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Statement of the Investment Company Institute
Hearing on "International Tax Reform"
Committee on Finance
United States Senate

October 3, 2017

The Investment Company Institute ("ICI")[1] appreciates the opportunity to provide the Committee its comments regarding international tax reform. ICI applauds the Committee for its efforts to improve and simplify the tax code in a manner that spurs US economic growth and job creation.

As the Committee is aware, an important component of any comprehensive tax reform initiative is updating our international tax system to make our nation more competitive in the global economy and to encourage foreign investment in the United States.

ICI supports changes to the Internal Revenue Code ("Code") that would increase foreign investment in US regulated investment companies ("RICs"), more commonly known as mutual funds. Specifically, ICI proposes an investment vehicle that would encourage foreign investment in RICs by reducing the disparate tax treatment between US and foreign funds and thereby allow RICs to compete more effectively with foreign funds for foreign investors.

Foreign Investment in US RICs Should Be Encouraged

ICI strongly supports increasing the international competitiveness of US mutual funds. Almost 47 percent of all mutual fund assets are held by US-domiciled funds.[2] The percentage of global fund industry assets held by US funds, however, has declined as investment markets have globalized.

Changes taking place in Asia, Europe, and elsewhere are providing many significant opportunities for growth in the asset management industry. "Cross-border mutual funds" (*i.e.*, mutual funds that are domiciled in one country but offered for sale in other countries) have enjoyed explosive growth. At the end of 2016, there were more than 100,000 foreign mutual funds and ETFs in existence, compared to fewer than 10,000 mutual funds

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$20.5 trillion in the United States, serving more than 100 million US shareholders, and US$6.7 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] https://www.ici.org/pdf/2017_factbook.pdf, Table 65.

and ETFs domiciled in the United States.[3] Today virtually no US mutual fund is marketed or offered on a cross-border basis, even though many cross-border mutual funds invest in US assets.

The US tax laws require US mutual funds to distribute essentially all their income and gains on an annual basis to avoid double taxation. This distribution requirement creates a substantial barrier to marketing US funds abroad because foreign investors incur a home-country tax when such income and gain is distributed to them. Foreign investors may also be subject to higher tax rates if their home country treats capital gain dividends paid by RICs as dividends that are not eligible for preferential capital gains tax rates. Many foreign funds, in contrast, are permitted to retain (or "roll up") their income without either current taxation of the fund or any obligation to distribute the income to investors.

US mutual funds could compete effectively against foreign mutual funds if they were not required to distribute their income currently to their foreign investors. US products would offer several advantages to foreign investors. First, the size and sophistication of US funds allow them to invest more efficiently and operate at lower cost than their smaller foreign counterparts. Second, the protection afforded by US securities regulation is considered state of the art, including in particular the protections afforded by the Investment Company Act of 1940. Third, the US has a deep pool of highly skilled workers to run its investment products. Fourth, the US already has underlying retail investment products in place for all major asset classes that would make the IRIC attractive to foreign investors.

Investment Vehicle to Encourage Foreign Investment in US RICs

ICI proposes an investment product called an International Regulated Investment Company ("IRIC") that is designed to reduce US tax disadvantages that prevent US mutual funds from competing effectively against foreign mutual funds. Prompt enactment of legislation creating IRICs is critical if US mutual funds are to compete in the rapidly globalizing investment markets. If the IRIC proposal is not enacted, US funds (particularly at small and medium sized fund companies) will continue to cede ground to foreign funds.

The IRIC provides foreign investors with a feeder vehicle through which they can access a US mutual fund without triggering certain negative tax consequences in their home countries. An IRIC would be a US mutual fund that could be acquired only by foreign shareholders (only nonresident alien individuals and their foreign estates, and qualified foreign pension funds) and that would invest only in the shares of a single US mutual fund that qualifies as a RIC under Subchapter M of the Internal Revenue Code. The IRIC would register with the Securities and Exchange Commission under the Investment Company Act of 1940.

The IRIC would not be required to distribute its income or capital gain annually. IRIC investors, however, would effectively pay the same annual US income tax as if they had invested directly in the RIC shares held by the IRIC. Instead of tax being collected on distributions by the RIC to the foreign investor, however, the tax would be paid by the IRIC on the distributions it receives from the underlying RIC. The tax rate applied to the IRIC's taxable income would be 30 percent (the current rate applied to taxable distributions, such as dividends,

[3] Id. Table 66.

paid to foreign persons) or 15 percent (if all the IRIC's shareholders were entitled under applicable tax treaties with the US to a rate of 15 percent or less) and the IRIC made a "treaty IRIC" election to pay tax at that rate.

Thus, the same US tax revenue would be collected, but the foreign investor would not be subject to tax in his or her home country until the IRIC shares were sold (absent a current inclusion tax regime comparable to the PFIC regime in the US). The RIC in which the IRIC invests would remain subject to the Internal Revenue Code's distribution requirements, as under present law.

Conclusion

ICI commends the Committee for its goal of modifying the international provisions of the Code in a manner that will improve US competitiveness abroad and thereby enhance foreign investment in the US. The proposal that ICI advances is consistent with this goal and, if adopted, will increase foreign investment in US RICs.

ICI would be pleased to work with the Committee on the IRIC proposal or other legislation that would level the playing field so US mutual funds are able to better compete in the rapidly globalizing investment markets.