MEMO# 2990

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EUROPEAN DEVELOPMENTS IN MUTUAL FUND TAXATION

- 1 - August 30, 1991 TO: INTERNATIONAL COMMITTEE NO. 21-91 RE: EUROPEAN DEVELOPMENTS IN MUTUAL FUND TAXATION ____ This memorandum summarizes recent tax developments in Europe regarding mutual fund taxation. 1. German Supreme Court Decision Will Force Review of Germany's System for Taxing Investment Income The German Supreme Court has ruled that Germany's system for taxing investment income is unconstitutional because investors receive different tax treatment depending on whether or not they voluntarily report income paid to them on securities held in bearer form. Since no mechanism exists in Germany for reporting to the German government the income paid to investors holding securities in bearer form, the only investors taxed on this income are those who voluntarily report it. German investors who hold their German mutual fund shares in bearer form can receive their fund distributions in cash by presenting the bearer shares for payment at the fund distributor's office, such as a bank's local branch. The court's decision requires that the German government take some action before January 1, 1993 to provide a modified taxation system for investment income that provides comparable treatment for all taxpayers. At the present time, it is not clear when the German government might act or what the proposed system might be. Opposition has already developed to any proposed reintroduction of a German withholding tax, which was effective for only six months in 1989, before being repealed to stop the outflow of capital that was triggered by the tax. 2. United Kingdom High Court Disallows Nonresident's Claim for Interest on Tax Refund 1 */ The claim for refund was based on the U.S.-U.K. income tax treaty, which apparently applied because the income was attributable to certain loans made by the U.K. branch to U.S. businesses. - 2 - The United Kingdom's high court has disallowed a claim by Commerzbank AG, a German bank with a U.K. branch, for interest on a tax refund.*/1 The U.K. Inland Revenue concluded, and the U.K. court agreed, that nonresidents are not entitled under U.K. law to repayment supplements (interest) on excess tax payments (tax refunds), even when they have a branch in the U.K. The court also rejected the bank's argument that denial of interest to a non-U.K. EC resident unfairly discriminates against non-U.K. taxpayers in violation of the European Economic Community Treaty (the Treaty of Rome). However, recognizing the importance of the issue, the U.K. court invited the European Court of Justice to rule. U.S. taxpayers would not be directly affected by any ruling of the European Court of Justice, which would affect only taxpayers resident in European Community countries. Any change in the U.K. position that U.S. taxpayers are not entitled to interest, a position that the U.K. maintained throughout the negotiations that recently led to refunds of excess tax payments to funds organized as Massachusetts Business Trusts, would have to be made either unilaterally by Inland Revenue or bilaterally pursuant to treaty negotiations with the U.S. 3. Irish Finance Act

Exempts "Specified Collective Investment Undertakings" from Irish Tax The 1991 Irish Finance Act (attached), effective retroactively to December 26, 1990, extends the exemption from Irish tax to certain non-UCITS open-end investment companies. Currently, funds structured as unit trusts and funds authorized under the UCITS directive are exempt from tax in Ireland. To qualify for the exemption, the fund must be (1) managed from the Dublin International Financial Services Centre ("IFSC"), (2) owned entirely by non-Irish residents and (3) designated as exempt by the Irish Central Bank. A fund which qualifies for the exemption is known as a "specified collective investment undertaking" ("SCIU"). SCIUs may be publicly or privately offered. Pursuant to the exemption, no tax is imposed at the fund level on the SCIU's income and gains. In addition, no tax is imposed on a shareholder's distributions, redemptions, repurchases, gifts or bequests of fund shares. Finally, the creation and transfer of SCIU shares are exempt from capital duty - 3 - and stamp duty. As a result of these exemptions from tax, however, SCIUs and their investors will not be able to claim benefits pursuant to Ireland's income tax treaties. If a variable capital company that would otherwise qualify as an SCIU is not designated as exempt by the Central Bank, a 10 percent rate of tax will apply to the entity's taxable income and gain. Like an SCIU, the fund's investors will be totally exempt from Irish tax on distributions, redemptions, repurchases, gifts or bequests of fund shares. Unlike an SCIU, however, the entity will be entitled to benefit from Ireland's income tax treaties with countries in which it invests. The ability of a variable capital company to forego complete tax exemption in exchange for Irish tax treaty benefits could be beneficial if the fund invests in high-income-generating securities, where the treaty benefits may more than offset the 10 percent Irish tax. We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment KDL:bmb

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