1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

Statement of the Investment Company Institute
Hearing on "Tax Reform Options: International Issues"
Committee on Finance
United States Senate

September 8, 2011

The Investment Company Institute ("ICI")[1] appreciates the opportunity to present the Committee with its comments regarding options for tax reform on international issues. The ICI applauds the Committee for its efforts to improve and simplify the tax code in a manner that spurs economic growth and job creation, and enhances the competitiveness of U.S. businesses in the global market.

As the Committee is aware, an important component of any comprehensive tax reform initiative should be rules that encourage foreign investment in the United States.

The ICI thus proposes two changes to the Internal Revenue Code ("Code") that would increase foreign investment in U.S. regulated investment companies ("RICs"), more commonly known as mutual funds. First, we recommend that the Congress make permanent a provision that exempts foreign investors in a RIC from U.S. withholding tax on certain amounts that would be exempt if received directly by those investors. Second, we propose a new investment vehicle that would encourage foreign investment in RICs. Both of these proposals, if adopted, would eliminate disparate treatment between U.S. and foreign funds and thereby allow RICs to compete more effectively with foreign funds for foreign investors.

Make Permanent Flow Through of Interest and Short-Term Capital Gains to Foreign Investors

Background

Code section 871(k) was added by the American Jobs Creation Act of 2004 to exempt foreign investors in an electing RIC from U.S. withholding tax on "interest-related dividends" and "short-term capital gain dividends." Interest-related dividends are amounts attributable to an electing RIC's U.S.-

---

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.9 trillion and serve over 90 million shareholders.

source interest income; short-term capital gain dividends are amounts attributable to an electing RIC's short-term capital gains. Section 871(k) permits electing RICs to "flow through" to their foreign shareholders the character of this income.

Prior to section 871(k)'s enactment, foreign investors in RICs were subject to U.S. withholding tax on amounts attributable to RICs' interest income and short-term capital gains because these amounts were treated under the Code as ordinary dividends. [2] Conversely, foreign investors are not subject to U.S. withholding tax on interest and short-term capital gains if the investments instead are made directly in the underlying securities or through foreign funds. Because of this disparate treatment, the Congress enacted section 871(k) to level the playing field and encourage foreign investment in RICs.

As originally enacted, however, section 871(k) was effective for only three years, beginning with a RIC's first taxable year beginning on or after January 1, 2005. This section was extended twice, for two years each time, in 2008 and 2010. Thus, section 871(k) currently is set to expire for dividends with respect to tax years of RICs beginning after December 31, 2011.

Reason for Change

Section 871(k) is important for RICs seeking to compete with foreign funds for foreign investors. The temporary nature of section 871(k), however, has limited its utilization. First, many RICs have been sufficiently unsure of the provision's long-term viability to incur the significant programming costs for the possibility of only temporary benefits. Second, foreigners have been unsure whether to make long-term investments in RICs without a long-term assurance that the flow-through benefits would be available. RICs will be more likely to make the necessary programming changes, and foreign investors will be more likely to invest in RICs, if the provisions are made permanent.

Proposal

The Internal Revenue Code should be amended to make the flow-through treatment of section 871(k) permanent. Specifically, sections 871(k)(1)(C)(v) and 871(k)(2)(C)(v), which contain the "termination" date for the flow-through of interest-related dividends and short-term capital gain dividends, should be stricken from the Code. This change will enhance the international competitiveness of the U.S. fund industry, thus encouraging foreign investment in RICs and in the U.S. markets.

New Investment Vehicle to Encourage Foreign Investment in RICs

Background

Under current law, a RIC must distribute substantially all of its income and capital gain each year. Shareholders thus are taxed currently on their RIC investments.

[2] The regular withholding rules continue to apply if a RIC does not elect flow-through treatment under section 871(k).

U.S. law imposes a 30 percent withholding tax on certain types of investment income paid by U.S. issuers to foreign portfolio investors. Income tax treaties entered into by the U.S. generally reduce this withholding tax rate to 15 percent for residents of our treaty partners. Dividends, including ordinary income dividends paid by a RIC, are subject to this withholding tax. Capital gains and portfolio interest generally are exempt from this withholding tax.

A foreign investor who receives annual distributions from a RIC also is subject to current taxation in his or her home (residence) country. Although a capital gain distribution from a RIC to a foreign investor is not subject to U.S. withholding tax, such distribution typically will be treated as an ordinary corporate dividend, rather than as a capital gain, by the foreign shareholder's home country. This loss of the distribution's favorable capital gains tax character causes these amounts to be taxed, in the foreign investor's home country, at the higher rate imposed on ordinary income.

Many foreign tax regimes, in contrast to the U.S. regime, do not require their mutual funds to distribute income or gains to their shareholders. These "roll-up" funds are common, for example, in many European countries. The income and gains realized by such a fund are retained and increase the fund's net asset value (and an investor's potential capital gain). These foreign countries likewise typically do not tax the gains realized by investors who are not resident in the country in which the fund is organized (*i.e.,* "foreign" shareholders). Thus, a "foreign" shareholder in a "foreign" fund typically will incur no tax in the country in which the fund is organized.

Thus, a foreign shareholder in a foreign roll-up fund typically incurs tax only in his or her home country – typically at favorable capital gains rates – and only when the fund shares are sold (absent an anti-deferral regime similar to the U.S.'s passive foreign investment company, or PFIC, rules).

Reason for Change

Given the disparate tax treatment between U.S. and foreign funds, RICs cannot compete effectively with foreign funds to attract foreign investors. The absence of current distributions by foreign roll-up funds creates two powerful incentives – tax deferral and favorable capital gains treatment for the entire investment return – for foreign investors to invest in such funds. Unless RICs can provide similar roll-up opportunities (and give foreign investors, resident in countries that choose not to impose current inclusion rules, the ability to defer tax until shares are sold), foreign investors will continue to be discouraged by U.S. tax laws from investing in RICs.

Proposal

Subchapter M of the Internal Revenue Code should be amended to permit the creation of a new fund entity that would facilitate investment by foreign shareholders in RICs. This "international regulated investment company" or "IRIC" would issue shares only to foreign shareholders and would invest only in RIC shares. U.S. residents would not be permitted to purchase shares in the IRIC.

The IRIC would not be required to distribute its income or capital gain annually. It would be required, however, to pay U.S. tax annually in an amount equal to the tax that would apply to the IRIC's

shareholders had they invested directly in the RIC shares held by the IRIC. An IRIC open only to foreign investors who are resident in countries that have tax treaties with the U.S. – that provide a 15 percent tax rate on dividends subject to withholding – would pay tax at a 15 percent rate on this income. An IRIC open only to foreign investors resident in countries with which the U.S. does not have a tax treaty, in contrast, would pay tax at a 30 percent rate on income subject to withholding tax.

Thus, a foreign investor would incur the same U.S. tax as if he or she had invested in a RIC directly, but would not be subject to tax in his or her home country until the IRIC shares were sold (absent a current inclusion tax regime comparable to the PFIC regime in the U.S.). The RIC in which the IRIC invests would remain subject to the Internal Revenue Code's distribution requirements, as under present law. The creation of this new vehicle would allow RICs to compete with foreign funds.

Conclusion

The ICI commends the Committee for its goal of improving and simplifying the international provisions of the tax code in a manner that will improve U.S. competitiveness abroad and thereby enhance foreign investment in the U.S. The proposals that we advance today are consistent with these initiatives and, if adopted, will increase foreign investment in RICs. We look forward to working with you to develop further these objectives.