

MEMO# 3134

September 25, 1991

BILL INTRODUCED TO ENHANCE INTERNATIONAL COMPETITIVENESS OF U.S. MUTUAL FUNDS

September 25, 1991 TO: TAX MEMBERS NO. 41-91 INTERNATIONAL MEMBERS NO. 5-91
ACCOUNTING/TREASURERS MEMBERS NO. 27-91 RE: BILL INTRODUCED TO ENHANCE
INTERNATIONAL COMPETITIVENESS OF U.S. MUTUAL FUNDS

Yesterday, Senator Max Baucus, Chairman of the Senate Finance Subcommittee on International Trade, introduced S. 1748, the "International Competitiveness Act of 1991," legislation designed to enhance the international competitiveness of U.S. mutual funds. Attached is Senator Baucus' Record statement upon introduction of the bill, which includes the bill's text and a description of its provisions. The bill would remove the competitive tax disadvantages currently faced by U.S. funds selling abroad and put the U.S. fund industry on a more equal footing with its foreign-based competitors. These objectives would be achieved by modifying the current withholding and distribution requirements applicable to foreign investors in U.S. funds.

Withholding Requirements Current U.S. withholding rules discourage foreign investment in U.S. funds in two ways. First, while interest on most U.S. obligations issued after July 18, 1984 is exempt from U.S. withholding tax when paid to foreign investors, including foreign investors in foreign funds, such interest is subject to withholding when the investor purchases shares of a U.S. fund holding these obligations. Second, short-term capital gains are exempt from U.S. withholding tax when received directly by foreign investors, including foreign investors in foreign funds, but subject to withholding tax when distributed to foreign investors by a U.S. fund. The bill would provide flow-through treatment to foreign investors for each of these types of income. Section 2 of the bill would amend section 852(b) of the Internal Revenue Code ("Code") to provide a mechanism for regulated investment companies ("RICs") to distribute to all shareholders as taxable interest the taxable-interest income earned by the RIC. Under proposed new Code section 852(b)(10), a - 1 - RIC could designate taxable interest distributed to shareholders as a "taxable-interest dividend" by mailing to shareholders a written notice not later than 60 days after the close of its taxable year. Under proposed new Code section 852(b)(11), the RIC could designate as a "qualifying-interest dividend", which would not be subject to U.S. withholding tax, that portion of the taxable-interest dividend that would have been exempt from U.S. withholding tax if the income had been paid directly to a foreign investor. A related amendment would exclude from U.S. estate tax the portion of a foreign investor's RIC stock that would have been exempt had the RIC's assets been owned directly by the foreign investor. Section 3 of the bill would amend Code section 852(b) to provide a mechanism for RICs to distribute to foreign investors as a "short-term capital gain dividend" the short-term capital gains

realized by the RIC. Under proposed new Code section 852(b)(12), any distribution designated as a short-term capital gain dividend would be exempt from U.S. withholding tax, just as long-term capital gains realized by a RIC are currently exempt when designated as capital gain dividends. Clerical amendments would change the Code's references to "capital gain dividends" to "long-term capital gain dividends," to distinguish short-term from long-term gains. Distribution Requirement The current distribution requirements applicable to RICs provide another incentive for foreign investors to purchase foreign funds rather than U.S. funds. These distribution requirements effectively result in foreign investors paying tax in their own countries on the U.S. fund's income on a current basis, while many foreign investors in foreign funds may pay tax in their own countries on such gain, if at all, only when the fund shares are sold. Section 4 of the bill would correct this tax disincentive by adding two new Code sections, Code section 1355, which defines a new type of U.S. corporation, an International Regulated Investment Company ("IRIC"), and Code section 1356, which provides the manner of taxing IRICs and their shareholders. Under proposed new Code section 1355, the IRIC would invest only in the shares of a single RIC and could be owned only by foreign investors. Under proposed new Code section 1356, the IRIC would have no distribution requirement of its own, but would pay U.S. tax on a current basis on any distributions from the RIC that would have been subject to U.S. withholding tax had the foreign investor held the RIC shares directly. If the IRIC's shareholders were all eligible by treaty for U.S. withholding tax at a rate of 15 percent or less, the IRIC could make a "treaty countries election", which would reduce the otherwise applicable tax rate from 30 percent to 15 percent on that portion of the - 2 - IRIC's earnings subject to tax. To provide comparable tax treatment for foreign investors in U.S. funds and foreign funds, - 3 - IRIC stock would not be deemed to be property within the U.S. and would, therefore, be exempt from the U.S. estate tax. The bill is proposed to be effective for taxable years beginning after date of enactment. We will keep you informed of developments. Keith D. Lawson
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