INVESTMENT COMPANY INSTITUTE

Keith Lawson
SENIOR COUNSEL – TAX LAW

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

202/326-5832 FAX: 202/326-5841
lawson@ici.org

By Electronic Delivery

April 13, 2012

Mr. Byung-Cheol Kim, Director
Corporation Tax Division
Ministry of Strategy and Finance
Government Complex II, 88 Gwanmoonro
Gwacheon City, Gyeonggi Province, 427-725
Korea

RE: *Clarification of Form U.S. Funds Should Use to Claim Treaty Relief*

Dear Sir:

The Investment Company Institute ("ICI")[1] requests guidance clarifying that regulated investment companies ("RICs") should claim at-source treaty relief by filing the form (No. 72-2[2]) used by other foreign corporations. RICs, as discussed in detail in the attachment, are organized in the United States and treated as corporations for U.S. tax purposes. Form No. 72-2 is the appropriate form because RICs are persons, liable to tax in the United States as residents, and the beneficial owners of their income. As such, RICs are entitled to treaty relief in their own right.

We request this clarification because of conflicting advice regarding which types of investment funds are to file Form No. 72-2 rather than Form No. 29-13 (Report of Overseas Investment Vehicle). A fund that is entitled to treaty relief in its own right, we submit, should file Form No. 72-2. A fund that may claim relief only to the extent that its investors are treaty-eligible, in contrast, should file Form No. 29-13. Because RICs are treaty-entitled, they should file Form No. 72-2.

---

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.3 trillion and serve over 90 million shareholders.

[2] Form No. 72-2, Application for Entitlement to Reduced Tax Rate on Domestic Sourced Income (for Foreign Corporation)

The Need for Administrable Rules for Claiming Treaty Relief

The ICI supports administrable rules that allow publicly offered, regulated collective investment vehicles ("CIVs") to receive the applicable withholding tax relief provided by Korea's double tax treaties. The letter we submitted to you in January identified several clarifications that we believed would ensure that restrictions proposed would not be applied in ways that did not appear to be intended.[3]

Administrable rules are necessary for several reasons. Two of the most significant reasons are discussed below. First, CIVs generally have many thousands (often tens or hundreds or thousands) of investors; these investors may buy or sell CIV units on a daily basis. The most common type of CIV, known in the U.S. as a "mutual fund," does not have a fixed number of units. Instead, an investor may purchase or redeem as many CIV units as the investor chooses from the CIV (either directly or through a nominee, such as a securities broker or a bank). Because both the number of CIV units held by a single investor, and the total number of CIV units outstanding, can change on a daily basis, the tracking of investor interests is challenging and, as discussed below, frequently is not handled at the CIV level.

Second, shareholder information in most markets, including in the United States, often is not available to the CIV itself. Specifically, CIV investors very often acquire their CIV interests through intermediaries, such as banks or securities brokers, rather than directly from the CIV. In many cases, intermediaries may purchase and redeem CIV units through other (typically far larger) intermediaries that, in turn, are in direct contact with the CIV. This tiered-distribution structure adds to the complexity of acquiring customer-specific information about a CIV's many thousands of investors.

While, in a few countries, all customer information must be provided by these intermediaries to the CIV, the far more typical approach is for customer information to remain with the intermediary. The intermediary has a very strong commercial reason to keep confidential the identity of its customers; if its competitors, including the CIV and its manager, knew the customers' identities, they could seek to deal directly with the customer (and effectively "take" the business from the intermediary).

The Organization for Economic Cooperation and Development ("OECD") has studied at length this need for administrable treaty-relief rules in the CIV context. Its findings have been published in two documents. First, the OECD's Committee on Fiscal Affairs in April 2010 approved a report entitled "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" (the "CIV Report").[4] Second, later that year, the OECD released its 2010

---

[3] *See* January 20, 2012 letter from ICI and ICI Global regarding Korean Treaty Relief for Offshore Investment Vehicles.

[4] http://www.oecd.org/dataoecd/59/7/45359261.pdf.

Update to the Commentary on Article 1 of the Model Convention.[5] This update included recommendations based upon the CIV Report. Both the CIV Report and the Update to the Commentary discuss factors that support providing certain types of CIVs with treaty benefits in their own right. RICs clearly satisfy the factors discussed in the CIV Report and the updated Commentary.

The Draft Presidential Decree

The draft Presidential Decree regarding Article 98-6 of the Korean Income Tax Law ("CITL")[6] appeared to provide the administrable rules we requested. Specifically, Paragraph 3 of Article 138-7 of the draft Presidential Decree provides that an offshore investment vehicle ("OIV") that (1) satisfies the requirements for qualifying offshore collective investment vehicle ("OCIV") status, (2) submits a "Confirmation report of OIV," and (3) meets certain conditions, would not be required to file beneficial owner details.

Form No. 29-13 Requires Considerable Details

Form No. 29-13 (Report of Overseas Investment Vehicles) requires extensive information about a CIV's investors. Specifically, Boxes 11-15 of the Form No. 29-13 require the following information about a CIV's investors:

- residence countries of its investors (Box 11);
- amount (in units) of CIV held by residents of each country (Box 12);
- percentage of total units held by the residents of each country (Box 13);
- number of beneficial owners resident in each country (Box 14); and
- the tax rate applied by type of income to the residents of each country (Box 15).

Just about the only details not required by Form No. 29-13 are the names of the CIV's investors.

Form No. 29-13 also requires that this information be provided on a quarterly basis. Those CIVs with a large number of intermediaries (many of which may transact CIV share purchases and redemptions through tiered-distribution structures) will have a far more difficult time acquiring this information on a quarterly basis than they would have acquiring it on an annual basis.

When a CIV can claim treaty benefits only on behalf of its investors – rather than in its own right – a government's interest in having some information about the CIV's investors is appropriate.

---

[5] http://www.oecd.org/dataoecd/23/43/45689328.pdf.

[6] This Decree was issued by MOSF Public Notice No. 2012-3 (January 6, 2012).

In these situations, information like that required by Form No. 29-13 can provide the government with comfort that only the appropriate level of benefit is being claimed. It is essential, however, that the procedures for collecting the required information– including the specificity of the information collected, the frequency of collection, and the procedures for updating information that might not be collected with sufficient promptness – be administrable. Without administrable procedures, the benefits of bilaterally-negotiated tax treaties effectively will be denied to the residents of the treaty partners.

RICs Should File Form No. 72-2 as a Foreign Corporation

RICs, as discussed above and in the detailed attachment, are both treated as corporations for U.S. tax purposes and entitled to treaty relief in their own right. RICs are persons, liable to tax in the United States as residents, and the beneficial owners of their income. RICs, consequently, should claim treaty relief by filing Form No. 72-2.

The detailed investor information required by Form No. 29-3 is not relevant to a RIC's claim for treaty relief. Were a RIC required to collect that information, it could establish that the overwhelming portion of all RIC shares (generally over 99 percent) are held by U.S. persons. The administrative burden of collecting this information, however, is both considerable and unnecessary. RICs are foreign corporations that satisfy, in their own right, every requirement for treaty relief. Consequently, a RIC should file Form No. 72-2 as a foreign corporation and represent that it is an overseas investment vehicle that is recognized, under the Korea-U.S. treaty, as the beneficial owner of its income.

* * *

We respectfully request that the guidance we seek be issued promptly. RICs, their advisers, and their custodians will appreciate greatly the clarification that they are to file Form No. 72-2. Please feel free to contact me (at lawson@ici.org or 001-202-326-5832) if I can provide you with any additional information.

Sincerely,

/s/ Keith Lawson

Keith Lawson
Senior Counsel – Tax Law

Attachment

April 13, 2012

U.S. REGULATED INVESTMENT COMPANIES ("RICS") SHOULD FILE FORM No. 72-2 TO CLAIM TREATY BENEFITS UNDER THE KOREA-U.S. INCOME TAX CONVENTION

Collective investment vehicles ("CIVs") that are organized in the United States as registered investment companies under the Investment Company Act of 1940[1] ("the 1940 Act") and taxed as regulated investment companies ("RICs") under the Internal Revenue Code[2] are persons resident in the U.S. and the beneficial owners of their income. As such, RICs are entitled to treaty relief in their own right and should file the form for foreign corporations (Form No. 72-2) to claim their benefits under the Korea-U.S. treaty.

This memorandum describes (1) the organization and operation of RICs; (2) the tax treatment provided to RICs and their shareholders; and (3) why RICs are (a) persons, (b) resident in the U.S., and (c) the beneficial owners of their income.

I. The Organization and Operation of RICs

A. Legal Form

Collective Investment Vehicles ("CIVs") in the United States may be organized, under the laws of the 50 states, as either corporations or business trusts. All U.S. CIVs that qualify for RIC tax treatment under Subchapter M of the Internal Revenue Code are treated for U.S. income tax purposes as corporations.

B. Distribution

RICs may be organized as retail investment vehicles, as institutional investment vehicles, or as combined retail/institutional vehicles (with separate classes of shares for the retail and institutional investors). RICs typically have thousands of shareholders; some RICs have hundreds of thousands of shareholders. Some RIC shareholders hold as nominees for their clients. Nominee accounts include street name accounts set up by brokerage firms, banks, and financial planners for their customers and those set up by so-called "fund supermarkets," which are created by financial services firms to invest their clients' assets in other firm's RICs. Because customer identity information is a valuable commercial asset, firms with the customer relationship may utilize the nominee account structure to shield the client's identity from competitors, including RICs and the financial services firms that manage RICs. The nominee account structure, importantly, does not shield client information from the Internal Revenue Service ("IRS").

---

[1] 15 U.S.C. §§ 80a-1 *et seq.*

[2] 26 U.S.C. §§ 851 *et seq*.

II. The Tax Treatment of RICs and Their Shareholders

A. U.S. (Domestic) Taxation of RICs and Their Resident Investors

1. *Domestic Taxation of RICs*

A CIV cannot qualify for RIC status (under Code sections 851 and 852) unless it is taxed as a domestic corporation and meets several tests, including those regarding the sources of its income, the diversification of its assets, and the distribution of its income. Among other things, a RIC must distribute with respect to its taxable year at least 90 percent of its income (other than net capital gain). The remaining 10 percent of ordinary income, and all capital gain, may be retained. All retained income, however, is taxed at regular corporate tax rates. Because a RIC that incurs corporate tax provides a lower return than one that does not incur such tax, RICs generally attempt to distribute all of their income.

In addition, U.S. tax law imposes an excise tax (under Code section 4982) on any RIC that does not distribute essentially all of its income during the calendar year in which it is earned. To eliminate any excise tax liability, a RIC must distribute by December 31 an amount equal to the sum of: (1) 98 percent of its ordinary income earned during the calendar year; (2) 98.2 percent of its net capital gain earned during the 12-month period ending on October 31 of the calendar year; and (3) 100 percent of any previously-earned amounts not distributed during the prior calendar year. A tax of 4 percent is imposed on the amount, if any, by which the RIC's required distribution exceeds the amount actually distributed. The excise tax, in effect, acts as an interest charge on undistributed amounts. RICs typically seek to avoid this charge by electing to distribute their income currently.

2. *Domestic Taxation of Resident Investors in RICs*

U.S. individuals and other taxpaying persons investing in RICs are taxed upon: (1) the receipt of RIC distributions (whether received in cash or reinvested in additional RIC shares); and (2) the disposition of RIC shares. A RIC shareholder is taxed on a distribution whether or not the shareholder was invested in the RIC on the date that the income was received by the RIC. In contrast, net operating losses or net capital losses realized by the RIC do not flow through to RIC shareholders; net capital losses are carried forward to the RIC's next taxable year, but net operating losses expire (and are lost).

All RIC distributions are taxed as ordinary dividends (because RICs are corporations for U.S. income tax purposes), unless the tax law expressly permits the character of the income to be retained. For example, the capital gains arising from the sale of RIC portfolio assets held for more than one year (which are taxable at rates below the marginal tax rate) may be paid as "capital gain dividends" eligible for the lower tax rates. In contrast, capital gains arising from the sale of RIC portfolio assets held for one year or less are distributed as ordinary dividends taxed at the investors' marginal tax rates.

An important feature of RICs investing more than 50 percent of their assets outside of the U.S. is that the RIC can flow through to its U.S. investors the ability to claim a credit against U.S. tax for the foreign taxes paid on the distributed income. To illustrate, assume that a foreign government imposes 15% withholding tax on a treaty-eligible dividend received by the RIC. If a RIC shareholder's interest in this dividend were $100, the RIC would pay an $85 cash dividend ($100 gross dividend less $15 foreign taxes) to the shareholder. However, the RIC would report to the shareholder and to the IRS that the dividend received was $100 and that the shareholder paid $15 of foreign taxes. This $15 foreign tax credit would offset $15 of the taxpayer's U.S. tax liability.

Any gain realized by a RIC investor upon the sale of fund shares is taxed as short-term or long-term capital gain depending upon the length of time the fund shares were held.

3. *Domestic Taxation of Non-Resident Investors In RICs*

The U.S. tax treatment of non-U.S. investors in RICs reduces significantly the attractiveness of RICs to non-U.S. investors. In addition, because RICs are almost never registered for sale outside of the United States, RICs generally are owned almost exclusively by U.S. investors.

There are three significant adverse tax effects of non-U.S. investments in RICs that, in general, limit substantially the attractiveness of RICs for non-U.S. investors. These adverse tax effects are: (1) U.S. taxation of non-U.S. source income; (2) current distributions of income and gain; and (3) resident-country taxation at "regular" rates of RIC capital gain distributions, where capital gains receive favorable treatment in the investor's residence country. Each of these tax effects, which results in a RIC's non-U.S. investors being disadvantaged vis-à-vis direct investors or investors in non-U.S. CIVs, is described briefly below.

First, non-U.S. investors in RICs are taxed in the United States when the RIC invests outside the United States. Because a RIC's distributions are treated as U.S.-source dividends, they are subject to U.S. withholding tax (at 30 percent or a lower treaty rate). Any non-U.S. investor investing in the same non-U.S. securities directly or through a non-U.S. CIV would not incur any U.S. tax. Thus, the income may be taxed in three countries (the source country, the United States, and the residence country) when the investment is made through a RIC, whereas the income would be taxed only twice (or perhaps once) if the investment is made directly or through a non-U.S. CIV. While a non-U.S. investor may be able to claim a foreign tax credit for the U.S. withholding tax, such a credit in all likelihood would not be available for the tax withheld by the source country on the payment to the RIC.

Second, non-U.S. investors in RICs in all likelihood will be taxed currently in their country of residence on the RICs' annual distributions. Residence country taxation occurs irrespective of whether that country otherwise permits deferral of tax through CIVs that do not distribute their income.

Finally, as we understand non-U.S. law, RIC capital gain dividends are treated in non-U.S. countries as "regular" dividends; the preferential "capital gains" nature of the distribution is not retained for non-U.S. tax purposes. Thus, RIC distributions of capital gains typically will not qualify for any tax preference provided in a residence country for capital gains.

A temporary legislative change effective for 2005 through 2011 made certain RICs more attractive to non-U.S. investors than they were previously. Specifically, legislation permitted a RIC to designate distributions of U.S.-source interest and short-term gain as such to non-U.S. investors (rather than as dividend income -- which was the treatment before the legislation was enacted and will be the treatment going forward unless extended by new legislation). This change had the effect of providing RIC shareholders from outside the U.S. with tax treatment comparable to that received by non-U.S. persons investing in the U.S. directly or through a non-U.S. CIV; these non-RIC investors already are exempt from U.S. tax on interest and short-term gains (as well as long-term gains -- on assets held for more than one year). Only long-term gains previously were exempt from U.S. withholding tax when paid by a RIC to a non-U.S. investor. Importantly, this legislation did not apply to non-U.S.-source interest income received by a RIC and distributed to its shareholders. All such income is treated as dividend income subject to U.S. withholding tax.

One last relevant feature of U.S. tax law involves information reporting of amounts paid to non-U.S. investors. U.S. payors (including brokers, banks, and funds) must report such payments to investors (on IRS Form 1042-S) and to the IRS (on IRS Form 1042). This tax information is available to resident-country governments under exchange of information provisions in U.S. tax treaties.

B. U.S. Taxation of U.S. Persons in Non-U.S. CIVs

The passive foreign investment company ("PFIC") rules, which effectively tax PFIC gains currently at ordinary income rates, generally apply to holdings by U.S. investors of non-U.S. CIVs. Specifically, the value of a U.S. investor's PFIC shares generally is: (1) marked to market (at the investor's election) each year; or (2) subject to an interest charge designed to eliminate any tax deferral benefit. Mark-to-market appreciation and all distributions are taxable at ordinary income rates. Gain from the sale of PFIC shares also is taxable at ordinary income rates. An alternative taxation regime for PFICs that elect treatment as "qualified electing funds" ("QEFs") provides some opportunity for capital gain treatment; the QEF regime typically is not available to investors, however, as it requires the CIV to calculate its income under U.S. tax principles.

The PFIC rules impose such significant tax costs that U.S. taxpayers typically do not invest in non-U.S. CIVs. Even if the PFIC rules did not apply, U.S. securities laws prevent public offerings in the U.S. by non-U.S. CIVs unless the U.S. securities laws applicable to U.S. RICs (which are quite detailed) are followed by the non-U.S. CIVs. The combination of the tax and securities law rules provide powerful disincentives for U.S. taxpayer investment in non-U.S. CIVs.

III. RIC Treaty Eligibility

A. Satisfaction of Treaty Requirements

RICs qualify for treaty benefits as persons, residents, and the beneficial owners of their income.

1. *Person*

Paragraphs 1(d) and (e) of Article 3 of the Convention define a "person" to include "any body corporate or any entity that is treated as a body corporate for tax purposes." To qualify as a RIC under section 851 of the Internal Revenue Code, the CIV must be a "domestic corporation." Thus, RICs are persons under the Convention.

2. *Resident*

Paragraph 1 of Article 4 of the Convention defines resident to mean "any person who, under the laws of that State, is liable to tax therein by reason of his domicile, residence, place of management, place of incorporation, or any other criterion of a similar nature." The Organization for Economic Cooperation and Development ("OECD") recently addressed the "liable to tax" issue in the context of CIVs. Specifically, on 23 April 2010 the OECD's Committee on Fiscal Affairs adopted a report entitled "The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles" in which it stated (in paragraph 29) that "a CIV that is opaque in the Contracting State in which it is established will be treated as a resident of that Contracting State even if . . . it receives a deduction for dividends paid to investors." The Protocol to the Convention further addresses the situation of partnerships and similar pass-through entities. In that (non-opaque) context, the partnership or similar entity is treated as a resident "to the extent that income derived by such partnership [or] similar entity . . . is subject to tax in that State as the income of a resident, either in its hands or in the hands of its partners or beneficiaries." Because RICs are liable to tax, and any income distributed by the RIC is liable to tax in the hands of RIC shareholders, RICs are residents under the Convention.

3. *Beneficial Ownership*

The Treasury Department's Technical Explanation of the Convention, in discussing the "beneficial ownership" requirement of Article 10 (Dividends) provides that "[u]se of the term 'beneficial owner' emphasizes that substance will prevail over form in determining the appropriate tax treatment, so that treaty benefits may be denied to a nominal recipient not entitled to the beneficial enjoyment of the dividend income." RICs, as discussed above, retain full control over their income and are not transparent (as discussed in detail in III.D, below); in addition, they are not acting as agents for other investors. RICs thus are the beneficial owners of their income.

B. RICs are Owned Almost Exclusively by U.S. Investors

RICs are owned almost exclusively by U.S. investors for the tax and securities law reasons discussed above. Thus, Treasury effectively is protecting only the interests of U.S. taxpayers when it supports the tax treaty eligibility of U.S. RICs. Moreover, significant burden would be placed on individual RIC shareholders if they were required to claim treaty benefits on their own behalf.

C. U.S. Tax Law Protects the Interests of Both Source and Residence Countries

Additional support for the treaty-eligibility of U.S. RICs comes for those provisions of U.S. tax law that protect the interests of the source and residence countries.

The interests of source countries are protected by the provisions of U.S. tax law (including U.S. withholding tax on distributions by RICs of non-U.S. source income) that severely limits the use of a RIC for treaty shopping. For example, assume the worst case scenario – in which the U.S. has treaties with both the source country ("Country A") and the residence country ("Country C"), but no treaty exists between Countries A and C. In this case, a $100 dividend paid by a Country A company to a Country C investor would be taxed at a 30% rate; the net distribution (pre-residence country tax) would be $70. If instead, the investment were made through a RIC, the net distribution (pre-residence country tax and before fund expenses) would be $72.25 ($15 withholding by Country A at 15% rate on the $100 dividend and $12.75 withholding by the U.S. at 15% rate on the net $85 dividend).

The interests of the residence country are protected by the provisions of U.S. tax law (discussed above) that require information reporting to the investor and the IRS of amounts paid to non-U.S. investors. The residence country tax authorities can access this information through exchange of information provisions.

D. RICs are Not Transparent

While the value of a RIC's shares includes the value of any income (such as dividends, interest, or capital gain) earned by the RIC, a shareholder has no right to receipt of that income until a dividend with respect to that income is declared. If an investor sells shares before the dividend is declared, the investor is not entitled to the dividend. Conversely, if the investor buys shares after the income is earned but before the dividend is declared, the investor is entitled to the dividend. Moreover, U.S. tax and securities laws prevent items of income or tax benefit from being allocated specially to individual shareholders. All shareholders in a RIC are entitled to an equal share of any tax treaty benefit received by the RIC.