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INTERNATIONAL DEVELOPMENTS IN INVESTMENT COMPANY TAXATION

January 16, 1992 TO: INTERNATIONAL MEMBERS NO. 2-92 RE: INTERNATIONAL DEVELOPMENTS IN INVESTMENT COMPANY TAXATION ____ This memorandum summarizes recent international tax developments regarding investment company taxation. 1. Australia: Proposal on the Taxation of Foreign Investment Funds. The introduction of a proposed tax regime to deal with deferral of Australian tax on passive income derived from foreign entities which are not controlled by Australian residents has been postponed. The foreign investment fund ("FIF") rules had been scheduled to become effective July 1, 1991, but legislation is now not expected to be introduced until March or April 1992, to take effect July 1, 1992. Under the proposal, which is similar to the United States' "passive foreign investment company" or "PFIC" rules, all income and gain derived from offshore interests would be taxable currently in Australia unless one of three exemptions apply. The first exemption would be for persons with de minimis holdings, defined as persons whose total foreign holdings total (A)$20,000 or less. (It is unclear whether the (A)$20,000 refers to market value or cost basis.) The second exemption would apply to persons who are "attributable taxpayers" under the "controlled foreign corporation" or "CFC" rules, which generally mirror the United States' CFC rules. A controlled foreign corporation is generally one in which five or fewer Australian residents own fifty percent or more of a foreign company. An attributable taxpayer would be one who is a ten percent or greater owner in a CFC. Thus, a person who is a less than ten percent owner of a CFC would be subject to the FIF regime, whereas a greater than ten percent owner would be under the CFC rules. The third exemption would be for interests in most companies which are primarily engaged in active businesses. The FIF regime would not apply to less-than-10-percent shareholders in a foreign company engaged primarily in an active business so - 1 - long as the company's stock is listed on an established exchange. For 10-percent-or-greater holders, the foreign company would not need to be listed for the exclusion from the FIF regime to apply, so long as the company is primarily engaged in an active business. Holders of interests in FIFs would be taxed on a mark-to- market system. Where market value information is unavailable, a deemed rate of return would be used to calculate the tax on the FIF. Provisions would be made to prevent double taxation where FIFs make distributions. It is unclear whether the proposal will provide for basis adjustments for distributions or modify the availability of capital gain treatment on disposition. 2. France: Increased Tax Rate on Capital Gains on Mutual Funds Organized as Corporations. The French Parliament has adopted a portion of the government's proposed 1992 tax bill. The legislation now goes to the Senate for discussion, which usually does not affect the bill's enactment. As part of the bill, rates on long term capital gains derived from "placement securities" was increased to the general capital gain rate of 34 percent. Previously, capital gain on placement securities had been 25 percent. Placement securities are defined to include the shares of French mutual funds organized in corporate form (such as SICAVs). 3. France: Tax Relief for Merging Investment Funds. Two principal fund types exist in France: the incorporated form, know as a SICAV (which is an open-end investment company) and the unincorporated form, known as a "Fond Common de Placement" or "FCP". Under French corporate law, either type of fund may merge into the other or into a fund of the same type. However, prior to the change in the tax law, only two SICAVs could merge without adverse tax consequences, as both were corporations. Mergers of a SICAV with an FCP or of two FCPs could result in tax to both the investors and the funds. The exchange of SICAV shares or FCP units for interests in the surviving fund was treated as a realization event for tax purposes and the shareholder was deemed to have recognized capital gain to the extent of the difference in value between the original cost of the shares or units and the value at the time of the merger. The new provisions allow individuals holding shares of a SICAV or units of an FCP which is merged into another fund to postpone any capital gain arising as a result of the exchange of their shares or units by "rolling over" their cost basis in their original shares to their new shares and treating the original cost as the cost of the new shares. Thus, when the new shares are ultimately disposed of, the gain on the original shares will be preserved and recognized at the time of disposition. - 2 - - 3 - Tax relief for the funds themselves is dependent on the accounting treatment of the securities acquired from the target fund. Essentially, the surviving fund can avoid gain recognition by rolling over the cost basis of the securities it receives in the merger from the target fund. The tax is then collected when the fund ultimately sells the securities. In addition, because French funds are exempt from tax on ordinary income and capital gain, and investors pay tax only when the income is distributed or their shares sold, the provisions allow undistributed income of the target fund to remain untaxed until it is distributed by the surviving fund. The effective date of these provisions is retroactive to January 1, 1990, for individual investors, and to taxable years ending after December 31, 1990 for funds. 4. United Kingdom: New Rules on Transactions in Financial Options and Futures by Investment Trusts Previously the Institute informed you that the Inland Revenue was modifying the Statement of Practice regarding the treatment of financial options and futures transactions engaged in by investment funds in order to help taxpayers determine when such transactions are "investment transactions" and when they are "trading" in securities. (See Institute Memorandum to International Committee No. 13-91, dated July 11, 1991.) The Inland Revenue has now released this document in final form. The Statement of Practice is of relevance both to U.K. resident investment vehicles such as investment trusts (the closed end, corporate form of fund) and unauthorized unit trusts, and to non-resident collective investment vehicles, both open- and closed-end. For resident investment vehicles, the distinction between investment transactions and trading is important because investment transactions give rise to capital gain, which is not taxable to the fund and does not need to be distributed, while trading transactions result in ordinary income which must be distributed annually. A non-resident fund which is trading may not have "distributor status" under the U.K. offshore funds legislation, which would mean that a U.K. resident investor in such a trading fund would be required to treat gain on the disposition of the fund's shares as ordinary income, rather than as capital gain eligible for inflation indexing adjustments and the annual 5,000 pound exclusion for capital gains. Basically, the Statement of Practice provides that financial futures or options transactions (including foreign currency futures contracts) legitimately entered into to minimize risk of loss and ancillary to another transaction will be considered investment transactions provided that the transaction to which the financial future or option relates is capital in nature. If a financial future or options transaction is not ancillary to another transaction, the future or option - 4 - transaction itself must be analyzed to determine whether it - 5 - itself is an investment transaction or is trading. Such a determination depends on the facts of the particular transaction. 5. Belgium: Dividend Withholding Abolished As the Institute reported in an earlier memorandum (see Institute Memorandum to International Committee No. 13-91, dated July 11, 1991), Belgium passed legislation dealing with the taxation of investment funds which generally mirrors that of France and Luxembourg. However, the legislation provided for a 25 percent withholding rate on distributions from Belgium funds, in the infrequent event that the funds choose to make a distribution, making the Belgian funds relatively unattractive compared to funds organized in other countries which had no withholding on distributions. This withholding tax has recently been repealed with respect to distributions to foreigners from qualified investment funds. The exemption does not require any minimum holding period or amount, nor is it limited to shareholders who are resident in a European Community member state. The exemption does not, however, apply to the portion of the distribution derived from dividends from Belgian corporations. The exemption is effective retroactively for all distributions made on or after January 1, 1991. * * * * * * * We will keep you informed of developments. David J. Mangefrida Jr. Assistant Counsel - Tax

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