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U.S. Senate Finance Committee

Tax Reform Working Group on International Tax

Comments of the Investment Company Institute on
the Tax Treatment of Non-U.S. Investment in U.S. Mutual Funds

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The Tax Code Should Encourage Foreign Investment in U.S. Mutual Funds

The Investment Company Institute (ICI)[1] is pleased to provide these comments on the tax treatment of foreign investors in U.S. mutual funds to the U.S. Senate Finance Committee Tax Reform Working Group on International Tax. The Institute applauds the Committee for its efforts to improve and simplify the tax code in a manner that spurs economic growth 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 Institute thus recommends that Congress make permanent a provision that exempts foreign investors in U.S. regulated investment companies (RICs) from U.S. withholding tax on dividend amounts that would be exempt if received by such investors through foreign funds. This proposed change to the Internal Revenue Code would increase foreign investment in RICs.

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

<u>Background</u>

The American Jobs Creation Act of 2004 added section 871(k) to the Internal Revenue Code, which exempts foreign investors in a RIC from U.S. withholding tax on "interest-related dividends" and "short-term capital gain dividends." These are amounts attributable to interest and short-term capital gains for which RICs have elected this flow-through treatment.

Prior to section 871(k), distributions by U.S. funds of interest and short-term gains were treated as ordinary dividends; as such, they were subject to U.S. withholding tax (at a 30 percent rate or lower treaty rate). In contrast, interest and short-term gains received by foreign investors directly or through foreign funds are exempt from U.S. withholding tax. Because of this disparate treatment, the Congress enacted section 871(k) to level the playing field and encourage foreign investment in U.S. funds.

[1] The Investment Company Institute (ICI) is a leading, global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $18.1 trillion and serve more than 90 million U.S. shareholders.

Section 871(k) permits U.S. funds to designate certain distributed amounts to foreign shareholders as interest-related dividends and short-term capital gain dividends; foreign shareholders receive these distributions exempt from U.S. withholding tax.

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 has been extended four times,[2] but has currently expired for dividends with respect to tax years of RICs beginning after December 31, 2014.

Reason for Change

Section 871(k) is important for RICs seeking to compete with foreign funds for foreign investors. The additional investment in RICs, rather than in foreign funds, benefits U.S. money managers (who hire U.S. workers and pay U.S. taxes) and the U.S. capital markets.

This provision, as discussed above, provides foreign investors in RICs with the same U.S. tax treatment they would receive if they invested directly in a RIC's underlying portfolio securities. In some respects, it should be noted, even these rules do not go far enough to level the playing field. For example, the estate of a foreign investor in a foreign fund will not incur any U.S. estate tax on the fund shares – even if the fund holds only U.S. equities – whereas a foreign investor in a RIC holding the same securities would be treated as having property situated in the U.S. for estate tax purposes.

The temporary nature of section 871(k), however, has limited its utilization by RICs and its attractiveness to foreign investors. Many RICs, for example, have been sufficiently unsure of the provisions' long-term viability to incur the significant programming costs for the possibility of only temporary benefits. The sporadic and often retroactive manner in which these provisions have been extended has done little to convince RICs that the benefits will be long-lasting.

Uncertainty also has impacted investment decisions by foreign investors. Many such investors have been unwilling to make long-term investments in RICs without a long-term assurance that the flow-through benefits would be available. Some foreign investors who nevertheless have invested in RICs have redeemed their shares before receiving a distribution that would have been subject to U.S. withholding tax only because section 871(k)'s application had not been extended before it expired.

A separate problem arises for those foreign investors who remain in the RIC after section 871(k)'s application has expired. Unlike most other expiring provisions, which generally need not be resolved until taxpayers are preparing to file tax returns, the flow-through provisions involve withholding taxes and should be addressed before they expire. Foreign investors can be forced to file U.S. tax returns to recover taxes, on amounts

[2] §871(k) expired at the end of 2014, for taxable years beginning after that date, again putting U.S. funds at a disadvantage relative to their foreign competitors. Prior to 2014, §871(k) was renewed four times in: *The Emergency Economic Stabilization Act of 2008* (PL 110-343); *The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010* (PL 111-312); *The American Taxpayer Relief Act of 2012* (PL 112-240); and *The Tax Increase Prevention Act of 2014* (PL 113-295).

attributable to interest and/or short-term capital gains, which were collected by the RIC on distributions made during the period after section 871(k) expired and before it was retroactively reinstated.

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" dates for the flow-through of interest-related dividends and short-term capital gains, should be stricken from the Code. This change will enhance U.S. RIC's international competitiveness, thus encouraging foreign investment in the U.S. markets.

Conclusion

The Institute 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, thus enhancing foreign investment in the U.S. Our proposal is consistent with these initiatives and, if adopted, will increase foreign investment in U.S. funds. We look forward to working with you to further develop these objectives.