

WHAT'S NEXT FOR TAX-TRANSPARENT FUNDS?

Since their introduction to the marketplace over 15 years ago, European tax-transparent funds have been constantly evolving. Today, they are sophisticated and highly-relevant vehicles for investment managers and asset owners who need to mitigate a range of industry pressures.

A lot can happen in 15 years. Ask Mark Zuckerberg, who introduced the world to an idea called “The Facebook” in 2004. That same year, Skype became available on our computers, and Google went public. 2004 was also a year after the completion of the Human Genome Project, and a year before YouTube was launched.

It was also the year that, following the launch of the first multinational pooling vehicle in Luxembourg in 2004 (which Northern Trust helped launch in conjunction with its regulators and the funds industry), one of our clients, a multi-national corporation, announced its intention to establish a tax-transparent global equity asset pooling vehicle in Dublin for pooling the assets of its transnational pension schemes¹.

Our client sought to achieve economies of scale and enhanced governance of their pension plan investments. Like other institutions since, it chose to do this via a tax-transparent fund (TTF) vehicle. That same rationale continues to resonate strongly with investors today.

Background: the pooling opportunity

For many years, the chief investment officers of large multinational corporations with pension plans across the world pursued an elusive ‘holy grail’ – the creation of a single, cohesive, investment structure across all pension assets.

The establishment of asset pooling as a widely-recognised, regulatory-approved concept has since allowed multinationals,

Clive Bellows

Head of Global Fund Services,
EMEA, Northern Trust

Asset managers require reliable distribution channels and close cost management – while governance and transparency considerations continue to be front-of-mind for investors.

The tax-transparent fund vehicle can assist with those challenges

¹ Professional Pensions: *IBM confirms use of pension pooling*, April 2004

insurance companies, pension funds and other institutions to achieve that goal by pooling assets across national borders.

While multinationals were among the first to use pooling techniques to make their investments more efficient for beneficiaries, asset managers also saw the opportunities. Today the use of a TTF continues to be a valuable part of the ‘toolkit’ available to managers for housing and distributing their funds – and potentially helping mitigate the business pressures they face.

Withholding tax drag: a transparent solution

To understand the importance of TTFs, it is first worth revisiting the principle of tax transparency and think about why it matters. Tax efficiency has become an important factor of fund performance in recent years, and this is particularly true in the case of withholding tax (WHT) applied on equity investment dividends. In order for tax-exempt investors to benefit most effectively from the use of pooling, a tax-transparent fund structure is generally recommended.

This is because without such a structure in place, WHT may be applied based on the tax entitlement of an opaque fund itself on investments in overseas securities, without regard to the underlying investor type or domicile. This can result in investors incurring higher effective tax rates than if they had invested directly in the market.

TTFs are a way of meeting this challenge. Most TTFs are structured so that, for tax purposes, ‘look-through’ tax treatment is applied, with WHT applied at the investor level. The fund’s underlying investors can then benefit from double taxation treaty agreements on eligible WHT relief as if the securities were held directly.

Managing tax efficiency – helping maximise performance

Without use of a TTF, the resulting “tax drag” on collective investment structures often exposes tax-exempt investors to significant additional WHT suffered.

This represents valuable lost revenue, especially so in light of current margin pressures. Indeed, research into revenues of publically-traded global investment firms reveals operating margins are eroding to levels only seen in the aftermath of the 2008 financial crisis, shrinking by 29% in 2018.²

Conversely, by restructuring their operations in more tax-efficient ways and utilising the tax treaties their clients are entitled to, investors can make significant contributions towards maximising investment performance through the use of a TTF.

By structuring their operations to utilise the tax treaties investors are entitled to, managers can make contributions towards maximising performance through use of a tax-transparent fund

² Casey Quirk (CQ): *Margins Shrink for Public Asset Managers as Fee Compress According to CQ Analysis*, February 7 2019

Even small variations in expenses can, over time, make a significant difference to investment returns. For example, based on an Irish Funds document published 2015, a UCITS³ CCF can potentially enhance returns in a global equity mandate by as much as US\$38 million on a US\$1 billion portfolio over a 10-year period when compared to an alternative opaque investment vehicle⁴.

Tax-transparent funds: their use by asset managers

As mentioned, the TTF was originally devised as a solution for cross-border pension fund pooling – a means of maximising tax efficiencies for pension funds from multiple domiciles, whilst gaining the benefits of utilising a pooling vehicle.

But with the key principles established, the TTF was also highly suitable as a fund vehicle for cross-border distribution to tax-exempt institutional investors – predominately European pension funds, and particularly effective for developed market equity mandates.

This continuing suitability means TTFs are today used for a wide range of diverse mandates, allowing investors from single or multiple jurisdictions to invest in a single tax-transparent fund, subject to any local market requirements.

Asset managers can therefore use TTFs to widen their investor type through use of a regulatory-approved structure with appeal to institutional investors. As these vehicles have become established in the European funds industry, further fund types have been developed by jurisdictions.

As well as the Irish Common Contractual Fund (CCF) vehicle mentioned at the outset, the most prominent TTFs now include the Dutch Fonds voor Gemene Rekening (FGR), Luxembourg's Fonds Commun de Placement (FCP) and the UK's Authorised Contractual Scheme (ACS).

The latter is the newest of these fund vehicles, being established in 2013. Northern Trust currently provides asset servicing solutions to US\$112 billion of ACS funds⁵ – a significant growth story over what is a relatively short period of time. Among these have been significant numbers of insurance assets, transferred out of life fund structures into an ACS as insurers seek to enhance cost-efficiencies. All these vehicles are suitable for realising the benefits of tax transparency.

Innovation in tax-transparent funds

The use of TTFs by investment companies has continued to evolve in sophistication – they now offer investment houses

“Setting up a tax-transparent fund is complex. But it is possible for individual pension schemes, as well as multinational firms, to take advantage of these vehicles by working with a partner who has the necessary knowledge and accounting systems to make this work smoothly.

“The AMX platform can offer institutional investors peace of mind to ensure tax reclaims are being correctly administered; the platform provides operational oversight of the tax services provided by the administrator through the use of robust technology and expertise.”

Aaron Overy

Head of Client and Manager
Development
AMX

³ UCITS stands for the EU's Undertakings for Collective Investments in Transferable Securities funds regime

⁴ Irish Funds: *Common Contractual Funds: The Tax Efficiency in Asset Pooling*, May 2015

⁵ Figure as of 31 March 2019. Source: Northern Trust

advantages of scale in reaching new clients and bringing fund products to market.

Since the first use of a TTF for transnational pooling, increasing numbers of investors and markets recognise the principles that underpin tax transparency. Likewise, TTFs continue to support asset managers in facilitating distribution of funds to institutional investors across multiple domiciles.

To demonstrate how the concept of tax transparency is recognised, from a standing start in 2004, Northern Trust now supports investments from 22 investor domiciles⁶ into the Irish CCF fund vehicle in our role as global custodian and asset servicer to all types of investment institutions.

From this perspective, we also continue to see new trends and innovations in the use of TTFs. These include the flexibility to use multiple TTFs for a single product, in line with jurisdictional or regulatory considerations and distribution strategies.

We are also seeing asset managers utilise TTFs alongside so-called 'feeder funds' for distribution purposes – for example, an opaque FGR being used for Dutch retail investors, set-up to 'feed into' an Irish CCF.

For fund of fund structures, our teams have seen the use of a 'building block' concept, meaning the selection of different fund structures used for different asset classes. An example of this is the use of a TTF for equities and the use of a separate corporate vehicle for fixed income assets within the overall structure. More than one vehicle can be thus used to create 'blended' investment outcomes for fund-of-funds.

Further recent innovations we have seen include the use of unit class hedging within a single TTF as part of a distribution strategy for entering new markets and attracting local investors. These examples show the TTF's robustness and scalability in helping accommodate the sophisticated requirements of managers and their investors.

A scalable platform for growth

One of the most exciting ways in which use of the TTF has evolved in recent years is as a hosted platform for asset managers to reach new investors. Via a platform, asset managers are able to optimise the tax efficiency of their fund ranges in a very cost-effective manner and enhance their attractiveness to new clients.

This has been particularly useful for smaller managers, who can leverage the technology and operational capability of a

“The Prescient Common Contractual Fund is an innovative, institutional-quality solution that offers tangible operational benefits and cost savings for investment managers and investors.

“Authorised and regulated by the Central Bank of Ireland as a Qualifying Investor Alternative Investment Fund (QIAIF), the umbrella fund structure offers segregated liability between sub-funds and has been developed to facilitate asset-pooling in a tax efficient manner.

“As a result, investors are treated on a look-through basis and deemed to be the direct beneficial owners of the underlying investments.”

Rob Childs

Head of International,
Prescient Fund Services

⁶ Domicile figure as of 31 March 2019, of which 14 domiciles have been supported on a treaty basis. Source: Northern Trust

platform to derive the benefits of tax transparency, but without the time, expense and resource of setting up an individual TTF.

Several platforms of this type are in operation today. They use a TTF as the underlying vehicle for hosting their funds. These platforms provide smaller players with fund infrastructure at lower costs. They can be an excellent way for boutique and mid-sized managers to distribute to new clients and quickly build scale.

Examples of these platforms include the Asset Management Exchange (AMX), an institutional asset management marketplace where asset owners can invest in external asset managers directly. Another is Prescient Fund Services, which provides outsourced platform fund services to asset managers, multi-managers and other institutional investors.

Northern Trust works with both organisations as their asset servicer, supporting both the platforms and their underlying clients.

Tax-transparent funds: Northern Trust's perspective

As a pioneer in facilitating cross-border tax transparent asset pooling, with more than US\$187.4 billion⁷ in TTF assets under custody, Northern Trust has been at the forefront of developments in this area.

We supported the launch of the industry's first tax transparent cross-border pooling solutions for multinationals through vehicles based in Ireland and Luxembourg⁸. We expanded our support for these vehicles across Europe and played a role in lobbying governments in Europe and beyond to recognise the concept of tax transparency.

In more recent years we joined HM Treasury workgroups to help develop its ACS fund vehicle, and worked with public sector stakeholders to develop TTF solutions for the UK Local Government Pension Scheme. We have also recently delivered TTF fund solutions for two global top 20 asset managers' UK operations.

The more things change...

Whether by enabling tax transparency, housing fund ranges or by supporting fund distribution, TTFs continue to facilitate solutions for the funds industry. With our experience of TTFs we believe at Northern Trust that the future will see increased demand from asset owners and asset managers alike for the efficiencies they enable.

⁷ Figure as of 31 March 2019. Source: Northern Trust

⁸ In 2005, Northern Trust supported the launch of the first Common Contractual Fund in Dublin and the first Fonds Commun de Placement in Luxembourg for two multinational corporations.

Tax-transparent fund *innovation*

Innovations and trends Northern Trust is seeing include:

- Use of feeder funds' to support distribution
- Selection of different structures used for separate asset classes
- Unit class hedging within a single fund vehicle
- Use of hosted funds platforms for asset managers

European tax transparent *vehicles*

Key fund structures include:

- Common Contractual Funds (CCF), Ireland
- Fonds voor Gemene Rekening (FGR), the Netherlands
- Fonds Commun de Placement (FCP), Luxembourg
- UK Authorised Contractual Schemes (ACS), United Kingdom

If they are not already doing so, asset managers that operate or are planning to launch equity-based European funds should certainly consider whether the use of a TTF may be useful.

So what will the next 15 years bring? Will space tourism become commonplace? Will 3D printing take over construction? Will borders and boundaries shift on global maps? It is likely that at least one (if not all) of these things will occur.

It is well-documented that the investment industry is in its own period of transformation, with many different challenges and requirements ahead. But sometimes, the more things change, the more they remain the same.

Fund managers will likely always need reliable distribution channels, and require costs to be managed closely. Technology will continue to move at breakneck speed. Governance and transparency considerations will surely remain front-of-mind. The TTF structure potentially assists managers with all of those challenges and changes.

None of us can say exactly what the next 15 years will hold, but we can make some educated guesses. In our opinion, the use of a TTF to support investors with multiple tax rates is here to stay and will continue to provide efficiencies for those who manage assets.

At Northern Trust, we expect the future will see more solutions that allow investment institutions to closely support their underlying investors through a TTF. It is a vehicle that continues to have a useful, innovative and evolving role to play for the funds industry.

For asset managers, it is potentially more cost-effective than ever now to derive the advantages of tax transparency, while optimising and creating efficiencies across their fund ranges

NORTHERN TRUST

Pioneers in the use of asset pooling and tax-transparent funds:

- Contributed to development of the UK's Authorised Contractual Scheme fund vehicle through participation in HM Treasury working groups
- Supported the first tax-transparent cross-border pooling solutions for multinational corporations in 2005 in Luxembourg and Ireland
- Secured a landmark ruling from the Italian Tax Authority in 2007 –becoming first custodian to secure reduced withholding tax for investors holding Italian equities through a tax-transparent vehicle