INVESTMENT COMPANY INSTITUTE

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

Keith Lawson
SENIOR COUNSEL – TAX LAW

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

By Electronic Delivery

June 1, 2012

Gd Ingemar Hansson
Skatteverket
S -171 94 Solna
SWEDEN

RE: *U.S. Mutual Funds (RICs) Should Qualify as Exempt Fund Undertakings*

Dear Director-General Hansson:

The Investment Company Institute ("ICI"),[1] on behalf of the U.S. fund industry, requests confirmation that U.S. mutual funds[2] qualify for the withholding tax exemption provided by Swedish domestic law for dividends paid to "fund undertakings."[3] An announcement by the Swedish Tax Authority that applies to all U.S. mutual funds will reduce substantially the administrative burden on U.S. funds, on their custodians and subcustodians, and on the Swedish Tax Authority. Without such an announcement, every U.S. fund seeking the exemption could be required to file a separate claim and provide sufficient supporting evidence of its qualification as a fund undertaking.

Our request is fully consistent with the recent Swedish Tax Authority announcement that all UCITS funds[4] will receive the "fund undertakings" exemption. Presumably, the guidance provided to UCITS was designed to eliminate the need for each fund to establish separately that it qualifies as a

---

[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 $13.4 trillion and serve over 90 million shareholders.

[2] A "mutual fund" is an open-end investment company that permits daily purchases and redemptions of its shares at net asset value. Our request, as discussed below, is limited to mutual funds that register under the applicable U.S. securities law – the Investment Company Act of 1940 – as open-end investment companies.

[3] http://www.regeringen.se/content/1/c6/17/55/29/dacaae9d.pdf

[4] A UCITS fund is one that satisfies the requirements of the Fourth Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive ("the UCITS IV Directive").

fund undertaking. U.S. mutual funds, as discussed below (and in the enclosed detailed memorandum), are in all relevant respects equivalent to UCITS funds and should receive the same relief.

Organization and Operation of U.S. Mutual Funds

U.S. mutual funds are required to register as open-end investment companies under the Investment Company Act of 1940 ("the 1940 Act").[5] Mutual funds, pursuant to the 1940 Act, must allow shareholders to redeem their fund shares on a daily basis. Although most U.S. mutual funds are organized for retail investors, some are organized only for institutional investment. Many are combined retail/institutional vehicles, with separate classes of shares for the retail and institutional investors. U.S. mutual funds typically have thousands of shareholders; some have hundreds of thousands of shareholders.

Requirements to Claim "Fund Undertaking" Status

A foreign investment fund that is located in an eligible country[6] will be treated as a fund undertaking and qualify for the domestic at-source exemption if:

- the fund is authorized in its home state;
- the fund is organized to make collective investments in transferable securities with capital raised from the public;
- the fund operates the principle of risk allocation; and
- and fund's units are redeemable on demand of the investor.

The Swedish Tax Authority, as noted above, already has announced that a UCITS fund registered under the UCITS IV Directive will be eligible for the domestic tax exemption provided for dividends. A comparable exception has been provided for a non-UCITS fund that is registered with the Swedish Financial Services Authority ("FSA") for sale in Sweden.

U.S. Mutual Funds Meet the "Fund Undertaking" Requirements

U.S. mutual funds meet each of the four requirements to be treated as a fund undertaking. First, our request is limited to those mutual funds that register under the 1940 Act as open-end

---

[5] 15 United States Code §§ 80a-1 *et seq.*

[6] An eligible country is one that (1) is established in the European Economic Area ("EEA"), (2) has a tax treaty with Sweden that includes an exchange of information provision, or (3) has entered into a tax information exchange agreement with Sweden. The U.S. meets the second requirement. Article 26 of the Swedish-U.S. income tax treaty provides for the exchange of tax information. *See also,* http://www.skatteverket.se/download/18.71004e4c133e23bf6db800062000/Double+taxation+agreements.pdf.

investment companies. Pursuant to the 1940 Act, U.S. mutual funds are both authorized by U.S. securities laws and subject to extensive regulatory oversight by the U.S. Securities and Exchange Commission.

Second, all such funds are pooled investment vehicles that hold securities of multiple issuers. Under the U.S. tax laws applicable to mutual funds (found in Subchapter M of the U.S. Internal Revenue Code),[7] a fund cannot qualify for Subchapter M treatment as a regulated investment company ("RIC") unless its portfolio is diversified sufficiently.[8]

Third, the risks of the fund's investments are shared equally by all of the fund's investors. Funds are required every day to calculate a net asset value ("NAV") for its shares. The NAV is calculated by dividing the value of a fund's assets, net of all expenses and other liabilities, by the number of shares outstanding. Every fund investor bears the same per-share risk that the value of the fund's portfolio securities will fall (as each receives the same per-share benefit that the value of the fund's portfolio securities will rise).

Finally, mutual funds are required to redeem an investor's shares upon shareholder demand. This daily redemption feature is one that distinguishes mutual funds from other types of U.S. investment vehicles (such as hedge funds).

It is instructive that the European Court of Justice, in the Santander case,[9] did not distinguish between the eight European UCITS and the two U.S. funds that were claimants in the consolidated test case. The Santander case, as you know, involved the application of Article 63 of the Treaty on the Functioning of the European Union (regarding free movement of capital) to withholding tax imposed by France on dividends paid by French companies to non-French funds (but not to French funds). As the Court effectively recognized, U.S. funds are equivalent to UCITS for all relevant withholding tax purposes. Indeed, the English-language version of the opinion refers to the two U.S. funds as "U.S. UCITS."

* * *

Consequently, we respectfully request that the Swedish Tax Authority issue this guidance to all U.S. mutual funds that register with the SEC under the Investment Company Act of 1940 as open-end investment companies. Such guidance will prevent each U.S. fund investing in Sweden from

---

[7] *See* Internal Revenue Code section 851 *et seq.*

[8] *See* Internal Revenue Code section 851(b)(3).

[9] The English-language version of the Court's opinion is found at: http://curia.europa.eu/juris/document/document.jsf?text=&docid=122645&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=944041.

being required to file its own proof of qualification and recover taxes by reclaim, rather than at-source. The administrative savings for U.S. funds, for their custodians, and for the Swedish Tax Authority, support our request. 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

Enclosure

June 1, 2012

U.S. OPEN-END REGISTERED INVESTMENT COMPANIES QUALIFY AS "FUND UNDERTAKINGS" UNDER SWEDISH DOMESTIC LAW

Mutual funds that are organized in the United States as registered investment companies under the Investment Company Act of 1940[1] ("the 1940 Act") meet all four requirements of Swedish law to be treated as "fund undertakings" exempt from withholding tax. These funds in all relevant respects are comparable to funds that satisfy the requirements for treatment as an Undertaking for Collective Investment in Transferable Securities ("UCITS") – which the Swedish Tax Agency already has determined qualify as "fund undertakings." Indeed, this comparability determination also has been made by the European Court of Justice which, in the Santander decision,[2] held that two U.S. funds were comparable to French UCITS for purposes of Article 63 of the Treaty on the Functioning of the European Union (regarding free movement of capital).

The letter accompanying this memorandum explains why U.S. mutual funds qualify as "fund undertakings" under Swedish law. This memorandum supplements the letter by providing additional information regarding U.S. funds. Specifically, the 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 ("IRC") 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

---

[1] 15 U.S.C. §§ 80a-1 *et seq.*

[2] The English-language version of the Court's opinion is found at: http://curia.europa.eu/juris/document/document.jsf?text=&docid=122645&pageIndex=0&doclang=EN&mode=lst&dir=&occ=first&part=1&cid=944041.

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").

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 tax treatment (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.

Under the "good income" test,[3] at least 90 percent of a fund's gross income must be derived from certain sources, including dividends, interest, payments with respect to securities loans, and gains from the sale or other disposition of stock, securities, or foreign currencies.

Under the "diversification" test,[4] at least 50 percent of the value of the fund's total net assets must consist of cash, cash items, government securities, securities of other funds, and investments in other securities which, with respect to any one issuer, represent neither more than 5 percent of the assets of the fund nor more than 10 percent of the voting securities of the issuer. Further, no more than 25 percent of the fund's assets may be invested in the securities of any one issuer (other than government securities or the securities of other funds), the securities (other than the securities of other funds) of two or more issuers which the fund controls and are engaged in similar trades or businesses, or the securities of one or more qualified publicly traded partnerships.[5]

Pursuant to the distribution requirement,[6] 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

[3] *See* IRC § 851(b)(2).

[4] *See* IRC § 851(b)(3).

[5] Each of these diversification requirements is applied at the close of each quarter of the fund's taxable year.

[6] *See* IRC § 852(a)(1).

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[7] 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 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.

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.

[7] *See* IRC § 4982.

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 <u>not</u> 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(a) of Article 3 of the Sweden-U.S. Convention defines a "person" to include "a trust . . . a company, and any other body persons." 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 Protocol, signed on September 30 2005, to the Convention, in discussing the "beneficial ownership" requirement of Article 10 (Dividends) provides that "the beneficial owner of the dividend . . . is the person to which the income is attributable for tax purposes." RICs, as discussed above, take the dividend income into account for their own tax purposes, retain full control over their income, and (as discussed in detail in III.C, below) are not transparent; in addition, they are not acting as agents for other investors. RICs thus are the beneficial owners of their income.

B. <u>RICs are Owned Almost Exclusively by U.S. Investors</u>

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>RICs are Not Transparent</u>

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 benefit received by the RIC.