent advance income tax rulings issued by the Canada Revenue Agency (CRA);[7] accordingly, this article will focus on the CCF.[8] The discussion is divided into five main sections. The first section will discuss the factors contributing to the funding pressures that pension funds currently face. The second section will review the international taxation of pension funds. The third section will describe the CCF structure. The fourth section will discuss the taxation of a CCF under the Income Tax Act (Canada);[9] in particular, one of the difficulties in determining the Canadian tax treatment is that certain features of the CCF structure resemble other types of investment arrangements more commonly used in Canada—namely, corporations, partnerships, and trusts. The fifth and concluding section of the article will comment on other regulatory issues to be considered in determining whether the CCF is an appropriate pooling vehicle for Canadian pension funds.

TRENDS IN THE GLOBAL PENSION FUND ENVIRONMENT

Canada, like many other countries, is facing a profound demographic shift associated with an aging population. The proportion of the population aged 65 years or older to the population under 65 is predicted to increase sharply by 2050.[10] For

4 There are some differences between the FCP and the CCF. For an overview of the FCP, see Deloitte & Touche LLP, *Pension Pooling: Panacea for Improved Performance and Streamlined Management of Pension Fund Assets* (Deloitte & Touche, 2006). The FCP is a broad-based vehicle for cross-border investment and is open to all persons other than individuals. In contrast, the CCF was initially limited to pension funds but has recently been opened up to institutional investors: see infra note 43 and the accompanying text.

5 "Netherlands Introduces Vehicle for International Asset Pooling," 2006 *World Tax Daily* 70-3.

6 For example, IBM has established a CCF and Unilever has established an FCP in respect of their respective pension funds. Nestlé is also reported to have been examining the use of such vehicles. See Chris Newlands, "Multinationals Plunge into Pooling," *European Pensions & Investment News*, September 13, 2004; and Jung, supra note 3.

7 CRA document no. 2004-0106731R3, September 7, 2005; and CRA document no. 2004-0067771R3, December 8, 2004.

8 For additional information on the FCP, see John K. Thompson and Sang-Mok Choi, *Governance Systems for Collective Investment Schemes in OECD Countries*, Organisation for Economic Co-operation and Development Financial Affairs Division Occasional Paper no. 1 (Paris: OECD, April 2001), 35-37.

9 RSC 1985, c. 1 (5th Supp.), as amended (herein referred to as "the Act").

10 International Monetary Fund, *Ageing and Pension System Reform: Implications for Financial Markets and Economic Policies*, a report prepared at the request of the Deputies of the Group of

most individuals, the main source of retirement income will be employer-sponsored pensions, supplemented by a relatively small amount from government-sponsored pensions.[11] Consequently, the continued financial viability of pension funds is of critical importance to governments and individuals alike.

Certainly, in the last 10 years, pension funds have experienced tremendous growth. For example, the Organisation for Economic Co-operation and Development has reported that the total value of pension funds in OECD countries grew from US$5.9 trillion in 1994 to US$15.6 trillion in 2004.[12] Canada has experienced similar growth.[13] It is expected that this trend will continue.[14]

Nevertheless, pension funds today operate in a very challenging environment. Many pension funds face significant funding issues resulting from a convergence of economic and regulatory factors. These issues are not unique to pension funds in any one country.[15] Moreover, while pension funds that provide retirement benefits on a "defined benefit" basis[16] have been most strongly affected, pension funds that provide benefits on a "defined contribution" basis[17] have not been entirely immune.

Economic Factors

Pension funds hold significant investments in equities. For example, a recent study by the OECD found that assets of pension funds in OECD countries represent 54.4 percent of the country's market capitalization.[18] Equities tend to constitute the second-largest

Ten by an experts group chaired by Ignazio Visco, Central Manager for International Affairs at the Banca d'Italia (Washington, DC: IMF, September 2005), 9-10, figure 1.1.

11 Ibid., at 12-13, table I.1.

12 *Pension Markets in Focus*, issue 2, supra note 1, at 4.

13 At the end of 2003, retirement savings of Canadians were worth $1.3 trillion, twice the savings in 1990, taking inflation into account. Of this, registered pension plans accounted for 63 percent of the assets: Statistics Canada, *The Daily*, February 7, 2006.

14 *Pension Markets in Focus*, issue 1 (Paris: Organisation for Economic Co-operation and Development, June 2005), 3.

15 *Ageing and Pension System Reform*, supra note 10, at 4-7.

16 Pension benefits are provided on either a defined benefit basis or a defined contribution basis. Under a defined benefit plan, the employer promises a pension that is fixed by formula, generally expressed as a percentage of the employee's salary multiplied by his or her years of employment with the employer. If the pension fund is insufficient to pay the promised pension benefit, the employer must make up the shortfall—for example, by making additional contributions to the fund.

17 Under a defined contribution plan, the amount of pension payable upon retirement is not fixed; instead, it is determined by the amount of employee and employer contributions made to the fund and investment returns thereon. In this case, the investment risk is shifted to the employee: if the return on the investment is reduced (for example, owing to a decline in equity markets), the consequence is that less retirement income may be available in the future to the employee; there is no immediate impact on the employer's funding obligation.

18 *Pension Markets in Focus*, issue 1, supra note 14, at 5.

asset class of pension funds after fixed income securities.[19] Consequently, the decline in equity markets between 2000 and 2002 had an adverse impact on pension funds. At the same time, market interest rates declined. Pension funds of defined benefit plans were particularly hard hit. [20] Market interest rates are often used as the basis for determining the discount rate for valuing pension liabilities of defined benefit plans.[21] The decrease in interest rates had the effect of increasing the present value of such liabilities. As a result, many defined benefit plans became "underfunded," and still are, even today.[22] Again, Canadian pension funds have not been immune from these economic developments.[23]

Financial Accounting Standards

Changes in financial accounting standards for recording pension fund liabilities have also adversely affected the funding of defined benefit plans. Generally, the accounting standards of most countries permit a smoothing of short-term pension gains and losses over several accounting periods, in recognition of the long-term duration of these liabilities.[24] However, this method has been criticized as unduly minimizing the pension liabilities of companies, and thus artificially inflating corporate earnings.

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19 Ibid., at 6.

20 *Ageing and Pension System Reform*, supra note 10, at 23-24.

21 For a summary of the use of discount rates and a list of countries that use a market-based discount rate, see *Ageing and Pension System Reform*, ibid., at 26, box II.2.

22 Ibid., at 21. The funding of defined benefit plans is measured in two ways: on a going concern basis and on a solvency or windup basis. In general, measurement on a going concern basis looks at whether the fund has sufficient assets to pay out all liabilities (pensions and other payments to members), on the assumption that the plan is ongoing. With measurement on a windup basis, the assets and liabilities are determined as if the plan were terminated as of a specific date. In Canada, pension legislation and regulators provide statutory definitions, based on generally accepted actuarial principles, for determining whether a pension plan is underfunded on a going concern basis or a solvency basis.

23 For example, the Office of the Superintendent of Financial Institutions (OSFI) characterized the health of federally regulated pension plans as "stable but fragile," estimating that 72 percent of defined benefit plans were less than fully funded at June 2005, with an average funded shortfall of 10 percent. The aggregate solvency deficit at June 2005 was estimated to be approximately $12 billion compared with an estimate of $4 billion in December 2004: Office of the Superintendent of Financial Institutions Canada, "Statement by Julie Dickson, Assistant Superintendent , Regulation Sector, Office of the Superintendent of Financial Institutions Canada, November 2005 Pension Update" (online: http://www.osfi-bsif.gc.ca/app/DocRepository/1/eng/speeches/2005_11_22_e.pdf). The federal government has responded to this issue by introducing regulations, applicable to federally regulated defined benefit plans, that provide greater flexibility to employers in funding solvency deficiencies. Final regulations were announced in Canada, Department of Finance, "Canada's New Government Provides Funding Relief for Defined Benefit Pension Plans," *News Release* 2006-064, November 7, 2006.

24 For a summary of the accounting treatment of pensions, see *Ageing and Pension System Reform*, supra note 10, at annex II.1.

For example, a recent study of 100 Canadian companies indicated that together they had $28.3 billion in off-balance-sheet pension liabilities in 2003.[25]

As a result, accounting standard setters are moving toward fair value accounting for the measurement of pension liabilities. Standard setters in the United Kingdom, as well as the International Accounting Standards Board (IASB), have already adopted this standard, and the Canadian Accounting Standards Board is apparently reviewing the issue.[26] The US Financial Accounting Standards Board (FASB) has also issued a new standard[27] that will require companies to fully recognize on their financial statements the obligations associated with defined pension plans and certain other retirement and benefit plans. The new standard will require companies to state the underfunded or overfunded status of these plans. The previous standard did not necessarily require the funded status of such plans to be completely reported on the balance sheet. The new standard is effective as at the end of fiscal years ending after December 15, 2006 for public companies. In addition, the FASB is continuing to examine other issues with respect to the financial accounting and reporting of post-retirement benefits and will be consulting with the IASB. The ongoing review is expected to address the issue of whether the practice of smoothing pension liabilities should be continued.

Impact of These Changes on Global Pension Funds

The challenges of funding deficits and changes in accounting standards have alerted employers to the fact that pension funds are of strategic importance to a company's overall profitability. Employers are recognizing the need to adopt more rigorous risk management strategies and pension governance models with respect to the management and investment of their pension funds.

For example, a Towers Perrin survey in 2004 noted a growing trend by companies to centralize management of their global pension funds at head office. Controlling costs and managing financial risk with regard to global pension liabilities were cited as the main concerns. Further, more than two-thirds of the respondents had formed central committees that included a specific oversight committee for pensions and other employee benefits, with corporate finance playing an increasingly active role.[28]

25 Christine I. Wiedman and Heather Weir, "Pension Accounting: The End of Smoothing?" (2005) vol. 69, no. 4 *The Ivey Business Journal* 1-8.

26 Ibid., at 1-2.

27 Financial Accounting Standards Board, "FASB Improves Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans," *News Release*, September 29, 2006 (online: http://www.fasb.org/news/nr092906.shtml); and David M. Katz, "FASB Rule Puts Pensions on Balance Sheet," *CFO.Com*, October 2, 2006 (online: http://www.cfo.com/article.cfm/7989634/c_8435337).

28 Towers Perrin, "Multinationals Rely More on Corporate HQ, Finance Units To Manage Global Benefit Programs," *Headlines OnLine*, December 2004.

A continuing trend in managing the pension funding issue is investment diversification, in terms of both asset classes and geography. In those countries where pension funds are oversized in comparison to the domestic capital market, pension funds have, in particular, sought international diversification of their portfolios.[29] Some countries have facilitated investment diversification by removing barriers. For example, in 2005, Canada repealed the foreign property investment limits specifically in order to meet "the growing retirement income needs of Canada's aging population and the requirements of pension funds, in particular large funds, by allowing broader international diversification opportunities for retirement investments."[30]

In this environment, there is renewed interest in the use of pooled vehicles on a global basis to structure pension fund investments. In a recent survey by Deloitte & Touche, 80 percent of the multinationals that responded indicated that they were considering the possibility of pension pooling, with 47 percent indicating that they would be implementing such vehicles within the next 12 months.[31] Approximately 75 percent of the multinationals considering pooling had total assets in excess of £1 billion with pension plans in 10 different countries. Equities and fixed income securities were the most likely asset classes considered for pooling.[32]

Further, the multinationals surveyed also indicated a growing interest in the use of pooled vehicles to improve risk management and governance through access to global custody arrangements and global benefit information. The other main reason cited for using pooled vehicles was the potential economies of scale that could achieved with respect to custody, brokerage, netting transactions, and administration costs.[33] In this regard, the Deloitte survey reported a growing awareness of the tax costs in structuring investments and recognition that tax-efficient investment strategies are a critical component in the management of pension funds.[34]

Thus, in the current environment, global pooling is potentially a vehicle by which companies can accomplish the three key goals: centralized management, rigorous risk controls, and investment diversification.

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29 *Pension Markets in Focus*, issue 1 (Paris: Organisation for Economic Co-operation and Development, June 2005), 6.

30 Canada, Department of Finance, 2005 Budget, Budget Plan, February 23, 2005, 165. The foreign property investment limits were repealed effective for taxation years beginning after 2004. Previously, the foreign investment of registered pension plans and registered retirement savings plans was, in general, limited to 30 percent of the cost base of the plan's assets. Foreign property held in excess of this limit was subject to a penalty tax of 1 percent per month.

31 *Pension Pooling Survey for Multinationals*, supra note 2. Twenty-five multinationals responded to the survey.

32 Ibid., at 6.

33 Ibid., at 8.

34 Ibid., at 3.

TAXATION OF CROSS-BORDER INVESTMENTS OF PENSION FUNDS

Taxation has traditionally been a roadblock to the use of pooled vehicles by pension funds for cross-border investment. In order to understand the tax issues associated with pooled vehicles, it is first necessary to review the taxation of pension funds with respect to direct cross-border investments.

Taxation of Pension Funds

In Canada, pension funds are subject to the same rules as any other taxpayer with respect to cross-border investments. Generally, interest or dividend income from the investment will be subject to withholding tax under the Income Tax Act, except as provided by the Act or by any applicable tax treaty. For example, a foreign pension fund that receives dividends and interest income from Canadian sources will generally be subject to 25 percent withholding under part XIII of the Act; however, there is limited relief for withholding on interest income. Pursuant to subparagraph 212(1)(b)(iv), no withholding is required on interest payable on any bond, debenture, or similar obligation where the payer and the recipient are dealing at arm's length and a certificate of exemption has been granted and is in force.[35] Otherwise, any relief from withholding must be attained at the treaty level.

Under most tax treaties, tax withholding is limited to 15 percent on dividends and 10 percent on interest payments; capital gains are generally taxable only in the state in which the taxpayer is resident. Some countries, however, have negotiated specific treaty articles that further reduce or exempt withholding on dividends and interest paid to pension funds resident in the other state. For example, under the Canada-US tax treaty, dividends and interest payments made from one state to a

35 Under subsection 212(14), the minister of national revenue may issue a certificate of exemption on application by a non-resident where certain conditions are met, including the following: (1) an income tax is imposed under the laws of the country of which the non-resident is a resident; (2) the non-resident is exempt under those laws from payment of such income tax; and (3) the non-resident is a person who either qualifies, or who would qualify if the person were resident in Canada, as a tax-exempt pension trust or pension corporation under section 149 of the Act and is thus exempt from taxation in Canada; or the non-resident is a trust or corporation that is operated exclusively to administer or provide superannuation, pension, retirement, or employee benefits. To apply for the certificate of exemption, the non-resident must complete Canada Revenue Agency form NR6A, "Application for Certificate of Exemption," accompanied by a certified copy of the instrument under which the non-resident was established, incorporated, or organized and a certificate or letter of exemption from tax issued to the non-resident by the country of residence. Generally, evidence of exemption must be presented to the person paying the interest. See also CRA document no. 9204, March 27, 1990; and CRA document no. 74630, September 12, 1990. Draft legislation released July 18, 2005 will amend subparagraph 212(1)(b)(iv) to broaden this exemption and make it available for interest payments on all forms of indebtness in general, and not simply interest payable only on a "bond, debenture or similar obligation." See Canada, Department of Finance, *Legislative Proposals Relating to Income Tax* (Ottawa: Department of Finance, July 2005), clause 177.

pension fund resident in the other state are exempt from the normal tax withholdings of 15 percent and 10 percent respectively.[36]

Taxation of Pooled Vehicles

When a pooled vehicle is used, the central question is whether the pension fund would be in the same tax position if it held the asset directly. For several reasons, often the answer is "no."

First, a question can arise as to whether the pooled vehicle itself is eligible for any tax treaty relief. Depending upon the legal form of the pooled vehicle, it may be a "person" that is "liable to tax" under the applicable treaty. Under the OECD model tax convention, a person is defined to include an "individual, a company and any other body of persons."[37] The question here is whether it is the pooled vehicle that is the person subject to the treaty or, rather, its investors (that is, the pension funds). This answer turns on whether the pooled vehicle is viewed as a legal entity distinct from its investors by the country in which the investment is made.

If the pooled vehicle is considered to be the "person" that is "liable to tax," there are potentially two consequences. First, any preferential relief on tax withholdings granted by the applicable tax treaty to the income from investments made by the pension fund would be lost, since the pension fund would no longer be viewed as the recipient of such payments. Second, if the pooled vehicle and the pension fund are not resident in the same country, there could be two levels of tax withholding: (1) by country A, where the investment is made, on the payment to the pooled vehicle in country B, where it is resident; and (2) by country B on the distribution from the pooled vehicle to the pension fund in country C.

"Liable to tax" means that the person is subject to a comprehensive income tax under the applicable domestic laws.[38] If the pooled vehicle is not liable to tax, tax withholdings on any distributions received by a pension fund from the investment will

36 Articles IV(1) and XXI(2) and (3) of the Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital, signed at Washington, DC on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997. To qualify for this exemption, the pension fund must generally be exempt from taxation under domestic law and operated exclusively to administer or provide pension, retirement, or employee benefits.

37 Article 3(1)(a) of the Organisation for Economic Co-operation and Development, *Model Tax Convention on Income and on Capital: Condensed Version* (Paris: OECD, January 2003) (herein referred to as "the OECD model treaty").

38 See also paragraphs 8.2 and 8.3 of the commentary on article 4 of the OECD model treaty for a discussion of the meaning of "liable to tax." For Canadian tax purposes, the CRA adopts the interpretation of the Supreme Court of Canada in *The Queen v. Crown Forest Industries Limited et al.*, 95 DTC 5389. Under this test, a person is liable to tax if the person is subject to the most comprehensive form of taxation that exists in the relevant country. Generally, this means taxation of worldwide income. Further, the CRA has stated that where a country imposes a comprehensive tax regime but exempts specific entities from that regime or subjects them to tax at a favourable rate, such entities will not be considered liable to tax. However, the CRA is reviewing its position: *Income Tax Technical News* no. 34, April 27, 2006.

be imposed in accordance with the domestic laws of the country in which the fund resides, unless the pension fund can establish that it, and not the pooled vehicle, should be viewed as the person liable to tax under the applicable treaty.

Clearly, if countries take differing positions with respect to the legal status of the pooled vehicle and whether it is eligible for treaty benefits, this increases the risk of double taxation. At the very least, the tax leakage can become a significant cost to the pension fund. For example, assume that a tax-exempt pension fund in country A invests in corporate securities of companies resident in country B, with an average annual dividend yield of 2.5 percent. Further assume that if the fund were to make this investment directly, there would be no withholding because the tax treaty between country A and country B exempts withholding on dividends paid to pension funds resident in country A. Now assume that the fund in country A makes the same investment but through a pooled vehicle (also resident in country A). The pension fund no longer qualifies for the special exemption on withholdings, so that dividend withholding is subject to the treaty rate of 15 percent. The pension fund has now incurred an annual tax cost of 37.5 basis points on its investment. This tax cost represents an equivalent underperformance by the fund. In an environment where many pension funds are facing significant funding liabilities, such tax leakage is increasingly unacceptable.[39]

THE COMMON CONTRACTUAL FUND

One solution that has been developed is the Irish CCF. The Irish CCF was initially established in 2003 as a specialized fund structure for cross-border investments of pension funds. However, recent amendments to the Irish legislation have expanded the scope of CCFs, as further described below.

Overview of the CCF

Initially, the Irish CCF was required to be structured as an Undertaking for Collective Investment in Transferable Securities (UCITS), which is a structure for collective investment authorized by legislative directive of the European Union.[40] In general, a UCITS fund that is established in one EU member state can be offered to investors in other member states without further regulatory approval. In addition, the UCITS regulations put certain restrictions on the type of investment that can be made.[41]

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39 Arthur Cox, "Common Contractual Fund" Briefing: Financial Services Group, May 2004, 1 (online: http://www.arthurcox.com/dynamic/publications/Financial Services Group briefing, May 2004.pdf).

40 Ireland, Statutory Instrument no. 211 of 2003, European Communities (Undertakings for Collective Investment in Transferable Securities) Regulations 2003, as amended (herein referred to as "the UCITS regulations").

41 This is accomplished through a "passport" system. A fund that is authorized under the laws of one EU member (the "home" state) and qualifies as a UCITS can then be sold to retail investors in other member states through a notification procedure, without the requirement of further regulatory approval by the states in which the investors are located. The home state is

However, legislative amendments in 2005 introduced two significant changes to the Irish CCF. First, amendments were passed to allow CCFs to be structured as non-UCITS funds. In contrast to a UCITS CCF, there is no restriction on the type of investment that a non-UCITS CCF can make.[42] Second, investments in CCFs were opened up to all persons other than individuals. As a result, institutional investors and pension funds can invest in the same CCF without tainting its tax-transparent status.[43]

Accordingly, the Irish definition of a CCF is twofold. A non-UCITS CCF is defined to be

> 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, where it is expressly stated in its deed of constitution to be established pursuant to [the Investment Funds, Companies and Miscellaneous Provisions Act, 2005] and which holds an authorisation in accordance with such Act and which is not established pursuant to Council Directive No. 85/611/EEC of 20 December 1985.[44]

While the introduction of a non-UCITS CCF is a significant development, this article will discuss only the UCITS CCF. A UCITS CCF is defined as

> an investment undertaking within the meaning of paragraph (b) of the definition of "investment undertaking" which is constituted otherwise than under trust law or statute law.[45]

The term "investment undertaking" is further defined to include a collective investment vehicle that is a UCITS.[46] The UCITS regulations defined a CCF to mean

> 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.[47]

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responsible for regulating the fund to ensure its compliance with UCITS legislation. For further background on UCITS, see Commission of the European Communities, *Annex to the Green Paper on the Enhancement of the EU Framework for Investment Funds*, Commission Staff Working Paper, COM(2005)314 final (Brussels: Commission of the European Communities, December 7, 2005).

42 Ireland, Investment Funds, Companies and Miscellaneous Provisions Act, 2005, no. 12 of 2005, section 8. The decision to use a non-UCITS or a UCITS CCF is largely one of investor preference.

43 Ireland, Finance Act, 2005, no. 5 of 2005.

44 Subparagraph (a)(i) of the definition of "common contractual fund" in section 739I(1) of the Irish Taxes Consolidation Act, 1997, no. 39 of 1997, as amended (herein referred to as "TCA 1997").

45 Subparagraph (a)(ii) of the definition of "common contractual fund" in TCA 1997 section 739I(1).

46 TCA 1997 section 739B.

47 UCITS regulations, section 2(1). This definition is incorporated in the definition of a CCF under TCA 1997 section 739I.

CCFs can be structured as one fund or as an "umbrella" fund in which various subfunds are offered (for example, North American Equity, Global Equity Fund, etc). Each subfund is governed by the set of investment policies and goals applicable to that fund. Units of the fund or applicable subfund are offered for sale to investors through a prospectus. A unit is an undivided interest in the assets of the CCF that is used as a notional form of computation to determine each investor's proportion of the investments of the fund or subfund. The stakeholders in the CCF structure consist of the following:

- the manager,
- the custodian, and
- the unitholders.

The rights and obligations of the stakeholders are governed by a deed of constitution. The deed of constitution is executed by the manager and the custodian. Unitholders do not execute the deed of constitution; rather, the UCITS regulations deem the deed of constitution to be binding upon each unitholder and all persons claiming through such unitholder as if he or she had been a party.[48] A custodian agreement is also entered into by the manager and the custodian with respect to the custody of the fund's assets. The principal rights and obligation of the manager, the custodian, and unitholders are described below.

The Manager

The manager must be an Irish company and is regulated by the Irish Financial Services Regulatory Authority.[49] The manager is responsible for managing the fund and administering the assets of each fund or subfund in accordance with the deed of constitution and the prospectus. The manager earns a management fee that is a percentage of the net asset value of the fund. Under the deed of constitution, the manager has the power to

- determine the investment policy of the fund or subfund;
- prepare an annual report in respect of each fund or subfund;
- terminate any fund or subfund with appropriate notice to the regulatory authority; and
- amend the deed of constitution to effect the purposes of the CCF, subject to prior approval by the regulatory authority.

The manager is generally not liable for any actions, losses, or damages borne by the CCF, unless the manager fails to comply with its obligations as set out in the deed of constitution or the UCITS regulations.

48 UCITS regulations, section 23(3).

49 Ibid., section 16. See also Deirdre Power, "The Irish Solution to the Asset Pooling Dilemma" (2005) vol. 16, no. 4 *International Tax Review*.

The Custodian

The custodian is the entity that holds and safekeeps the assets of the fund. The custodian is also required to be a resident of Ireland.[50] The custodian's fees are borne by the CCF. Under the deed of constitution, the custodian is required to

- ensure that the sale, issue, repurchase, redemption, and cancellation of units are carried out in accordance with the deed of constitution and the regulations;
- ensure that the income of each fund or subfund is applied in accordance with the deed of constitution and the UCITS regulations;
- prepare a report to the unitholders each accounting period, certifying that the CCF has been managed in that period in accordance with the deed of constitution and the UCITS regulations;
- certify that any amendment to the deed of constitution does not prejudice the rights of the unitholders or release the manager and the custodian from any of their obligations to the unitholders as set out in the deed of constitution; and
- terminate the CCF upon the occurrence of certain events (for example, if the manager is no longer able to carry out its duties or if a change in law makes the CCF illegal or impracticable to continue).

The custodian is generally not liable to the manager or the unitholders for any losses, unless such losses occur as a result of the custodian's unjustifiable failure to perform its obligations as set out in the deed of constitution and/or the custodian agreement.

Unitholders

Each unitholder holds an undivided co-ownership interest as a tenant in common with the other unitholders in the assets of the fund or applicable subfund. Each unit of a fund or subfund ranks pari passu with the other units. The liability of the unitholder is limited to the subscription price of the units. Unitholders are entitled to the gross income (dividends, interest, etc.) of the fund or subfund, pro rata to their unitholdings. Income accrues to unitholders as it arises. In addition, typical rights of unitholders include the following:

- a right to an annual report from the manager;
- a right to notice of termination of the fund issued at least two months in advance of the effective date of termination; and
- a right to approval by a majority of unitholders of any amendment to the fund that would prejudice the rights of the unitholders or would release the custodian or the manager from any responsibility to the unitholders as set out in the deed of constitution.

50 UCITS regulations, section 19.

There are several important exclusions from the rights of unitholders:

- There are no voting rights attached to the units.
- Unitholders have no rights with respect to the representation or management of the fund or any subfund.
- There is no right to call for meetings of unitholders (except as may be determined in the manager's discretion).

Irish Taxation of a CCF

Under Irish tax law, the CCF is considered to be a transparent investment vehicle. The income and gains of the CCF are considered to arise to each unitholder in proportion to the value of the units held, as if the income and gains had arisen or accrued to the unitholders directly, without passing through the CCF.[51] Unitholders who are not residents of Ireland are not subject to Irish tax on the redemption of their units or on distributions.[52]

CANADIAN TAXATION OF A CCF

The key Canadian tax issue is whether a CCF is a tax-transparent pooling vehicle. A subfund of a CCF structured to hold Canadian investments would not be appealing to investors if the CRA did not agree to look through the CCF to the actual unitholders. In two advance tax rulings on UCITS CCFs,[53] the CRA did confirm that the CCF was a non-entity and that the proper taxpayers were the unitholders. However, in reaching this conclusion, it was first necessary to assess how the CCF should be characterized under Canadian law. This question arises because a CCF possesses characteristics that are shared by other forms of investment undertaking more commonly used in Canada—namely, corporations, partnerships, and trusts.

While the Act uses the concepts of corporation, trust, and partnership, it does not define them.[54] Thus, in determining how to characterize a foreign business structure for Canadian tax purposes, a preliminary issue arises—the adoption of an appropriate

51 TCA 1997 section 739I.

52 Ibid.

53 CRA document no. 2004-0106731R3, September 7, 2005; and CRA document no. 2004-0067771R3, December 8, 2004.

54 Under subsection 248(1) of the Act, the term "corporation" is defined simply to include an incorporated company. The term "trust" is defined in section 108 to include an inter vivos trust and a testamentary trust and to exclude certain specific trust arrangements for certain sections of the Act, but the underlying concept of "trust" itself is not defined. Similarly, while the Act does provide definitions for specific types of trust arrangements—for example, "mutual fund trust," "unit trust," "inter vivos trust," "testamentary trust," and "personal trust"—all of these definitions rely on the assumption that they are trusts.

methodology.[55] Canadian jurisprudence, as set out by the Supreme Court of Canada in *Spire Freezers*, has adopted a two-step approach.[56] First, it is necessary to ascertain the characteristics of the foreign business structure under the relevant foreign law. Second, it is necessary to identify the Canadian business structure that most closely resembles the foreign business structure. Underlying this second step is a further necessity to identify the most pertinent characteristics of the applicable Canadian business structure, since the foreign business structure may not possess all of the attributes ascribed to that structure by Canadian law.[57]

Ascertaining the Form of the Foreign Business Structure

In order to ascertain the form of the foreign business structure for Canadian tax purposes, it is necessary to consider not only the relevant foreign statutes, but all the facts and circumstances surrounding the creation of the structure, including any organizational documents that govern the parties to the arrangement.[58] Applying this analysis to a CCF, the relevant foreign statutes would be the UCITS regulations, the Tax Consolidations Act, and the Investment Funds, Companies and Miscellaneous Provisions Act, 2005. The organizational documents to be considered would be the deed of constitution, the custodian agreement, and the prospectus. The following characteristics of a CCF are the most relevant to the determination:

- It is a contractual arrangement between the unitholders, the custodian, and the manager.
- The unitholders have direct property rights as tenants in common in the assets of the CCF.
- The purpose of the arrangement is to realize profits on behalf of the unitholders in the form of income or gains from holding the underlying assets.

The other legal concept on which the CCF rests is co-ownership rights as tenants in common. To understand the concept of tenants in common, it is helpful to contrast the other form of co-ownership, joint tenancy. At common law, a joint tenancy exists where two or more people have the same proprietary interest in the property and the following conditions are met:[59]

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55 See John R. Owen, "Foreign Entity Classification and the Character of Foreign Distributions," in *Report of Proceedings of the Fifty-Seventh Tax Conference*, 2005 Conference Report (Toronto: Canadian Tax Foundation, 2006), 20:1-59, at 20:1; and Marc Darmo, "Characterization of Foreign Business Associations," International Tax Planning feature (2005) vol. 53, no. 2 *Canadian Tax Journal* 481-505, at 483-84.

56 *Spire Freezers Ltd. v. The Queen*, [2001] 2 CTC 40 (SCC). For a detailed discussion and review of Canadian and British jurisprudence, see Darmo, supra note 55, at 484-86. See also Owen, supra note 55, at 20:2-3.

57 Darmo, supra note 55, at 484-85.

58 Ibid., at 488-89.

59 Bruce H. Ziff, *A Property Law Reader: Cases, Questions and Commentary* (Toronto: Thomson Carswell, 2004), 701-9.

1. *Unity of interest:* the interest of each joint tenant must be identical in nature, duration, and extent to the interest(s) of the other(s).
2. *Unity of title:* the interest of each joint tenant must arise from the same document.
3. *Unity of possession:* each joint tenant must have an equal right to occupy or possess the entire property, not holding any part separately to the exclusion of the other(s).
4. *Unity of time:* the interests of the joint tenants must arise or vest at the same time.

One of the significant consequences of a joint tenancy is the right of survivorship. For example, if A and B hold a property as joint tenants and A dies, B inherits A's interest. In contrast, for a tenancy in common to exist, the only requirement is unity of possession. There is also no right of survivorship; on the death of a tenant in common, the interest of the deceased co-tenant forms part of his or her estate.[60]

The property rights of unitholders in the assets of a CCF are consistent with the proprietary rights of tenants in common. Each unitholder is free to deal with its units as it sees fit, and there is no right of survivorship.

The next step is to compare the CCF structure against each relevant Canadian business structure—corporation, partnership, and trust.

Corporation

Canadian corporations today are formed by incorporation under the applicable provincial or federal statute in accordance with the conditions of the statute. These statutes are substantially similar, reflecting the historical evolution of corporations under common law.[61]

The CRA adopts the following definition of "corporation":

> A corporation is an entity created by law having a legal personality and existence separate and distinct from the personality and existence of those who caused its creation or those who own it. A corporation possesses its own capacity to acquire rights and to assume liabilities, and any rights acquired or liabilities assumed by it are not the rights or liabilities of those who control or own it. As long as an entity has such separate legal identity and existence, the Department will consider such entity to be a corporation even though under some circumstances or for some purposes the law may ignore some facet of its separate existence or identity.[62]

Embedded in this definition are the following concepts: (1) the corporation has a legal personality separate and apart from its owners (shareholders); (2) it can acquire

60 Ibid.

61 For a review of the origins of the corporation, see Owen, supra note 55, at 20:3-29.

62 *Interpretation Bulletin* IT-343R, "Meaning of the Term Corporation," September 26, 1977, paragraph 2.

rights and liabilities that are separate and apart from its shareholders; and thus, implicitly, (3) the rights of shareholders are separate and apart from those of the corporation.

Separate Corporate Personality

A corporation has the capacity and the rights, powers, and privileges of a natural person.[63] The possession of separate legal personality is the hallmark that distinguishes the corporation from the partnership and the trust. A corporation "acts" through its officers and directors. Actions of shareholders are not legally binding upon the corporation, and vice versa. There is no concept of mutual agency between a corporation and its shareholders.[64]

Limited Liability

Generally, under corporate law, a shareholder is not liable for the acts of the corporation.[65] Similarly, a corporation is not liable for the acts of a shareholder. Historically, limited liability has been a key characteristic that differentiates corporations from other forms of business structure, though in recent years the defining nature of this characteristic appears to have been eroded to some extent (for example, through the formation of limited liability partnerships and unlimited liability corporations). In the context of foreign business structures, it is critical to understand how limited liability, or lack thereof, is created under the foreign law. For example, where members and the foreign business structure are jointly and severally liable, this could be an indication that the foreign business structure is still a separate legal person.[66]

Shareholders' Rights

The rights of shareholders flow from the class of shares that they hold and any agreement, such as a unanimous shareholders' agreement, that modifies such rights. A shareholder does not have any beneficial or legal interest in any particular property or assets of the corporation. A shareholder also does not automatically share in the profits of the corporation. For example, on common shares, profits may be distributed in the form of dividends, if and when declared by the board of directors. Certain types of preferred shares entitle the shareholder to a fixed dividend, but this right flows from the terms of the share. Shares of a corporation are normally transferable unless contractually provided otherwise. For example, private corporations often place restrictions on the transfer of shares. Shareholders also generally do not participate in the management of the corporation. The corporation is managed by

63 See, for example, section 15 of the Ontario Business Corporations Act, RSO 1990, c. B.16, as amended (herein referred to as "OBCA").

64 Darmo, supra note 55, at 497.

65 See, for example, OBCA section 92.

66 Owen, supra note 55, at 20:24-25.

the board of directors, which, although elected by shareholders, is not acting in the capacity of a representative or agent of the shareholders.[67]

Comparison with the CCF

The CCF lacks two significant qualities that a corporation possesses. First and foremost, the CCF does not have separate legal personality. Second, the unitholders have a direct claim on the property of the CCF. On this basis, it would be inappropriate to characterize a CCF as a corporation under corporate law.

Partnership

Like many corporations, partnerships are created by statute under the applicable provincial law. Provincial partnership statutes are substantially similar, codifying the common-law concept of partnership that Canada inherited from Britain.[68] In the discussion that follows, examples of statutory requirements are drawn from the Ontario Partnerships Act (OPA).[69]

The CRA adopts the following definition of "partnership": "the relation that subsists between persons carrying on business in common with a view to profit."[70] Thus, there are three essential characteristics of a partnership: (1) a partnership is a personal relationship; (2) the members of a partnership must carry on business in common; and (3) there must be a view to profit.

Personal Relationship

The personal nature of a partnership is key to understanding the nature of a partnership as a form of business organization, and the rights and obligations of the individual partners.[71] Accordingly, in determining whether a partnership exists, Canadian jurisprudence has emphasized, as the first requirement, the parties' intention to form a partnership.[72] The inherent personal nature of a partnership has also resulted in the conclusion that partners are fiduciaries and must deal with each other in utmost good faith.[73]

The personal nature of a partnership also permeates other characteristics. First and foremost is the principle of mutual agency. Under the OPA, each partner is expressly

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67 Darmo, supra note 55, at 496-500.

68 For a review of the origins of Canadian partnership law, see Owen, supra note 55.

69 RSO 1990, c. P.5, as amended.

70 *Interpretation Bulletin* IT-90, "What Is a Partnership?" February 9, 1973, paragraph 2. See also the definition of "partnership" in OPA section 2; and, for a more detailed discussion, Darmo, supra note 55, at 490-504.

71 Owen, supra note 55, at 20:31-32; and Darmo, supra note 55, at 497-98.

72 Owen, supra note 55, at 20:31-32.

73 For example, a partner cannot compete with the partnership unless the partnership gives its consent. Where such consent is not obtained, the partner must account for and pay over to the partnership all profits made by the partner from the competing business: OPA section 30.

stated to be an agent of the partnership for the purpose of carrying on the business of the partnership. Further, the acts of every partner bind the other partners.[74] Lastly, a partnership is dissolved upon the death or insolvency of a partner unless the partnership agreement provides otherwise.[75]

Carrying On Business in Common

The OPA defines "business" to include "every trade, occupation and profession."[76] While this is a very broad definition, the notion of carrying on business in common implies a collective goal. Thus, Canadian jurisprudence has generally looked to whether there is a community of interest among members in determining whether a business organization is a partnership.[77] This principle is evident in a number of provisions of the OPA.

First, partners generally have unlimited liability: a partner is jointly and severally liable for the debts and obligations of the partnership incurred while that person was a partner.[78] Second, partnership rights are generally non-transferable. For example, an assignment of a partnership interest does not entitle the assignee to become a partner; rather, it entitles the assignee to receive the profits that the assigning partner would otherwise receive.[79] Third, partners are generally viewed as having an undivided interest in the assets of the partnership; for example, a partner cannot unilaterally sell partnership property.[80] The OPA expressly provides that partners share equally in the profits and contribute equally to the losses of the business unless the partnership agreement provides otherwise.[81] A partner also has the right to participate in the management of the partnership's affairs unless the partnership agreement provides otherwise.[82] This right can also be viewed as flowing from the requirement that the business be carried on in common.

View to Profit

The term "profit" is not defined in the OPA. However, at minimum, there must be an intention of the members to gain or benefit from their activities.[83] To assist in determining whether or not the sharing of profits of a business results in a partnership,

74 OPA sections 6 and 7.

75 OPA section 33(1).

76 OPA section 1(1).

77 Owen, supra note 55, at 20:33-35.

78 OPA section 10. Note that there are exceptions, as in the case of a limited partner of a limited partnership.

79 OPA section 31.

80 OPA section 21.

81 OPA section 24(1).

82 OPA sections 24(5), (8), and (9).

83 Owen, supra note 55, at 20:34-35.

the OPA sets out additional rules.[84] Joint tenancy, tenancy in common, joint property, common property, or part ownership does not, in and of itself, create a partnership with respect to the property held, whether or not the tenants or owners share in any profits therefrom. The sharing of gross returns does not, in and of itself, create a partnership, whether or not the persons sharing such returns have a joint or common right or interest in the property from which or from the use of which the returns are derived. Lastly, the receipt by a person of a share in the profits of a business that is contingent on or varies with the profits does not, in and of itself, make the person a partner.

Comparison with the CCF

When compared with the partnership, it is clear that the CCF does not possess the requisite characteristics of personal relationship and carrying on business in common with a view to profit.

- *Personal relationship*. There is no evidence, under the relevant foreign law, suggesting that unitholders are agents in respect of one another or the CCF, or that a unitholder has the capacity to bind other unitholders or the CCF. There is no sharing of property. Further, the CCF continues even if a unitholder dies or otherwise withdraws from the fund.
- *Carrying on business in common*. The foreign law governing the formation of a CCF also does not indicate that the unitholders share an intent to carry on business in common. A unitholder's liability is limited to the issue price of the unit for which it subscribed. Unitholders under the deed of constitution do not have a right to participate in the management of the CCF. For example, if they are not satisfied with the fund's performance, they cannot appoint a new manager; the remedy is simply to withdraw from the CCF. Further, each unitholder is a tenant in common and is therefore free to deal independently of other unitholders with respect to its own interest in the assets of the fund.
- *View to profit*. According to the provisions of the OPA, the fact that unitholders are tenants in common with respect to the assets of the CCF and are entitled to gross profits does not lead automatically to the conclusion that there exists a partnership. Nevertheless, it is still necessary to examine what distinguishes partnerships that hold property with a view to profit from non-partnership arrangements.

  The leading case is *A.E. LePage Ltd. v. Kamex Developments Ltd.*[85] In *Kamex*, co-owners of an apartment building were held not to be partners even though (1) profits were to be paid to the co-owners in proportion to their respective interests and each co-owner was liable to pay any deficiency in the same proportion; (2) co-ownership rights were subject to a right of first refusal; and

84 OPA section 3.

85 (1977), 16 OR 193 (CA); aff'd. (sub nom. *A.E. Lepage Ltd. v. March*) [1979] 2 SCR 155.

(3) sale of or other dealings with the property required approval by the majority vote of the co-owners. For the court, the critical issue was that the co-owners did not relinquish their rights to deal separately with their interests in the property. Further, the fact that the co-owners contractually agreed to restrict their dealings in respect of their interests in certain circumstances was not inconsistent with their rights as co-owners. Consequently, the court did not find the requisite intent to create a partnership.

In contrast, in *Volzke Const. Ltd., etc.*,[86] the court found that a partnership did exist between co-owners. In *Volzke*, Westlock and BP Limited ("BP") were co-owners of a shopping mall. A general contractor sued Westlock for non-payment for work on the basis that Westlock was a partner of BP, which had awarded the contract. In finding that BP and Westlock were partners, the court noted in particular that the parties had agreed to share the development costs of the shopping mall and any future profits therefrom, and they maintained a common bank account against which cheques were signed in connection with the mall development.

In the context of a CCF, the reasoning of *Kamex* should be applicable. Unitholders have not relinquished their rights to deal independently of one another with respect to their interests in the assets of the fund. Thus, on the basis of *Kamex*, and for the other reasons discussed above, a CCF should not be considered a partnership under Canadian law.

Trust

The trust is a common-law concept referring to an arrangement under which a person ("the trustee") holds property for the benefit of another ("the beneficiary").[87] At common law, a trust exists only if three certainties are present: (1) certainty of intention to create a trust (by the settlor); (2) certainty of the subject matter (property) of the trust; and (3) certainty of the objects of the trust (that is, the beneficiaries of the trust must be ascertainable). No specific words are required to demonstrate an intention to create a trust; rather, the courts will consider the facts as a whole.[88]

The characteristics of the trust are unique. Legal title and beneficial enjoyment of or interest in the property are separated. As a result, trusts can be very flexible vehicles for holding property, if appropriately structured. However, in contrast to contracts (discussed below), as a general principle the terms of a trust cannot be varied, even with the agreement of all parties. A trust may be varied only if the trust deed authorizes the variation in the circumstances, or by consent of the court. In practice, it is extremely difficult to amend the terms of a trust.[89]

86 [1986] 4 WWR 668 (Alta. CA).

87 For a review of common-law origins of trusts, see Owen, supra note 55, at 20:39-44.

88 See D.W.M. Waters, *Law of Trusts in Canada*, 2d ed. (Toronto: Carswell, 1984), chapter 5.

89 Owen, supra note 55, at 20:42; and Waters, supra note 88, at 10-14.

It is also important to understand the rights and obligations of the trustee and the beneficiary. While legal title to the property vests in the trustee, the trustee is obliged to administer the property in accordance with the trust deed. A trustee is also a fiduciary with respect to the beneficiary and therefore must act in utmost good faith in administering the trust.[90]

The beneficiary's interest in the trust property constitutes a proprietary right (albeit an equitable right) and is not merely a personal right against the trustee. Thus, the interest of the beneficiary is derived from the property.[91] In addition, a beneficiary is generally not liable for debts and obligations of the trust or the trustee.[92]

Comparison with the CCF

In comparing the CCF with the trust, the central issue is whether the three certainties (certainty of intention, certainty of subject matter, and certainty of objects) are present. On the basis of the foreign law, it is very difficult to conclude that the first certainty—the requisite intent to create a trust—is present. The UCITS regulations, under which CCFs are established, expressly permit collective investments to be structured in a number of forms, including trusts or corporations.[93] Since there is the opportunity to choose to structure the CCF as a trust, failure to do so is compelling evidence of a direct intention not to create a trust. The other distinguishing characteristic of the trust, the separation of legal and beneficial ownership, is also not present. Unitholders are co-owners as tenants in common in the property of the CCF. These proprietary rights are set out in the UCITS regulations and are reiterated in the deed of constitution and prospectus.

The question of whether a pooled investment vehicle is a contract or a trust was considered in the decision of *Fraser et al. v. MNR*.[94] *Fraser* concerned a taxpayer's ability to deduct certain losses in respect of investments in a pooled mortgage fund referred to as a general mortgage syndicate ("GMS"). At issue was whether GMS was a trust or a contractual arrangement. If GMS was a trust, the taxpayer would not be able to deduct certain losses incurred. The founders of GMS argued that the fund was a contractual investment syndicate in respect of which each investor owned the underlying assets as a tenant in common. Both at trial and on appeal, the courts found that GMS was a trust. The decision turned on whether the parties had demonstrated an intent to create a trust. On this question, it was noted that trust returns had been filed for tax purposes, that there was no express provision in the documentation at the time GMS was established providing that it was not a trust, and that the taxpayer personally did not feel that she owned the mortgages. The decision in

90 Waters, supra note 88, at 31-34.

91 Owen, supra note 55, at 20:43-44; and Waters, supra note 88, at chapter 26.

92 Owen, supra note 55, at 20:44; and Waters, supra note 88, at 10-14.

93 UCITS regulations, section 3(3).

94 89 DTC 620 (TCC); aff'd. 91 DTC 5123 (FCTD); aff'd. 95 DTC 5684 (FCA).

Fraser can be distinguished on this basis. A CCF is not administered as a trust for tax purposes or otherwise; it is created under an express provision in the UCITS regulations that authorizes the use of a corporation or a trust for the same investment purpose; and unitholders are co-owners as tenants in common. For these reasons, the CCF should not be viewed as a trust.

Status of the CCF as a Contractual Investment Fund

The foregoing analysis has concluded that the CCF is not a corporation, partnership, or trust. It is also relevant to consider whether it possesses the characteristics of a contract under Canadian law.

Contracts

Under the common-law theory of contract, there must be (1) an offer, (2) acceptance, and (3) consideration.[95] Further, the common-law theory of contract does not recognize contracts made for the benefit of third parties. There must be privity of contract. Third-party beneficiaries do not generally have legal standing to sue for breach of the contract for lack of privity.[96] This is a critical point for the characterization of the CCF: if the unitholders are viewed as beneficiaries of a contract between the manager and the custodian, it would be difficult to argue under Canadian law that the CCF is formed by contract.

The relationship between the manager and the unitholders fits well within the test of offer, acceptance, and consideration. The prospectus is the document through which the offer is communicated to unitholders. Because the manager retains liability for statements made in the prospectus, the manager could be viewed as the person making the offer. Acceptance of the offer by unitholders is evident through subscription for the units and payment of the subscription price to the manager. Further, the unitholders are deemed to have accepted the provisions of the deed of constitution. Lastly, the manager receives consideration in the form of subscription proceeds and the ongoing management fees.

However, this analysis is complicated by the role of the custodian. The custodian also executes the deed of constitution, but at the same time, a separate custodian agreement is executed between the manager and the custodian. The custodian agreement establishes a contractual relationship between the manager and the custodian. Thus, the question is whether there is a contractual link between the unitholders and the custodian. The only direct contractual link is the deed of constitution, which is executed by the manager and the custodian and which the unitholders are deemed by the regulations to have executed. Thus, in order to establish a contractual link between the unitholders and the custodian, it is necessary to conclude that there are two contracts embedded in the deed of constitution—one between the manager and

95 S.M. Waddams, *The Law of Contracts*, 4th ed. (Aurora, ON: Canada Law Book, 1999), 18-20.

96 Ibid., at 193-207.

the unitholders with respect to the investment management of the CCF, and another between the custodian and the unitholders with respect to the custody and administration of the CCF. Overlying these contractual relationships would be a third contract between the manager and the custodian, as set out in the custodian agreement.

The alternative position is that the manager is acting as agent for the unitholders when executing the deed of constitution and the custodian agreement. An agent is a person who has express or implied authority to act and bind another person, the principal.[97] The difficulty with the agency argument is that it is not clear whether at the time the deed of constitution or the custodian agreement is executed, there are identifiable unitholders or, at the very least, prospective unitholders.

The other issue to consider is whether there exists a separate contract between unitholders. In some instances, members of unincorporated associations have been found to contract with one another.[98] While unitholders have agreed to be bound by the rules of the CCF, there is no evidence of offer, acceptance, and consideration passing from one unitholder to another. Further, there is no mutual liability between unitholders. Unitholders are expressly limited in their liability to the subscription price. Unitholders are free to dispose of their units at will without the consent of other unitholders. Thus, the better view is that there is no contract formed among the unitholders.

In conclusion, while the CCF may not fit neatly within the Canadian common-law concept of contract law, the intention of the parties should be respected, particularly given that the CCF more closely resembles a contractual relationship than a corporate, partnership, or trust business structure.

CONCLUSION

The tax obstacles in structuring pooled vehicles for cross-border investment are increasingly being recognized, given the funding deficits and other regulatory issues that many pension funds currently face. The CCF is an important development in this regard. Critical to the success of the CCF is the acceptance of its transparent status by the tax authorities in the countries in which investments are made. This is not an easy question, as revealed by the review of the applicable Canadian law. Nevertheless, for Canadian tax purposes, the CCF should be viewed as a contractual arrangement between the unitholders and not as a corporation, partnership, or trust.

The author is not aware of any Canadian pension fund utilizing a CCF with respect to its cross-border investments. However, with the repeal of the foreign property limits, many funds will be seeking additional opportunities to make investments outside Canada, and the appetite and demand for tax-effective cross-border investment strategies should increase. If CCFs are to be utilized by Canadian pension funds,

97 Waters, supra note 88, at 42-46.

98 *Orchard et al. v. Tunney*, [1957] SCR 436; *Foran v. Kottmeier* (1973), 39 DLR (3d) 40 (Ont. CA); leave to appeal to SCC refused [1973] SCR xi.

it is important for the CCF to be accepted by provincial and federal pension legislators. Pension legislation imposes qualitative and quantitative restrictions on the type of investments that a Canadian pension fund can make. Most provincial pension regulators have adopted schedule III of the federal Pension Benefit Standards Regulations.[99] Under schedule III, for example, a pension fund is prohibited from investing more than 10 percent of the total book value of the fund's assets in any one person.[100] This rule does not apply to an investment by a pension fund in a segregated fund, a mutual fund, or a pooled fund where the segregated fund, mutual fund, or pooled fund, as applicable, in turn complies with this condition. The question of whether an investment in a CCF meets this condition again turns on whether or not the CCF is viewed as a transparent entity. The fact that the CCF's transparent status has been accepted by the CRA is not binding upon pension regulators, though it is strongly persuasive.

Another potential issue is whether the foreign investment entity (FIE) rules would apply to an investment made through a CCF. The FIE rules are a complex set of rules, effective for taxation years beginning after 2002, designed to tax offshore investments of Canadian-resident taxpayers (other than exempt taxpayers).[101] The FIE rules could apply to investments made through a CCF because of the very broad definition of a FIE. A FIE not only includes the trust and corporate forms of business structure, but also includes an association, a fund, a joint venture, an organization, a partnership, and a syndicate.[102] In general, if an offshore investment constitutes a FIE, the Canadian taxpayer will be subject to taxation on an accrual basis rather than when distributions from those investments are received. Exempt taxpayers are not subject to the FIE rules. An exempt taxpayer includes pension funds of registered pension plans (RPPs).[103] As a result, the investments of a pension fund of an RPP should not be taxable under the FIE rules, even if the CCF is a FIE.

The CCF has also raised the issue of taxation of cross-border investment by pension funds in the global community. In February 2006, the OECD met to discuss the tax and other regulatory hurdles to the use of pooled investment vehicles. The meeting concluded by recommending that further work be done by a special working group composed of industry specialists and government representatives from both OECD and non-OECD countries, which is to look at ways of harmonizing and improving the application of tax treaties to pooled investment funds.[104] Given the

99 Pension Benefit Standards Regulations, 1985, SOR/87-19, as amended, schedule III.

100 Ibid., schedule III, section 9.

101 Proposed sections 94.1 to 94.4 of the Act in the July 2005 draft legislation, supra note 35.

102 Definitions of "entity," "non-resident entity," and "foreign investment entity" in proposed subsection 94.1(1) of the Act.

103 Paragraph (a) of the definition of "exempt taxpayer" in proposed subsection 94.1(1).

104 Organisation for Economic Co-operation and Development, "Improving Tax Treaty Benefits for Collective Investment Funds," *News Release*, March 17, 2006.

increasing use of pooled funds by pension funds, as well as individual investors, and the globalization of investment, this is a welcome development. In the interim, the tax treatment of the CCF, and its Luxembourg and Netherlands counterparts, will have to be dealt with bilaterally. For example, the United States and Ireland recently concluded a competent authority agreement clarifying the taxation of CCFs under the Ireland-US income tax treaty.[105] It is to be hoped that the action by the United States and Ireland will set an example for other countries to conclude other competent authority agreements providing certainty on the treatment of CCFs under their respective tax treaties.

105 Competent Authority Agreement Regarding the Income Received by Irish Unit Holders in a Common Contractual Fund, February 9, 2006.