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EUROPEAN DEVELOPMENTS IN MUTUAL FUND TAXATION

July 11, 1991 TO: INTERNATIONAL COMMITTEE NO. 13-91 RE: EUROPEAN DEVELOPMENTS IN MUTUAL FUND TAXATION ____ This memorandum summarizes recent tax developments in Europe regarding mutual fund taxation. 1. United Kingdom: U.K. Investment Managers Acting for Offshore Funds Proposed legislation in the U.K., Clause 69 of the 1991 Finance Bill (attached), contains two important changes relating to U.K. investment managers acting for offshore funds. The Finance Bill is proposed to be effective retroactive to April 1, 1991. Consideration and enactment of the Finance Bill is expected in July. The first proposed change provides that a U.K. investment manager carrying on activities for a number of offshore fund clients will not be treated as the U.K. taxable agent for an "unconnected" (defined by reference to common stock ownership) offshore fund when it performs services such as making investment decisions and executing trades. This change will permit most offshore funds to abandon the "echo" system whereby a U.K. investment manager rendering services to a number of offshore funds would merely "advise" the offshore fund manager on the appropriate buy or sell order and the offshore fund manager would then immediately place the order. However, U.K. investment managers providing advice to connected foreign investors still need to take care. In addition, Inland Revenue is likely to place increased focus on transfer pricing. Under U.K. law, a fund's gains on its portfolio securities will not be taxable so long as the fund engages in "capital" or "investment transactions" rather than "trading" activities. In the 1990 Finance Act, pension funds and authorized unit trusts were permitted to treat all trading of options and futures contracts as "capital". The change proposed by the 1991 Finance Bill would extend to offshore funds this exemption from having options and futures transactions treated as "trading". However, U.K. investment trusts (the corporate, closed-end form of fund) would still not be covered by any legislative exemption for their options and futures transactions. Consequently, investment trusts must still demonstrate that their options and futures - 1 - transactions are not "trading". To assist them in this determination, Inland Revenue is revising and clarifying the two Statements of Practice dealing with this issue. Despite this proposed change, the distinction between "trading" and "capital" will remain relevant for offshore funds with U.K. investors because Inland Revenue will not treat an offshore fund as a "qualifying fund" for purposes of the U.K. offshore funds legislation (i.e., give the fund "distributor status") if it is "trading". If an offshore fund loses its distributor status, its U.K. resident investors would be required to treat all gain on the disposition of fund shares as ordinary income, rather than as capital gain eligible for inflation indexing adjustments and the 5,000 pound annual exclusion for such gains. The second proposed change expands the definition of "investment transactions", which identifies the types of transactions that U.K. investment managers can execute for connected offshore funds without subjecting the offshore fund to U.K. tax, to include options and futures contracts, except those relating to land. 2. Italy: Capital Gains Tax Reform For Italian Residents Italy has modified in many respects its taxation of capital gain, effective January 28, 1991. Italian residents are now generally taxable on gain on securities held for less than 15 years. In addition, gain is taxable without regard to the period the securities are held if dispositions of shares by a taxpayer exceed certain percentages of a company's share capital. The legislation does not affect investments by U.S. funds in Italian securities, which remain exempt from capital gains taxation pursuant to Article 13 of the U.S. - Italian Income Tax Treaty. It may, however, be necessary for funds selling Italian securities to notify the broker of the exemption from withholding in advance of the sale. Application to Mutual Fund Holdings Investments in authorized Italian "fondi communi di investmento" by individual Italian residents remain exempt from capital gains tax. Also exempt are gains on investments in a number of Luxembourg-based SICAVs which were authorized for sale in Italy under the old foreign exchange control legislation, which expired in mid-1990. At the present time, it appears that individuals' investments in other non-Italian UCITS are not exempt from capital gains tax, although the issue is unclear. In July 1990, Italy enacted a separate tax of 12.5 percent on the capital gains of Italian resident individuals' investments in funds located outside Italy. It is unclear at present whether the July 1990 - 2 - system has been superseded by the new rules, so that gains would now be taxed under the new system at 25 percent, or whether the old regime still applies. Further legislation may be passed in the future that will clarify the taxation of gains on other UCITS. 3. Belgium: New Framework For Investment Funds Belgium has enacted legislation, effective January 1, 1991, which generally mirrors the securities and tax treatment provided for funds by France and Luxembourg. Under the law, Belgium has two types of investment vehicles -- those with and without legal personality. The funds without legal personality are known as FCPs (Fond Common de Placement), which may be open or closed-ended. Because an FCP is treated as a collective pool of investments beneficially owned by the investors, who hold certificates evidencing their participation, no entity-level tax is imposed on the FCP's income and gain. Funds with legal personality may be open-end (SICAVs) or closed-end (SICAFs). Both SICAVs and SICAFs are, in principle, liable for corporate tax, but the tax is computed not on profits but only on certain non-deductible expenses and benefits gained from non-arm's-length transactions that typically do not arise merely from investment management. No tax is imposed on SICAVs or SICAFs with respect to their income and gain, whether these amounts are retained or distributed to investors. Thus, Belgian individual investors can now invest in domestic "roll up" bond funds and so convert taxable income into tax free capital gains. The legislation also provides other tax rules. First, all funds (whether FCPs, SICAVs or SICAFs) are exempt from capital registration duty. In addition, the movable property withholding tax does not apply to shareholders' redemptions of fund shares. At present, Belgian funds appear to have one disadvantage that may limit their attractiveness. Specifically, the legislation imposes 25 percent withholding on any dividend distribution from a fund. While the Belgian government has stated that it intends to exempt nonresidents from the withholding tax, no such legislation has yet been implemented. Thus, the withholding tax will apply if a fund distributes, rather than "rolls up", its income and gains. * * * * * * * * We will keep you informed of developments. Keith D. Lawson Associate Counsel - Tax Attachment