INVESTMENT COMPANY INSTITUTE

MARY S. PODESTA
SENIOR COUNSEL

December 20, 2002

Mr. Alexander Schaub
Director-General
Rue de la Loi
Wetstraat 200
B-1049 Brussels
Belgium

Dear Director Schaub:

We are writing to express the Investment Company Institute's concern with recently proposed changes to the German tax regime for capital gains that, if adopted, would create a significant tax incentive for German investors to buy German funds rather than non-German funds. The Institute is the national association of the US investment company industry.[1] Many of our members manage European mutual funds organized under the UCITS Directive through their European-based affiliates.

The proposed German law, among other things, would impose tax on assets held for more than one year. As proposed, the new law would provide two distinct advantages to German funds compared to non-German funds. First, German shareholders in German funds would include in income only half of the gains attributed (but not distributed) to them from their fund investments under the "half-income taxation method" (*Halbeinkünfteverfahren*);[2] conversely, German shareholders in non-German funds would include in income the full amount of gains attributed to them. In addition, shareholders in German funds would be permitted to deduct taxes already paid when calculating gains upon the redemption of their interests in the fund. This deduction would not be available to shareholders in non-German funds. Both of these positions are clearly discriminatory.

The UCITS Directive was adopted in 1985 and recently amended with the goal of creating a single market in Europe for investment funds under which a fund organized in any member state easily and effectively can be marketed throughout the European Union. We share the concerns that have been expressed by European fund associations

[1] The Institute's membership includes 8,955 open-end investment companies ("mutual funds"), 533 closed-end investment companies, and 6 sponsors of unit investment trusts. Our mutual fund members have assets in excess of $6.216 trillion, accounting for approximately 95% of total US industry assets, and over 90.2 million individual shareholders.

[2] Existing German law allows shareholders of German funds, but not foreign funds, to use the half income tax method for dividends.

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that these tax laws, if adopted, would seriously threaten that concept.[3] Given the choice between two otherwise comparable investment funds, investors naturally would choose the fund with a significantly lower tax burden. As a result, the changes being considered in Germany would effectively eliminate competition by non-German funds in that market. This is not only contrary to the concept of a single market, but is contrary to the best interests of German investors, whose investment choices would be significantly reduced.

In addition, it is our understanding that these measures may be contrary to European law by constituting a restriction on capital movements prohibited by Article 1 of Directive 88/361.[4]

We are pleased that the Commission has initiated an infringement procedure against Germany with respect to the discriminatory treatment of dividends on foreign investment funds.[5] However, the extension of this discriminatory treatment to capital gains in the proposed new law would exponentially increase its discriminatory effect and have serious immediate adverse consequences on the industry. We therefore urge you to consider whether action can be taken against the new law before it is scheduled to take effect in February 2003, in addition to pursuing the infringement procedure against the existing law.

We would be glad to discuss these issues with you or your staff at any time. You may contact me at (202) 326-5826 or at podesta@ici.org or Keith Lawson, Senior Counsel for tax issues, at (202) 326-5832 or at lawson@ici.org.

Sincerely,

Mary S. Podesta

Mary S. Podesta
Senior Counsel

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[3] *See, e.g.*, "FEFSI Urges ECOFIN to Address German Tax Plans," December 3, 2002 (available at www.fefsi.org).

[4] *See* Judgment Verkooijen, June 6, 2002, case C-35/98 and Judgment Schmid, May 30, 2002, case C-516/99.

[5] *See* European Commission News Release: IP/02/1924 (December 19, 2002).