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Foreign Investors in U.S. Mutual Funds: The Trouble with Treaties

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FOREIGN INVESTORS IN U.S. MUTUAL FUNDS: THE TROUBLE WITH TREATIES

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The United States is generally a tax haven for foreign portfolio investors: the United States exempts from tax most U.S. source interest and capital gains, but taxes dividends from U.S. companies; tax treaties generally eliminate U.S. tax on interest and reduce the 30% statutory rate on dividends.

Foreign investors in U.S. mutual funds have not been treated as favorably. Fund distributions (other than of net capital gains) were originally treated as taxable dividends, regardless of the fund's underlying income. Interest or short-term capital gains earned by the mutual fund — which would have been tax exempt if directly earned by a foreign investor — were converted into taxable dividend income when distributed.

To encourage foreign investment in U.S. mutual funds, Congress in 2004 modified the mutual fund distribution rules to exempt from tax fund dividends that are attributable to the fund's U.S. source interest income or short-term capital gains. The stated goal of the legislation was to tax foreign investors on the same basis as if they had directly earned their share of a fund's income.

These provisions fail to fully achieve this goal by denying pass-through treatment for foreign source interest and dividends. This policy appears to be aimed at preventing foreign investors from using a U.S. mutual fund to obtain U.S. treaty benefits.

Foreign source income should retain its source and character when distributed to foreign shareholders. This tax treatment is consistent with the tax results a foreign investor realizes when he or she invests directly or through a partnership and encourages foreign investment in mutual funds that invest globally. The treaty shopping concerns may be illusory. To address potential treaty abuse, Congress could consider limiting the pass-through of foreign source income to treaty residents.

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I. INTRODUCTION

U.S. mutual funds hold roughly 50% of the worldwide total net assets of all mutual funds.[1] U.S. mutual funds provide many potential benefits to investors, including diversification, regulatory oversight, professional investment management,[2] economic exposure to a wide variety of asset classes, daily liquidity for shareholders of open-end funds, simple procedures to reinvest income, and instant liquidity for shareholders of closed-end and exchange-traded funds (ETFs).[3] Mutual funds offer small domestic investors access to foreign markets and issuers that would be practically impossible to accomplish through direct investment.[4] The basic U.S. tax and regulatory regime governing mutual funds has been stable for seventy years,[5] and U.S. mutual fund management fees are among the lowest in the world.[6]

U.S. mutual fund shareholders have benefited from a relatively benign tax regime in Subchapter M.[7] If a fund satisfies certain requirements regarding the composition and distribution of its income, the fund avoids

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[1] INV. CO. INST., 2014 INVESTMENT COMPANY FACT BOOK 219 tbl.60 (54th ed. 2014) [hereinafter FACTBOOK], https://www.ici.org/pdf/2014_factbook.pdf. In 2013, U.S. mutual funds held $15 trillion in assets, and the total worldwide assets of mutual funds were $30 trillion.

[2] Mutual funds can be divided into those funds that offer active management, in which fund managers trade securities based on their views of expected future price, and passive management, in which managers construct their portfolios to match a particular index, such as the S&P 500 index.

[3] There are mutual funds that offer exposure to commodities, foreign stocks and bonds, and narrow sectors of the market.

[4] To purchase foreign securities, an investor may have to open a foreign brokerage and bank account and deal with foreign currency and tax issues.

[5] Mutual funds are subject to the provisions of the Investment Company Act of 1940, which is codified at 15 U.S.C. § 80a-1(b)(1)–(8) (2012). The tax rules governing mutual funds are in Part I, Regulated Investment Companies (sections 851 through 855), of Subchapter M of the Internal Revenue Code (Code). This article uses the terms "mutual fund," "fund," and "RIC" interchangeably.

[6] Ajay Khorana, Henri Servaes, & Peter Tufano, *Mutual Fund Fees Around the World*, 22 REV. FIN. STUD. 1279, 1287–88 tbl.2 (2009) (finding that funds sold in the United States had the lowest total expense ratio in a sample of eighteen countries).

[7] *See supra* note 5.

entity-level taxation; instead, the fund's shareholders are taxed on fund distributions. Moreover, unlike dividends paid by other U.S. corporations, dividends paid by a mutual fund partially reflect the tax character of the underlying fund income, such as net capital gain and tax-exempt interest. By characterizing certain portions of mutual fund dividends in accordance with the fund's income, Subchapter M aims to impose roughly the same tax burden on fund shareholders had they directly earned their share of the fund's income, i.e., modified pass-through treatment.[8]

For foreign persons investing directly in U.S. stocks, bonds, and derivatives, the United States is a tax haven: most U.S. source interest income and capital gains of foreigners are exempt from tax regardless of amount. Dividends paid by U.S. corporations, royalties paid for the use of intangible property in the United States, and gains from the sale of U.S. real property interests are generally the only types of passive investment income taxed by the United States.[9]

In contrast to the favorable U.S. tax regime for foreign direct investment, Subchapter M historically has been less hospitable to foreign investment. Before 2004, Subchapter M recharacterized only a fund's net capital gains and tax-exempt interest when they were distributed.[10] A fund distribution was otherwise treated as a U.S. source dividend even though it was economically attributable to the fund's underlying foreign source interest, dividends, or short-term capital gains.[11] Consequently, a foreign

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[8] *See infra* Part II.B.

[9] U.S. source dividends and royalties are taxed at 30%. I.R.C. §§ 871(a)(1), 881(a)(1) (U.S. source dividends and royalties paid to foreigners are subject to a 30% tax). Treaties reduce the 30% rate on dividends to 15%, 5%, or 0% depending on the recipient's ownership percentage of the payor corporation. I.R.S. PUB. 515, Withholding on Tax on Nonresident Aliens and Foreign Entities 51 tbls.1 (2016), https://www.irs.gov/PUP/individuals/international/Tax_Treaty_Table_1.pdf. Source basis taxation of royalties is generally eliminated under treaties. *Id.* Rental income from U.S. property is also potentially subject to flat 30% tax, but since rental property generally constitutes a U.S. trade or business, rental income is taxed at graduated rates (with allowance for deductions). *Id.* This article focuses solely on income traditionally earned by RICs such as capital gains, interest, and dividends, and will not further discuss the taxation of royalties and real estate income.

[10] Certain mutual funds are able to pass through foreign tax credits. *See* I.R.C. § 853(a)(1) discussed *infra* Part II.B. A dividend that is attributable to a fund's qualified dividend income is treated as a qualified dividend, regardless of a particular investor's holding period in the fund shares. *See* I.R.C. § 854(b)(1)(B). Notice 2004-39 sets forth rules for applying the differing tax rates in section 1(h) to the capital gains dividends paid by RICs. I.R.S. Notice 2004-39, 2004-1 C.B. 982. These rules are only relevant for U.S. taxpayers.

[11] Since a RIC is a U.S. corporation, a dividend paid to a foreign investor would be

investor in a U.S. mutual fund often faced a significantly higher U.S. tax burden than if the investor had earned directly his or her share of the fund's income.

To encourage foreign investment in U.S. mutual funds, Congress amended in 2004 sections 871(k) and 881(e) of the Internal Revenue Code (Code) to exempt from tax mutual fund dividends paid to foreign investors if the dividends are attributable to a fund's interest income and short-term capital gains.[12] The stated goal of the legislation was to tax foreign mutual funds investors on the same basis as if they had directly earned their share of the fund's underlying income.[13]

The legislation, however, fails to fully implement this policy goal. In particular, only *U.S. source* interest is reclassified; *foreign source* interest and dividends are *not* reclassified, and when they are distributed to a foreign shareholder, they are a taxable *U.S. source* dividend.[14] Consequently, a foreign investor that owns a global money market, bond, or stock fund will be taxed on the fund's foreign source income even though it would have been exempt from U.S. tax had the foreign investor directly earned the foreign source income.

The legislative history does not discuss the rationale for excluding foreign source income. Earlier versions of the 2004 legislation provided for look-through treatment for foreign source interest that was exempt from foreign tax *without* regard to a treaty.[15] The limitation on reclassifying foreign source income thus appears to be motivated by a concern that foreign investors could invest in a Regulated Investment Company (RIC) and indirectly obtain U.S. treaty benefits that the investors could not obtain directly.[16]

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taxed at 30%. I.R.C. §§ 871(a)(1), 881(a)(1) (U.S. source dividends paid to foreigners are subject to a 30% tax rate). Capital gain dividends paid by a RIC were exempt from U.S. tax. *See infra* note 59.

[12] American Jobs Creation Act of 2004 § 411(a)(1).

[13] H.R. REP. NO. 108-548, pt. 1, at 164 (2004).

[14] I.R.C. § 871(k)(1)(E) (defining qualified interest income to include only U.S. source interest).

[15] *See infra* Part. III.D.

[16] The extension of look-through treatment for foreign investors in U.S. mutual funds raises a policy question of whether such treatment should also be expanded for U.S. persons. Income, such as nonqualified dividends, interest, and short-term capital gains, is taxed at the same rates for U.S. taxpayers. The character of the income, however, can still matter because of its interaction with a U.S. taxpayer's other income. The failure to pass through short-term capital gains does not fully implement Subchapter M's policy goal of tax transparency and seems unnecessarily detrimental to U.S. taxpayers.

This article first briefly reviews the U.S. taxation of foreign portfolio investors and U.S. mutual funds and their U.S. shareholders, and it discusses why foreign investment in U.S. mutual funds had been historically tax inefficient. It then analyzes and critiques the 2004 amendments and explores the complications that arise when applying treaties to RICs. It builds on and extends two important articles that examine the treatment of foreign investors in U.S. funds and the international tax issues of global investment funds.[17]

This article argues that the treatment of a RIC's foreign source income is inconsistent with the policy goals of the 2004 amendments and the general goal of neutrality of tax treatment of portfolio returns earned by investing directly or through a mutual fund, and it recommends extending look-through treatment to all foreign source income. This article demonstrates that the treaty shopping concern is mostly illusory, but it considers alternatives such as limiting look-through to foreign investors who are eligible for treaty benefits. This could be done on a unilateral, bilateral, or multilateral basis.

II. THE TAXATION OF U.S. MUTUAL FUNDS AND THEIR U.S. SHAREHOLDERS

A. Regulated Investment Companies

The tax rules governing mutual funds and their shareholders are found in Subchapter M, the contours of which were largely established in the Revenue Act of 1942.[18] To qualify as a RIC, an entity must be a domestic corporation (including a trust taxed as a corporation) and must be generally registered under the Investment Company Act of 1940 as a management company or unit investment trust.[19]

A RIC avoids corporate-level tax by satisfying certain distribution, gross income, and diversification tests. A RIC satisfies the *distribution test* by distributing 90% or more of its *investment company taxable income*

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[17] *See* Robert J. Staffaroni, *Foreign Investors in RICs and REITs*, 56 TAX LAW. 511 (2003); Kimberly S. Blanchard, *Cross-Border Problems of Investment Funds*, 60 TAX LAW. 583 (2007).

[18] *See* Jeffrey M. Colon, *Oil and Water: Mixing Taxable and Tax-Exempt Shareholders in Mutual Funds*, 45 LOY. U. CHI. L.J. 773, 778–788 (2014).

[19] I.R.C. § 851(a)(1)(A)–(B). Certain common trust funds can also be taxed as RICs. I.R.C. § 851(a)(2). Common trust funds are funds maintained by a bank to collect and invest capital received in its capacity as a trustee, etc., in connection with fiduciary accounts such as trusts and estates. I.R.C. § 584(a).

(ICTI),[20] which is regular corporate taxable income with certain adjustments, such as the exclusion for net capital gains (NCGs).[21] A RIC avoids corporate-level tax on its NCGs if it distributes 90% or more of its NCGs.[22] In calculating its ICTI and NCGs, a RIC deducts dividends of the ICTI and NCGs paid to its shareholders.[23] The deduction for dividends paid is the mechanism by which RICs avoid corporate-level tax.

To satisfy the *gross income* requirement, a RIC must derive at least 90% of its gross income from investment-type income such as dividends, interest (both taxable and tax-exempt), income from securities lending, gains from the sale of stock and securities, gains realized from foreign currencies, and derivatives based on stocks or securities such as options, forwards, and futures.[24] The underlying premise of the gross income requirement is that RICs should focus on earning investment income as opposed to operating income.[25]

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[20] I.R.C. § 852(a)(1)(A). The deduction for dividends paid must equal or exceed 90% of ICTI determined without regard to the deduction for dividends paid (excluding net capital gain dividends and exempt-interest dividends). *Id.* Although tax-exempt interest is not ICTI, a corporation must also distribute 90% of its tax-exempt income (less allocable expenses). I.R.C. §§ 852(a)(1)(B), 851(b). When distributed, tax-exempt interest retains its character if, at the close of each quarter, at least 50% of the RIC's assets are tax-exempt obligations. I.R.C. § 852(b)(5). If a RIC is not eligible to pay a tax-exempt dividend, the interest will generate earnings and profits for the RIC and when distributed will constitute a taxable dividend.

[21] I.R.C. § 852(b)(2)(A)–(C).

[22] I.R.C. § 852(b)(2)(A). NCGs are the excess, if any, of net long-term capital gains (NLTCGs) over net short-term capital losses (NSTCLs). NLTCGs, in turn, are the excess, if any, of long-term capital gains over long-term capital losses, and NSTCLs are the excess, if any, over short-term capital losses over short-term capital gains. I.R.C. § 1222. Thus, long-term losses and short-term losses in excess of short-term gains reduce NCGs.

[23] I.R.C. § 852(b)(2)(D) (allowing for dividends, other than capital gains and exempt-interest dividends, to be deductible in computing ICTI), (b)(3)(A) (subjecting RICs to a tax on the NCGs less capital gains dividends paid).

[24] I.R.C. § 851(b)(2). Dividends also include Subpart F inclusions under section 951(a)(1)(A)(i) and certain passive foreign investment company (PFIC) inclusions. I.R.C. § 851(b) (flush language); Treas. Reg. § 1.851-2(b)(2) (as amended in 1978). Also included is income related to a RIC's investment activities. I.R.C. § 851(b)(2)(A). To avoid failing the gross income test, a RIC can interpose a foreign corporation to hold the property that is generating the nonqualifying income. See Willard B. Taylor, *"Blockers," "Stoppers," and the Entity Classification Rules*, 64 TAX LAW. 1 (2010), for a discussion of the use of such entities.

[25] *See* John Morley, *Collective Branding and the Origins of Investment Management Regulation: 1936-1942*, 6 VA. L. & BUS. REV. 341, 357 (2012) (finding that investing in ETFs helps alleviate the tax burden generated by the distribution requirement). *See also*

In keeping with Congress's goal of RICs being passive investors, the *diversification tests* ensure that RICs will generally not own controlling interests in their portfolio companies. RICs are subject to two diversification tests, the 50% and 25% tests.[26] The 50% test requires that at least 50% of a RIC's total assets consist of cash, government securities, securities of other RICs, and securities of other companies.[27] In making this calculation, however, a RIC can only count the securities of a single issuer in an amount up to 5% of the RIC's assets, and it may not count more than 10% of the outstanding voting securities of the issuer.[28] In addition, no more than 25% of a RIC's total assets can be invested in a single issuer, the securities of certain publicly traded partnerships, or two or more issuers that the RIC controls and are determined to be engaged in the same or similar trades or businesses.[29]

B. U.S. RIC Shareholders

A RIC that satisfies the distribution, income, and diversification tests is not subject to corporate-level tax to the extent it distributes its ICTI and NCGs. Instead, a RIC's shareholders are taxed on the dividends received. A goal of the RIC tax regime is to tax shareholders similarly to how they would have been taxed had they directly earned their share of the RIC's income. Consequently, distributions of NCGs, tax-exempt interest, and qualified dividends[30] retain their tax character when distributed.[31]

William A. Birdthistle, *The Fortunes and Foibles of Exchange-Traded Funds: A Positive Market Response to the Problems of Mutual Funds*, 33 DEL. J. CORP. L. 69, 90–91 (2008) (examining the tax advantages for mutual funds created by investing in ETFs).

[26] I.R.C. § 851(b)(3) (both of these tests are determined quarterly).

[27] I.R.C. § 851(b)(3)(A).

[28] I.R.C. § 851(b)(3)(A)(ii). With respect to securities where market quotations are available, "value" means the market value; with respect to other securities and assets, "value" means a fair value as determined by the board of directors. I.R.C. § 851(c)(4).

[29] I.R.C. § 851(b)(3)(B)(i)–(iii). Control is defined as "ownership in a corporation of 20% or more of the total combined voting power of all classes of stock entitled to vote." I.R.C. § 851(c)(2). A RIC is protected against failing the diversification tests solely because of subsequent changes in value of the securities in the portfolio. I.R.C. § 851(d)(1) (stating that a RIC will not fail a diversification test solely as a result of changes in the value of a portfolio from one quarter to the next, unless the diversification test is not satisfied immediately after the acquisition of any security and is partly or wholly the result of such acquisition).

[30] I.R.C. § 1(h)(11)(B)(i)(I), (iii) (defining a qualified dividend as a dividend from a domestic corporation if the shareholder satisfies certain holding period requirements). I.R.C. §§ 1(h)(11)(D)(iii) (subjecting dividends issued by a RIC to the limitations set forth in

Not all distributed income, however, retains its tax character. In particular, short-term capital gains become ordinary dividends when distributed. This can be unfavorable to an individual taxpayer with capital losses because short-term gains can offset a shareholder's capital losses without limit, whereas an individual can use only up to $3,000 of capital losses against ordinary income, such as dividends, interest, and wages.[32]

Although the failure to pass-through the character of short-term capital gains is generally detrimental to an individual shareholder, the RIC regime is sometimes more beneficial than direct investment. In computing ICTI, a RIC deducts management expenses solely against ICTI and not against NCGs or qualified dividend income.[33] This netting rule ensures that expenses are not netted against tax-favored income but against ordinary income. Moreover, if a shareholder directly held the fund's securities, the deduction for investment expenses would probably be limited.[34]

Certain RICs are eligible to pass through foreign income taxes paid. Under section 853(a), a RIC can elect to pass through foreign income taxes paid to its shareholders if more than 50% of the value of the RIC's assets consists of stock or securities in foreign corporations.[35] In such case, in computing its income, each RIC shareholder must include a proportionate share of the RIC's foreign taxes paid as foreign source income, and in computing its foreign tax credit, it must treat the proportion of the dividend received attributable to the RIC's foreign source income as foreign source income.[36]

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section 854), 854(b)(1)(B)(i)(III) (prescribing that a dividend received from a RIC whose qualified dividend income is less than 95% of its gross income is qualified dividend income to the extent designated by the RIC), 854(b)(4) (stating that the term "qualified dividend income" as used in section 854 has the same meaning as under section 1(h)(11)(B)).

[31] A RIC shareholder can be taxed on a fund's gains accruing before the investor became a shareholder. *See* Colon, *supra* note 18, at 817–28.

[32] I.R.C. § 1211(b).

[33] I.R.C. § 852(b)(2)(A) (excluding NCGs from ICTI); Rev. Rul. 2005-31, 2005-1 C.B. 1084 ("A RIC's investment company taxable income equals its taxable income (exclusive of net capital gain) reduced by allowable expenses and its deduction for dividends paid determined without regard to capital gains dividends and exempt-interest dividends.").

[34] If a taxpayer's trading does not constitute a trade or business, investment expenses would be deductible only to the extent that they exceed 2% of a taxpayer's adjusted gross income. I.R.C. §§ 67(a), 212. Pursuant to section 67(c)(2), the Treasury is prohibited from treating expenses of publicly offered RICs as being subject to the 2% floor of section 67. I.R.C. § 67(c)(2).

[35] I.R.C. § 853(a).

[36] I.R.C. § 853(b)(2)(A)–(B). The statute specially provides that the foreign source

Since a $1 tax credit reduces taxes by $1, it usually is more beneficial for a RIC to pass foreign taxes through to its shareholders than to deduct or credit them against its ICTI.[37] It is likewise generally more beneficial for a U.S. taxpayer to elect the foreign tax credit under section 901 than to deduct the foreign taxes.[38]

If a RIC does not make the section 853 election, either because it opts not to or because it does not hold the requisite percentage of foreign assets, the RIC may elect to credit the taxes pursuant to section 901[39] or simply deduct them from ICTI under section 164.[40] If a RIC deducts the foreign taxes, ICTI is decreased by the amount of the foreign taxes, and a RIC's shareholder's taxes are roughly reduced by the amount of the deduction times the shareholder's marginal tax rate.[41]

Since not all of a RIC's income retains its character when distributed, the RIC regime can be described as a modified pass-through regime. The failure to pass through the character and source of all RIC income historically has made RICs a tax-inefficient vehicle for foreign investors.

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characterization is for the purpose of computing the foreign tax credit and therefore does not otherwise convert a RIC dividend into foreign source income. *See* I.R.C. § 853(b)(2)(B). To illustrate, assume that a RIC earns $10,000 of ICTI, $8,000 of foreign source income and $2,000 of U.S. source income, and pays $1,000 of foreign taxes. If the RIC makes a section 853 election and distributes all of its ICTI, a shareholder will receive a dividend of $9,000 (the ICTI less the foreign taxes), but will have to include $10,000 in income (the dividend plus the foreign taxes). If the shareholder elects the foreign tax credit under section 901, it can potentially reduce its U.S. taxes by $1,000. *See* I.R.C. § 901(a). The actual amount that can be credited will depend on the shareholder's total U.S. and foreign source income and allocable deductions. *See* I.R.C. §§ 861(b), 904 and the regulations thereunder. *See infra* Part III.B (discussing the application of this rule to foreign investors).

[37] The leading tax treatise on mutual funds states that eligible RICs typically make the section 853 election to pass through foreign income taxes paid to its shareholders. SUSAN A. JOHNSTON & JAMES R. BROWN, JR., TAXATION OF REGULATED INVESTMENT COMPANIES AND THEIR SHAREHOLDERS, ¶ 3.08[3][b][i] (2016). Using data for tax years 2003 and 2004, however, one researcher estimates that less than 25% of eligible funds make the section 853 election. Janie Casello Bouges, *When Mutual Funds Fail to Make Foreign Tax Elections: What Does the Investor Lose?*, 25 J. TAX'N INV. 33 (2008).

[38] A deduction could be more beneficial than a credit for a taxpayer who has expiring excess foreign tax credits.

[39] I.R.C. § 901(a).

[40] I.R.C. § 164(a)(3).

[41] In limited circumstances, it can be beneficial for the RIC to retain up to 10% of its income and elect to credit foreign taxes against its tax liability. See JOHNSTON & BROWN, *supra* note 37, at ¶ 3.08[3][b][ii], for a discussion of when doing so can be beneficial.

III. FOREIGN INVESTORS AND U.S. MUTUAL FUNDS

A. The U.S. Taxation of Foreign Portfolio Investors

Foreign portfolio investors[42] are taxed at a flat 30% rate on U.S. source income that is fixed, determinable, annual or periodic (FDAP), such as interest paid by U.S. obligors and dividends from U.S. companies.[43] Most U.S. source interest, however, including interest on bank deposits and portfolio debt, is exempt from the 30% tax.[44] In addition, foreign investors pay no U.S. tax on capital gains from the sale of debt instruments, most stocks, options, commodities, and derivatives.[45] Dividends paid by a U.S.

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[42] This article focuses solely on foreign portfolio or passive investment. A passive investor is one who does not hold a sufficient interest in an entity to influence management's business decisions or control the entity. Portfolio investment is generally defined to be direct or indirect ownership of less than 10% of an entity's voting power. ORG. FOR ECON. CO-OPERATION & DEV. [OECD], OECD BENCHMARK DEFINITION OF FOREIGN DIRECT INVESTMENT, at 17 (4th ed. 2008) (describing how direct investors, in contrast to portfolio investors, seek to establish a lasting interest in the enterprise and to influence management, which is evidenced by owning at least 10% of the voting power of the enterprise). A foreign person is a foreign corporation or a nonresident alien. *See* I.R.C. § 7701(a)(5) (defining a foreign corporation as a corporation not organized in the United States or under state law); I.R.C. § 7701(b) (defining a nonresident alien as an individual that is neither a citizen nor a resident of the United States).

[43] I.R.C. § 871(a)(1) (placing a 30% tax on the U.S. source FDAP income of nonresident aliens); I.R.C. § 881(a) (placing a 30% tax on the U.S. source FDAP income of foreign corporations).

[44] I.R.C. § 871(i)(1) (granting an exemption for interest on bank deposits); I.R.C. § 871(h)(1) (granting an exemption for interest on portfolio debt). Portfolio interest is all U.S. source interest on registered obligations, but it excludes certain contingent interest and interest received by 10% shareholders. I.R.C. § 871(h)(4) (excluding certain contingent interest); I.R.C. § 871(h)(3) (excluding interest received by 10% shareholders).

[45] Gains from the sale of U.S. real property and stock of a U.S. company that is a U.S. real property holding company are treated as effectively connected income and subject to tax, unless the company is publicly traded and the seller owns 5% or less. I.R.C. § 897(a)(1) (treating such gains as effectively connected income); I.R.C. § 897(c)(3) (exempting such gains when the company is publicly traded and the seller owns less than 5%). With the exception of gains from the sale of U.S. real estate, capital gains of foreign persons are neither FDAP income nor generally subject to U.S. tax. The heading to section 871(a)(1), which describes FDAP income, limits its application to "income other than capital gains." *See* I.R.C. § 871(a)(1); Treas. Reg. § 1.871-7(a)(1) (as amended in 1997) (stating that nonresident aliens are generally not taxable on "gains from the sale or exchange of property"); Treas. Reg. § 1.1441-2(b)(2)(i) (as amended in 2013) (excluding gains from the sale of property from FDAP income for withholding tax purposes). In addition, the sale of personal property, including stocks and bonds, by a foreign person is generally foreign

corporation and passive royalties received for the use of intangible property in the United States are the only passive investment income taxed by the United States. The *foreign source* investment income of foreign persons without a U.S. trade or business, such as interest paid by a foreign obligor or dividends from a foreign corporation, is naturally exempt from U.S. tax.[46]

The United States has a long history of encouraging foreign investment in U.S. stocks, bonds, and commodities, even for large-scale investment activity. Trading in securities can sometimes constitute a trade or business if the taxpayer executes a sufficient number of trades throughout the year and attempts to profit from short-term price movements rather than price increases that reflect longer-term strategies.[47] Since 1936, foreign investors have benefited from two statutory trading safe harbors, one for "trading" and the other for "trading for one's own account." A foreign investor trading its own funds will not have a U.S. trade or business even if it has a U.S. office and hires employees with or without discretionary authority to effect the transactions.[48] Trading on behalf of others through a broker or other independent agent is also not a U.S. trade or business if the investor does not have an office or fixed place of business in the United States through which the transactions are effected.[49] If a foreign investor's trading

source income and therefore exempt. *See* I.R.C. § 865(a)(2) (qualifying income from the sale of personal property by nonresidents, which includes nonresident aliens with a foreign tax home and foreign corporations, as foreign source income). U.S. source capital gains from the sale of intellectual property contingent on use in the United States are subject to U.S. tax under section 871(a)(1)(D) as are U.S. source capital gains of nonresident aliens present in the United States for 183 days or more. *See* I.R.C. § 871(a)(2). Derivative income is generally sourced by the residence of the recipient, except to the extent that a foreign person receives a dividend equivalent payment, i.e., a payment that is determined by reference to a U.S. source dividend. *See* I.R.C. § 871(m).

[46] *See* I.R.C. § 872(a)(1) (including only U.S. source income in the gross income of a nonresident alien not engaged in a U.S. trade or business).

[47] *See, e.g.*, Estate of Yaeger v. Comm'r, 55 T.C.M. (CCH) 1101 (1988), *aff'd*, 889 F.2d 29 (2d Cir. 1989); Ball & Northrop v. Comm'r, 80 T.C.M. (CCH) 184 (2000). If a foreign investor's activities rise to the level of those of a trade or business, the United States taxes the effectively connected income at graduated rates with deductions for ordinary and necessary business expenses. I.R.C. § 871(b).

[48] I.R.C. § 864(b)(2)(A)(ii), (B)(ii) (excluding from the term "trade or business" the trading of stocks, securities, and commodities for a non-dealer taxpayer's own account). *See* Erika W. Nijenhuis, *The Section 864(b)(2) 'Trading in Derivatives' Safe Harbor*, 39 TAX MGM'T. MEMORANDUM (BNA) 371 *passim* (Nov. 9, 1998), for a discussion of this provision.

[49] I.R.C. § 864(b)(2)(A)(i), (B)(i), (C) (trading through U.S. broker or other

activity falls within these safe harbors, the activity will not constitute a U.S. trade or business regardless of the number of trades, the amount traded, or the gain recognized; the foreign investor's capital gains will be exempt from U.S. tax; and the FDAP rules will apply to the investor's U.S. source interest and dividends.

The U.S. policy is to encourage foreign capital to flow unimpeded by source basis taxation. Underlying this policy is the belief that this capital increases market liquidity and helps to lower the cost of capital for all businesses, and that the lost revenue from source taxation is compensated by the increased income of U.S. intermediaries, such as brokers and advisers.

The United States has entered into sixty-seven bilateral income tax treaties, which modify the application of domestic tax rules for treaty residents.[50] The principal aim of tax treaties is to mitigate tax avoidance and double taxation, which is accomplished primarily by significantly reducing or eliminating source country taxation. Under most U.S. treaties, any residual tax on U.S. source interest is eliminated, the 30% tax on royalties is eliminated, and the 30% rate on dividends is reduced to a maximum rate of 15%.[51] For shareholders owning more than 10% of the payor corporation, the treaty dividend rate generally drops to 5%, and in recent treaties, the dividend rate drops to 0% for distributions from 80%-owned subsidiaries or to pension plans.[52]

Given the favorable tax treatment accorded to foreign passive investors under the Code and tax treaties, the United States holds itself out as a tax haven for passive foreign investment capital. In 2011, foreigners received \$568 billion of U.S. source income, of which \$509 billion (90%) was exempt from tax.[53] \$444 billion (78% of all payments) was paid to treaty residents.[54] Of the \$59 billion subject to tax, only \$8.9 billion of tax was

independent agent does not create a trade or business provided that a taxpayer has no U.S. office or fixed place of business).

[50] https://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties—-A-to—Z.

[51] For a table summarizing the treaty rates applicable to U.S. source income received by treaty residents, see I.R.S. PUB. 515, Withholding on Tax on Nonresident Aliens and Foreign Entities 51 tbl.1 (2016), https://www.irs.gov/PUP/individuals/international/Tax_Treaty_Table_1.pdf.

[52] *Id.*

[53] Scott Luttrell, *Foreign Recipients of U.S. Income, 2011*, STAT. INCOME BULL. 8 tbl.1 (Feb. 27, 2015), https://www.irs.gov/pub/irs-soi/soi-a-init-id1501.pdf.

[54] *Id.*

collected ($5.4 billion was collected from treaty investors).[55] Foreign investors received $110 billion of U.S. source dividends, of which treaty residents received about 90%.[56] These data demonstrate that treaty residents supply most of the foreign capital invested in the United States.[57]

B. The U.S. Taxation of Foreign Investors in RICs

Although the United States has long been a tax haven for direct foreign portfolio investors, accessing U.S. capital markets indirectly through RICs has been historically tax inefficient for foreign investors. Gain realized by a foreign investor on the sale of shares of a U.S. mutual fund has been treated similarly to the gain from the sale of other capital assets and therefore exempt from U.S. tax.[58] In addition, under long-standing administrative guidance, distributions of capital gain dividends by U.S. RICs have been treated as tax-exempt capital gains for foreign shareholders.[59] The tax inefficiency specifically arose with respect to mutual fund distributions that were treated as ordinary dividends and therefore taxed at 30% (unless reduced by a treaty) even though the dividends were attributable to a fund's short-term capital gains, interest income, foreign source dividends, or swap income. If a foreign investor had directly earned any of this income, it would have been exempt from U.S. tax.[60]

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[55] *Id.*

[56] *Id.* at 9 tbl.1.

[57] One can assume that treaty residents also supply indirectly a portion of the capital invested by nontreaty residents, e.g., through investment in entities in the Cayman Islands.

[58] In an open-end mutual fund, an investor may request that the fund redeem his or her shares at net asset value (NAV). Since 2010, a redemption of shares of a publicly traded RIC is treated as a sale or exchange and not a dividend regardless of the percent of the shares redeemed. *See* I.R.C. § 302(b)(5).

[59] *See* Rev. Rul. 69-244, 1969-1 C.B. 215, *obsoleted by* T.D. 8734, 1997-2 C.B. 109 (stating that capital gain dividends do not constitute fixed or determinable annual or periodical income under section 1441 and are not subject to withholding under sections 1441 and 1442). In addition, a RIC (or intermediary such as a bank or brokerage house) can elect to reduce withholding on distributions representing capital gain dividends (and exempt interest dividends). Treas. Reg. § 1.1441-3(c)(2)(i)(D) (as amended in 2015). Special rules for RIC distributions are found in Treas. Reg. § 1.1441-3(c)(3)(i)–(ii) (as amended in 2015).

[60] Prior to 1986, distributions from RICs that invested primarily in foreign securities could be treated as foreign source income and therefore exempt from U.S. tax. Rev. Rul. 69-235, 1969-1 C.B. 190, held that dividends and capital gains dividends paid by a RIC to a nonresident alien were foreign source income if 80% or more of the RIC's gross income was foreign source. The 80% rule was based on former section 861(a)(2)(A), which was effective for payments made before January 1 1986, and which provided that if less than 20% of a

To add further insult to injury, a foreign investor in a RIC that makes a section 853 foreign tax credit election may also be taxed on the foreign taxes paid by the RIC even though the investor does not actually receive the income.[61] Section 853(b)(2)(A) provides that *each shareholder* of a RIC that makes a section 853 election must "include in gross income and treat as paid by him his proportionate share of such taxes." For a U.S. shareholder, this provision places the shareholder in the same position had he or she directly earned the foreign source income and prevents a shareholder from obtaining the benefit of a deduction and credit.[62] To ensure that a U.S. investor can credit the foreign taxes, section 853(b)(2)(B) treats as foreign source income the portion of the RIC dividend that represents both the grossed up foreign taxes and the associated foreign source income.[63]

For a foreign investor, however, this provision is punitive. Since a foreign investor only receives as a dividend the cash the RIC receives *after* foreign taxes, a foreign investor is taxed on income it never receives.[64]

U.S. corporation's gross income was U.S. source, any dividend paid by the corporation was foreign source if less than 20% of the gross income for the three years preceding the distribution was U.S. source. Former I.R.C. § 861(a)(2)(A), *amended by* Pub. L. No. 99-514, § 1214(b), 100 Stat. 2085, 2542 (1986) (codified as amended at I.R.C. §§ 861, 871), effective for payments after December 31, 1986. After the amendment, all dividends from U.S. corporations, except corporations that had a section 936 election in effect, were U.S. source. *See* I.R.C. § 861(a)(2). The same ruling held that if 20% or more of the RIC's income was from U.S. sources, capital gains dividends would be U.S. source. This was primarily relevant for nonresident aliens who were subject to tax under section 871(a)(2); a nonresident not subject to section 871(a)(2) would not be taxed on capital gains regardless of their source. *See* I.R.C. § 871(a)(2).

61 *See* I.R.C. § 853(b)(2)(A).

62 Assume a RIC earns $100 of foreign dividends subject to a withholding tax of $15 and distributes $85 to its U.S. shareholder. If a RIC were able to pass through the $15 of foreign taxes to the shareholder but the shareholder did not have to gross up the $85 received by the $15 of foreign taxes, the shareholder would get a double benefit for the $15—a $15 deduction ($100 minus $15) coupled with a $15 credit against $85. Instead, a shareholder is treated as receiving a $100 dividend with a $15 credit, which is the same tax treatment as if the shareholder had earned directly the foreign source income.

63 *Id.* In the absence of this rule, the dividend would be treated as U.S. source in its entirety. When this provision was enacted, however, a dividend from a RIC that invested primarily in foreign assets could have been foreign source. *See* Rev. Rul. 69-235, *supra* note 60.

64 Under the gross up rule in section 853(b)(2)(A), if a RIC receives a $100 dividend subject to a source base tax of $15, the RIC distributes $85, but a foreign shareholder has FDAP income of $100 on which the U.S. withholds 30%, unless a treaty applies. Prior to 1986, dividends from a fund that invested primarily in foreign assets would have been foreign source and the resourcing rule would be superfluous except for those foreign funds

Since the resourcing rule of section 853(b)(2)(B) applies *only* for purposes of determining a taxpayer's foreign tax credit, and since foreign portfolio investors are not eligible to credit foreign taxes against their FDAP liability, both the dividend received and the foreign tax gross up are U.S. source income.[65]

To stimulate foreign investment in U.S. mutual funds, in 2004, Congress extended look-through treatment for a RIC's U.S. source interest and short-term capital gains for foreign shareholders.[66] The potential adverse effects for foreign shareholders of a RIC making a section 853 election, however, were left untouched.

C. Expanding Look Through for Foreign Shareholders

In the American Jobs Creation Act of 2004,[67] Congress modified the treatment of RIC dividends paid to a foreign shareholder by providing for look-through treatment to the extent that the dividends were attributable to a fund's interest income ("interest-related dividends" (IRDs)) or short-term capital gains ("short-term capital gain dividends" (STCGDs)).[68]

The motivation for the change was twofold. First, Congress noted the disparate U.S. tax consequences to a foreign investor investing directly in a

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that could not satisfy the 80% rule of former section 861(a)(2)(A). *See supra* note 60.

65 I.R.C. § 906(b)(3) (denying nonresident aliens and foreign corporations the ability to credit foreign taxes against their FDAP tax liabilities). In addition, a foreign investor could not deduct the foreign taxes against his or her FDAP liability. *See* C.C.A. 2001-52-046 (Nov. 21, 2001) (confirming that foreign tax gross up and RIC distribution is U.S. source income and that the resourcing rule applies only for foreign tax credit purposes for Puerto Rican residents).

66 American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 411(a)(1), 118 Stat. 1418, 1500.

67 American Jobs Creation Act of 2004. Various versions of the legislation had been introduced in previous sessions of Congress. *See, e.g.*, S. 1748, 102d Cong. (1st Sess. 1991); S. 1733, 103d Cong. (1st Sess. 1993); H.R. 2015, 104th Cong. (1st Sess. 1995); H.R. 2018, 106th Cong. § 305 (1st Sess. 1999); H.R. 1669, 108th Cong. § 305 (1st Sess. 2003).

68 American Jobs Creation Act of 2004 § 411(a)(1); I.R.C. § 871(k)(1)(A) (exempting foreign individuals from the FDAP tax on IRDs); § 881(e)(1)(A) (providing the same exemption for foreign corporations); § 871(k)(2)(A) (exempting foreign individuals from the FDAP tax on STCGDs); § 881(e)(2) (providing the same exemption for foreign corporations). In addition, IRDs and STCGDs are exempt from withholding. I.R.C. §§ 1441(c)(12) (stating that there is no withholding on IRDs and STCGDs paid to nonresidents), 1442(a) (stating the same for foreign corporations). A fund must inform its shareholders of the amount of an IRD or a STCGD. *See* I.R.C. § 871(k)(1)(C)(i) (applying to an IRD); § 871(k)(2)(C)(i) (applying to a STCGD).

fund's underlying securities and indirectly through a fund.[69] In addition, Congress was concerned that U.S. mutual funds were developing offshore parallel funds for foreigners to mitigate the tax inefficiencies of the U.S. RIC regime and wished to encourage U.S. financial institutions to bring such activities on-shore:[70]

> [T]he Committee believes that, to the extent a RIC distributes to a foreign person a dividend attributable to amounts that would have been exempt from U.S. withholding tax had the foreign person received it directly (such as portfolio interest and capital gains, including short-term capital gains), such dividend similarly should be exempt from the U.S. gross-basis withholding tax.

A STCGD is limited to a RIC's *qualified short-term gain*, which is the excess of net short-term gains over net long-term capital losses.[71] By according look-through treatment to short-term capital gains, the statute converts what under pre-2004 law was ordinary U.S. source dividend income taxed at 30% (unless reduced by treaty) into tax-exempt capital gain. The exemption accorded to a RIC's short-term capital gains is consistent with the treatment of portfolio capital gains realized directly by foreign investors.[72]

The amount that a RIC can designate annually as an IRD is limited to the RIC's *qualified net interest income* (QII), which is a RIC's "qualified interest income" reduced by allocable deductions.[73] QII is limited to certain categories of *U.S. source* interest income, including short-term original issue discount, interest on registered obligations, interest from certain bank deposits, and any IRD received from another RIC.[74]

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[69] H.R. REP. NO. 108-548, pt. 1, at 164 (2004).

[70] *Id.*

[71] I.R.C. § 871(k)(2)(D). Net short-term gain is the excess of short-term gains over short-term losses. I.R.C. § 1222(5). Net long-term capital loss is the excess of long-term capital losses over long-term capital gains. I.R.C. § 1222(8). Thus, long-term losses first reduce long-term gains and then any net short-term gains.

[72] Capital gains are not considered to be FDAP income subject to 30% tax under section 871(a)(1)(A). I.R.C. § 871(a)(1)(A). In addition, capital gains realized from the disposition of personal property by a foreign person are generally foreign source income and are therefore not subject to a tax under sections 871 or 881. I.R.C. § 865(a)(2).

[73] I.R.C. § 871(k)(1)(D).

[74] I.R.C. § 871(k)(1)(E)(i) (applying to short-term original interest discount), (ii) (applying to interest on registered obligations), (iii) (applying to interest on bank deposits), (iv) (applying to IRDs received from other RICs). Some categories of U.S. source interest,

Even if interest satisfies the QII income test at the RIC level, an IRD will be treated as a taxable U.S. source dividend if it is attributable to interest on debt issued by the foreign shareholder or any corporation or partnership with respect to which the foreign shareholder is a 10% shareholder.[75] The second restriction is designed to prevent a foreign shareholder from using a RIC as a conduit for U.S. source interest that would otherwise not be exempt under the portfolio interest rules.[76]

To compute its IRD, a RIC must reduce its qualified interest income by "properly" allocable expenses, guidance for which was provided in

however, are excluded from the definition of QII, such as interest received from a corporation or partnership if the RIC is a 10% shareholder and interest that is contingent interest. I.R.C. § 871(k)(1)(E)(ii)(I) (excluding interest if RIC is a 10% shareholder), (II) (excluding contingent interest defined under section 871(h)(4)). The fact that a RIC owns 10% or more of the debtor taints all of the interest paid even though the RIC shareholder's proportionate share of the interest is significantly less. This approach is inconsistent with treatment of interest held by a partnership. *See* Treas. Reg. § 1.871-14(g)(3) (as amended in 2015) (making the 10% shareholder determination at the partner level). These limitations track exceptions to the portfolio interest rules under which U.S. source interest paid to a 10% shareholder (and U.S. source contingent interest) do not qualify as tax-exempt portfolio interest, and they are designed to prevent a foreign RIC shareholder from obtaining a U.S. tax benefit that it could not obtain if it invested directly in the underlying assets. I.R.C. § 871(h)(3)(A) (excluding from portfolio interest any interest received by 10%-or-more shareholder (determined by vote) and 10%-or-more partner (determined by capital or profits); I.R.C. § 871(h)(4) (excluding from contingent interest, which is interest determined by reference to receipts, cash flows, income, profits, or change in the value of property of the debtor or a related person, or dividend or distributions made by the debtor or a related person from portfolio interest).

[75] I.R.C. § 871(k)(1)(B)(i). An interest-related dividend will be taxable unless the withholding agent receives a statement that the beneficial owner of the RIC stock is not a U.S. person. I.R.C. § 871(k)(1)(B)(ii). An IRD received by a controlled foreign corporation (CFC) is treated as an ordinary dividend to the extent the dividend is attributable to interest paid by a related person to the CFC. I.R.C. § 881(e)(1)(B)(ii). A person is related to a CFC if the person is a U.S. shareholder of the CFC, a related person to the U.S. shareholder, or a related person under section 267(b). *See* I.R.C. § 267(b). This rule tracks the portfolio interest limitation applicable to CFCs. *See* I.R.C. § 881(c)(3)(C). Note, exempted from this rule is any interest of the RIC attributable to short-term original issue discount and bank deposit interest. *See id.* This rule similarly applies to IRDs received by CFCs. I.R.C. § 881(e)(1)(B)(i). Exactly how a RIC is to determine that its shareholder is a 10% shareholder in another corporation or partnership is unclear.

[76] The reason for the first restriction is unclear. If a foreign shareholder — individual or corporate — issued debt, the interest paid on such debt would generally be foreign source income and therefore would not constitute qualified interest income in the first place. *See* I.R.C. § 861(a)(1) (determining the source of interest generally by the residence of the obligor).

Revenue Ruling 2005-31.[77] Under the facts section of the ruling, a RIC earned $10,000 of dividends (all qualified dividends (QDI)); $10,000 of interest (all qualified interest); $5,000 of STCG; and $5,000 of net LTCG.[78] The RIC had $10,000 of general and administrative (G&A) expenses, and it distributed $20,000 (total income less G&A expenses) to its U.S. and foreign shareholders.[79]

Because of the different tax regimes for foreign and U.S. taxpayers, the RIC must make separate determinations for each. For U.S. shareholders, the RIC must determine the portion of the dividend that is a NCG and QII, since these amounts are subject to special tax rates.[80] For foreign shareholders, the fund must determine the portion that is an IRD, STCGD, and NCG, since these amounts are exempt from tax.[81]

The ruling first concludes that neither NCG, STCG, nor QDI are reduced by expenses.[82] Thus, for foreign shareholders, the RIC reports $5,000 of NCG and $5,000 as STCGD, and for U.S. shareholders, $5,000 of NCG and $5,000 of QDI.[83]

In determining the portion of the dividend that is an IRD, the RIC's QII is reduced by the portion of the G&A expenses equal to the percentage of its ICTI (STCGs, interest, and dividends) that is qualified interest income. Since the RIC's QII constitutes 40% of the RIC's ICTI,[84] 40% of the G&A expenses ($4,000) are allocated to QII resulting in an IRD of $6,000. This

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[77] Rev. Rul. 2005-31, 2005-1 C.B. 1084.

[78] *Id.*

[79] *Id.*

[80] Although both qualified dividends and net capital gains are taxed at the same rates for individuals, it is necessary to distinguish between them since the NCGs can be offset by a shareholder's capital losses up to the amount of the NCGs plus $3,000. I.R.C. § 1211(b). In the absence of any NCGs, a shareholder can use only $3,000 of capital losses against his other income. *Id.*

[81] *See supra* note 68; I.R.C. 852(a)(1)(A).

[82] These conclusions derive respectively from the statutory mechanism for taxing a RIC's NCG, *see* I.R.C. § 852(b)(3), the definition of QDI, *see* I.R.C. § 871(k)(1)(D), and a statement on the legislative history discussing STCGD ("In computing the amount of short-term capital gain dividends for the year, no reduction is made for the amount of expenses of the RIC *allocable* to such net gains."). H.R. REP. NO. 108-548, pt. 1, at 166 (2004) (emphasis added).

[83] The distinction between ordinary dividend and qualified dividends is irrelevant for foreign shareholders, as a RIC's dividend income is not recharacterized under section 871(k). I.R.C. § 871(k).

[84] Excluding NCG of $5,000, the RIC's ICTI is $25,000. Qualified interest income is 40% of ICTI ($10,000/$25,000). *See* I.R.C. § 871(k)(1)(E).

determination is relevant only for foreign shareholders; for U.S. shareholders, the G&A expenses effectively reduce a RIC's interest income and short-term capital gain. Even though the sum of the amounts determined for IRD, STCGD, NCG, and QDI ($26,000) exceed the actual distributions, the ruling concludes that the RIC could apply different designations to the dividends depending on whether the shareholder was a foreign or a U.S. person, which ensures that U.S. and foreign shareholders will only report collectively $20,000 of total dividends.

Prior to the issuance of the ruling, mutual funds faced a potential dilemma in determining the amount of QDI and QII. If investment expenses were only allocated against a RIC's non-QDI income, QII could be reduced or vice versa.[85] This determination could have created a conflict between U.S. and foreign shareholders.

This ruling is generally favorable to U.S. shareholders because it allocates expenses away from favorably taxed income — NCG and QDI — and thereby reduces less favorably taxed income such as interest and non-qualified dividends. The ruling is also favorable to foreign shareholders because it allocates expenses away from NCGs and STCGs to interest and dividends. Although expenses allocated to QII reduce income that is tax-exempt in the hands of foreign shareholders, expenses allocated to dividends of the RIC reduce income that is taxable at 30%. For an equity RIC, the RIC's dividend income is likely greater than interest income.

D. A Critique of the Statute

Although the legislative history to the foreign RIC provisions states that a goal of the amendments is to tax foreign RIC shareholders on the same basis as if they had directly earned their share of the RIC's income, the statute fails to accomplish this goal. None of a RIC's foreign source income is recharcaterized. In particular, the definition of qualified interest income is limited to *U.S. source* interest income — the statute does not recharacterize foreign source dividends (including similar income such as Subpart F inclusions and passive foreign investment company inclusions), interest, swap income, or foreign currency gains. These items count toward the RIC income test, but constitute foreign source income in the hands of the RIC, or would be foreign source income if earned directly by a foreign

[85] Letter from Keith Lawson, Senior Counsel, Inv. Company Inst., to Barbara Angus, Int'l Tax Counsel, Dep't. of Treasury (Nov. 17, 2004) (on file with author); Steve Conlon, *The Best of Both Worlds*, CAP. CHANGES IN DEPTH 3–4 (May 31, 2005), http://business.cch.com/capChanges/CCID_02-04_05.pdf.

investor.[86]

Consequently, a distribution of a RIC's foreign source interest, foreign source dividends, or swap income is taxed as an ordinary U.S. source dividend, even though had a foreign shareholder earned the income directly it would have been exempt from U.S. tax. The legislative history surprisingly does not shed any light on the rationale for these omissions.

Before the enactment of sections 871(k) and 881(e), similar bills were introduced in prior legislative sessions as the Investment Competitiveness Act.[87] Some of these earlier bills included under the definition of QII certain categories of *foreign source* interest:

> (ii) any interest derived by the regulated investment company from sources outside of the United States other than interest that is subject to tax imposed by a foreign jurisdiction if the amount of such tax is reduced (or eliminated) by a treaty with the United States.[88]

Thus, in these earlier versions, foreign source interest (but not foreign source dividends) that was exempt from foreign taxes without regard to a treaty would have constituted QII. The apparent focus of this exception was interest paid on *Eurobonds*, which are bonds denominated in a currency different from the currency of the countries in which they are issued and sold.[89] Like interest on portfolio debt, interest on Eurobonds is generally exempt from domestic tax.[90] As discussed below,[91] this provision suggests

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[86] Treas. Reg. § 1.863-7(b) (as amended in 2012) (sourcing notional principal contract income by the residence of the recipient); I.R.C. § 1293(a)(1) (requiring a shareholder of a qualified electing fund (QEF) PFIC to include in income as ordinary income its share of the PFIC's ordinary earnings and as a LTCG its share of the QEF's NCG); I.R.C. § 1296(c)(1)(A), (2) (recognizing that the gain on mark-to-market (MTM) election of marketable PFIC stock is ordinary income and generally U.S. source income since MTM gain is sourced in the same manner as the sale of stock); I.R.C. § 951(a)(1) (requiring a U.S. shareholder of a CFC to include in income subpart F income and any section 956 inclusion); I.R.C. § 988(a)(3)(A) (stating that a foreign currency gain attributable to a section 988 transaction is ordinary income sourced by the residence of the taxpayer). *See* Willard B. Taylor, *Foreign Investment in Regulated Investment Companies*, TAX MGM'T. INT'L J. (June 13, 2008).

[87] *See supra* note 67.

[88] *See, e.g.*, H.R. 1669, 108th Cong. § 2(a) (2003) (proposing new section 871(k)(1)(E)(ii)).

[89] CHRIS O'MALLEY, BONDS WITHOUT BORDERS: A HISTORY OF THE EUROBOND MARKET (2014).

[90] John Glover, *Eurobonds as Refugees from Tax Men Turn 50 in $4 Trillion Market*,

that treaty shopping concerns may account for the failure to extend look-through treatment to a RIC's foreign source income.

By excluding foreign source interest, foreign source dividends, and income that would be foreign source if realized directly by a foreign person from look-through treatment, the statute fails to achieve its stated policy goal of taxing foreign shareholders similarly to how they would have been taxed had they directly earned their share of the underlying RIC income. In addition, a foreign investor in a RIC making a section 853 election is further penalized by being taxed on income that it never receives.[92] Consequently, RICs holding foreign assets or earning foreign source income continue to be tax inefficient investment vehicles for foreign investors compared to either investing directly or through a true pass-through entity such as a partnership.[93]

E. Investing Through Partnerships Compared to Investing Through RICs

The foreign RIC amendments impose significant tax burdens on foreign shareholders to the extent a RIC earns income that is neither capital gains nor U.S. source interest. In particular, a RIC's foreign source interest and dividends, and swap income are converted to taxable U.S. source dividends when distributed by a RIC to a foreign shareholder. A foreign investor's U.S. tax burden is thus significantly different depending on whether the investor invests directly in such assets or indirectly through a RIC.

Instead of comparing the U.S. tax consequences to a foreign investor that invests in a RIC with those arising from investing directly, one may more appropriately compare a foreign investor's RIC tax burdens to those arising when investing in an investment partnership.[94] An investment partnership replicates the investment options available to a RIC shareholder, such as professional investment management, back office

BLOOMBERG (June 24, 2013, 9:44 AM), http://www.bloomberg.com/news/articles/2013-06-23/eurobonds-as-refugees-from-tax-men-turn-50-in-4-trillion-market ("The most important attribute of Eurobonds, by a mile, is that they're free of withholding tax"). David Munves, *The Eurobond Market*, *in* THE HANDBOOK OF EUROPEAN FIXED INCOME SECURITIES 167 *et passim* (Frank J. Fabozzi & Moorad Choudhry eds., 1st ed. 2003).

[91] *See infra* Part IV.D.

[92] I.R.C. § 853(b)(2)(A).

[93] Foreign assets constitute roughly 25% of the assets of U.S. equity RICs and 15% of U.S. bond funds. FACTBOOK, *supra* note 1, at 163 tbl.4.

[94] The actual entity could be a U.S. or foreign partnership, a U.S. LLC, or a foreign entity that is treated as a partnership for U.S. tax purposes.

functions, and efficient executions of purchases and sales.

Assume a foreign investor is a partner in a U.S. or foreign partnership[95] that earns the following income: capital gains from selling U.S. and foreign stocks; interest from bonds issued by U.S. and foreign issuers; and U.S. and foreign source dividends. In addition, assume that the partnership falls within the trading safe harbor and that there is no special allocation of the partnership's income or expenses.[96] A partnership is not taxed on income it earns; instead the partners are taxed on their distributive shares of the partnership's income.[97] Pursuant to statutory mandates reflecting the conduit nature of partnership taxation, the character of partnership income passes through to the partners.[98] For example, the LTCGs of a partnership retain their character as LTCGs and must be separately reported, regardless of the partner's holding period in his or her partnership interest.[99]

For partnerships with foreign partners or foreign source income, it is generally necessary to determine and separately report the source of the partnership income so that the partners can determine their U.S. tax liability. Since foreign partners of an investment partnership are subject to U.S. tax only on their distributive share of the partnership's income that constitutes *U.S. source* FDAP income, the partnership must separately

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[95] A domestic partnership is a partnership created or organized under the law of the United States or any state. I.R.C. § 7701(a)(4). A foreign partnership is a partnership that is not domestic. I.R.C. § 7701(a)(5). In the case of a general partnership, it may not be clear where it is formed since there are generally no state filing requirements.

[96] If the partnership were engaged in a U.S. trade or business, the partners would also be engaged in a U.S. trade or business, and the partnership income would be subject to residence basis taxation in the hands of the partners. I.R.C. § 875(1) (stating that a foreign partner is engaged in U.S. trade or business if partnership is so engaged). Unger v. Comm'r., 58 T.C. 1157 (1990), *aff'd*, 936 F.2d 1316 (D.C. Cir. 1991) (stating the same for partnerships with permanent establishment).

[97] I.R.C. §§ 701, 702.

[98] I.R.C. § 702(a) (requiring the partnership to separately state and the partners to account separately for, inter alia, STCGs and LTCGs, qualified dividends, and other items provided for in regulations); I.R.C. § 702(b) (stating that items of partnership income required to be separately stated have the same character as if "realized directly from the source from which realized by the partnership, or incurred in the same manner as incurred by the partnership"). The reference to "source" in section 702(b) should not be interpreted to refer to the source of income rules of sections 861 and 862, but instead to the character of the income, e.g., earned income or passive income.

[99] *See, e.g.*, Rev. Rul. 68-79, 1968-1 C.B. 310 (stating that a partner should take into account his share of the partnership's LTCGs even though the holding period of partnership interest was less than the long-term period).

report such income.[100] For U.S. partners, the partnership must separately report the partnership's foreign and U.S. source income and expenses so that the partners can determine their U.S. foreign tax credit.[101]

The initial task is to determine whether the source of an item of income is determined at the partner or partnership level. The statutory mandate implementing the conduit or aggregate concept of partnership taxation in section 702 seems to require that the source of income should be determined at the partnership level and then taken into account separately by the partners.[102] The source of interest and dividend income, which is determined by the residence of the payor, should be passed through to the partners.[103] Consequently, a foreign partner would not be subject to any U.S. tax on its distributive share of the partnership's U.S. source portfolio interest, foreign source interest, and dividends, but would be taxed on its share of U.S. dividends and U.S. source interest that did not qualify as portfolio interest.

Application of the source rules is more difficult when the source of the income depends on the residence of the seller (as in the case of sales of personal property) or where certain activities related to the generation of the income occur (as in the case of income from personal services). The difficulty arises because of the different tax results if an entity or aggregate approach is adopted. In the case of sales, the partnership and individual partners could have different residences, and in the case of services, the individual partners could perform their services inside and outside of the United States.[104]

Section 865(i)(5) provides that the source of income from the sale of personal property is determined at the partner rather than the partnership level.[105] This rule ensures that a foreign partner will realize foreign source

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[100] Treas. Reg. § 1.702-1(a)(8)(ii) (as amended in 2005) (requiring that each partner take into account separately any partnership item that would affect the partner's tax liability if it were not taken into account separately).

[101] Treas. Reg. § 1.704-1(b)(4)(viii) (2016).

[102] *See* I.R.C. §§ 701, 702.

[103] Craik v. United States, 31 F. Supp. 132, 135 (Ct. Cl. 1940) (holding that under the predecessor statute to section 871(b), the Revenue Act of 1918, a foreign partner of U.S. partnerships is not subject to U.S. tax on its distributive share of foreign source income of the U.S. partnership). *See* Revenue Act of 1918, ch. 2, §§ 213(c), 218(a), 40 Stat. 1066, 1070. The source of certain guaranteed payments is not entirely clear. *See* Lewis R. Steinberg, *Fun and Games with Guaranteed Payments*, 57 TAX LAW. 533, 535 (2004).

[104] *See* Gregory May, *Wrongs and Remedies: The U.S. Tax Treatment of Multinational Partnerships of Individuals*, 103 TAX NOTES 1509, 1510 (June 21, 2004).

[105] I.R.C. § 865(i)(5). The statute grants the Treasury authority to change this result in

income from the partnership's sale of personal property, such as stocks and bonds, and a U.S. partner will realize U.S. source income. For foreign partners, this rule is generally of little consequence because capital gains from selling personal property, whether U.S. or foreign source, are not FDAP.[106] For U.S. partners, the main consequence of this rule is that it will affect the determination of a U.S. partner's foreign tax credit.[107] In addition, sourcing partnership income at the partner level may slightly increase the administrative burdens, since the partnership will have to segregate the source of such income depending on the tax residence of the partners who receive an allocation of the income.

Just as the sale of RIC shares by a foreign investor is exempt from U.S. tax, a sale of an interest in an investment partnership should also be exempt. First, under section 865, the sale of personal property, including intangible property, of a foreign person is foreign source income.[108] Second, under section 741, the sale of a partnership interest generates capital gain or loss, unless the partnership holds any assets, such as unrealized receivables or appreciated inventory, in which case a portion of the amount realized from the sale of a partnership interest is treated as ordinary income.[109] Since an investment partnership generally does not hold receivables or inventory, section 751 should not apply to a sale of a partnership interest by a foreign

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regulations. *Id.* To date, no regulations have been issued. A U.S. citizen, resident alien, or nonresident alien with a U.S. tax home is a U.S. resident, as is a U.S. corporation. Citizens and resident aliens are not treated as having a foreign tax home (and being a foreign resident for purposes of section 865) unless a tax of 10% is actually paid to a foreign country. I.R.C. § 865(g)(2).

[106] I.R.C. § 871(a)(1). FDAP does not generally include gains from the sale or exchange of property. *See id. See also* Treas. Reg. § 1.1441-2(b)(2)(i) (as amended in 2013) (excluding gains from the sale of personal property from FDAP income for purposes of withholding). There is one situation in which the source of capital gains could matter for a foreign person. Under section 871(a)(2), a nonresident alien present in the United States for 183 days or more during a taxable year is subject to a flat 30% tax on U.S. source capital gains for that taxable year. I.R.C. § 871(a)(2). Since a foreign person who is resident in the United States for 183 days or more is generally a resident alien, *see* I.R.C. § 7701(b)(1)(A)(ii), and thus is subject to residence basis taxation, this rule mainly applies only to persons whose days of presence do not count for determining U.S. tax residency, e.g., students and diplomats. *See* I.R.C. § 7701(b)(5). In order for section 871(a)(2) to apply, these persons would also have to have a U.S. tax home or the gains would have to be foreign source.

[107] U.S. source income does not increase a U.S. person's foreign tax credit limitation under section 904. *See* I.R.C. § 904(a).

[108] I.R.C. § 865(a)(2).

[109] I.R.C. § 751(a).

investor.[110] Finally, although the U.S. tax consequences to a foreign investor selling a U.S. or foreign investment partnership interest are identical, there are differences in the withholding requirements applicable to a foreign and U.S. partnership.[111]

A foreign investor in an investment partnership is only taxed on the partnership's U.S. source dividend income; foreign source income, capital gains, and U.S. interest that is portfolio interest are exempt from U.S. tax. Investing through a RIC that earns foreign source income is therefore generally more tax inefficient than investing directly or through an investment partnership because a foreign shareholder is taxed on the RIC's foreign source income. Additionally, when investing directly or through a partnership, a foreign investor avoids U.S. tax on foreign taxes paid by the investor or the partnership, which may not be the case when investing in a RIC.[112]

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[110] For U.S. investors, section 751 can apply since, under section 751(c), unrealized receivable includes interest in certain foreign corporations described in section 1248. I.R.C. § 751(c)(2). In a controversial ruling, the Service adopted a look-through or aggregate approach for the sale of a partnership interest by a foreign partner and held that a foreign partner's gain from the sale of a partnership engaged in a U.S. trade or business was effectively connected income (ECI) to the extent that the gain was attributable to the ECI property of the partnership. Rev. Rul. 91-32, 1991-1 C.B. 107. Gain attributable to the non-ECI property was exempt foreign source income. *Id.* For a discussion of the revenue ruling, see N.Y. STATE BAR ASS'N TAX SECTION, REPORT ON GUIDANCE IMPLEMENTING REVENUE RULING 91-32 (2014). The sale of an investment partnership not engaged in a U.S. trade or business would not be ECI regardless of whether an aggregate or an entity approach were adopted.

[111] U.S. source FDAP income paid to a U.S. partnership is not subject to withholding. Treas. Reg. § 1.1441-5(b)(1) (as amended in 2014) (no withholding required on U.S. source FDAP paid to U.S. partnerships). Instead, the U.S. partnership must withhold when such amounts are distributed to a foreign partner or included in the foreign partner's distributive share of partnership income. Treas. Reg. § 1.1441-5(b)(2) (as amended in 2014) (requiring a withholding on distributions consisting of U.S. source FDAP paid to a foreign person or when included in a foreign person's distributive share on the earlier of (1) the date the K-1 is mailed, or (2) the fifteenth day of the third month after the end of the partnership's taxable year). In the case of a foreign partnership that is a nonwithholding foreign partnership, payments of U.S. source FDAP income to the partnership are treated as if made to the individual partners, and the payor will withhold based on the tax status of the individual partners. Treas. Reg. § 1.1441-5T(c)(1)(i) (2014). If the tax status of the individual partners cannot be determined, it is presumed that they are foreign and the payee must withhold at 30%. Treas. Reg. § 1.1441-5T(d)(3) (2014). If the foreign partnership is a withholding foreign partnership, the partnership and not the payor will withhold based on the tax status of the partners. Treas. Reg. § 1.1441-5T(c)(2)(i) (2014).

[112] *See supra* Part III.B.

A RIC offers one potential advantage for foreign investors through the treatment of investment expenses. In a RIC, investment expenses reduce ICTI. If a RIC earns only U.S. source dividend income, for example, such income is reduced by investment expenses, and a foreign investor is taxed on the (net) distributed amount. In essence, a foreign investor receives a deduction against U.S. source FDAP income, which would not be possible if it received the income directly.[113] In the case of an investment partnership, if the investment expenses are charged as a percentage of assets under management (e.g., 1%), these fees would probably have to be separately stated for foreign partners and would therefore not reduce U.S. tax on U.S. source FDAP income.[114]

The foreign mutual fund provisions fail to implement fully their purported goal of imposing the same U.S. tax burdens on foreign investors whether they invest directly or through a U.S. RIC, especially to the extent the RIC earns foreign source income. The infirmities of the statute are even more apparent when comparing the U.S. tax burdens of foreign investors in a RIC with those of an investment partnership that earns the same income as the RIC. The lack of discussion in the legislative history for excluding foreign source income from look-through treatment is especially surprising.

Prior to the enactment of the foreign mutual fund provisions, similar bills had been introduced in Congress, and these bills provided that foreign source interest income that was exempt from foreign tax *without regard to any U.S. treaty provision* would be treated as qualified interest income.[115]

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[113] In computing ICTI, a RIC is not allowed to deduct net operating losses. I.R.C. § 852(b)(2)(B). Consequently, the excess of investment expenses over investment income does not provide a current or deferred tax benefit to RIC shareholders. Since such expenses reduce a RIC's net asset value (NAV), however, a RIC shareholder who sells its shares will realize a tax benefit because its amount realized will decrease.

[114] For an overview of typical hedge fund compensation, see DONALD J. MARPLES, CONG. RESEARCH SERV., RS22689, TAXATION OF HEDGE FUND AND PRIVATE EQUITY MANAGERS (2007). A common practice for fund managers is to waive the management fee in exchange for an increased share of fund profits and thereby convert ordinary income into LTCGs. *See* Gregg D. Polsky, *Private Equity Management Fee Conversions*, 122 TAX NOTES 743 (Feb. 9, 2009). The IRS issued proposed regulations in 2015 aimed at requiring income from many types of fee waivers to be treated as disguised payments for services under section 707(a)(2)(A). REG-115452-14, 80 Fed. Reg. 43,652 (July 23, 2015). A fee waiver that is treated as additional distributable share of partnership income to the fund manager in a fund that generates FDAP income would benefit a foreign investor because a nondeductible expense (the 1% fee) would be converted, via a reduction in the investor's share of FDAP income, into a deduction.

[115] *See supra* note 67.

This provision, which was omitted in the final legislation, suggests the policy rationale for excluding foreign source income from look-through treatment may have been to prevent third-country foreign investors from obtaining U.S. treaty benefits with respect to foreign source income by investing in a U.S. RIC.[116] The tax treaty issues raised by cross-border investment by RICs with U.S. and foreign investors are addressed next.

IV. RICS AND TREATIES

This section examines the treatment of mutual funds under tax treaties. It focuses first on the current treatment of RICs under treaties and the recent OECD efforts to accommodate mutual funds in tax treaties. It then discusses how the exclusion for pass-through treatment of foreign source income was primarily intended to prevent third-country foreign investors in U.S. RICs from availing themselves of U.S. treaty benefits and how this concern is exaggerated.

One of the primary goals of tax treaties is to eliminate (or mitigate) double taxation, or the taxation of an item of income by both the source and residence countries.[117] Treaties use various mechanisms to accomplish this goal. For investment income, the relevant provisions reduce or eliminate source basis taxation of interest, dividends, royalties, and capital gains.[118] By reducing source basis taxation, the residence country's tax receipts are generally increased since the residence country's credit for source basis

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[116] *See* Staffaroni, *supra* note 17, at 533.

[117] Tax treaties are officially captioned as conventions for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income and on capital gains. *See also* ORG. FOR ECON. CO-OPERATION & DEV. [OECD], MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION, para. 2 (2014) [hereinafter OECD Model Treaty] (noting that the main purpose of the OECD Model Treaty is to "clarify, standardize, and confirm the fiscal situation of taxpayers . . . through the application by all countries of common solutions to identical cases of double taxation.").

[118] *See, e.g.*, Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-U.K., art. 2, para. 1, July 24, 2001, T.I.A.S. No. 13,161 [hereinafter U.S.-U.K. Treaty] (prohibiting the source country from taxing interest); *id.* art. 13, para. 5 (prohibiting the source country from taxing gains other than gains from real property); *id.* art. 12 (prohibiting the source country from taxing royalties); *id.* art. 10 (limiting the source country's taxation of dividends to a maximum rate of 15%, 5%, or 0% depending on recipient's ownership percentage). In addition, under the "Other Income" article, investment income that does not fall under one of the previous categories, such as swap income, is only taxable in the state of residence. *Id.* art. 22, para. 1 (prohibiting the source country from taxing "other income").

taxation will decrease.[119]

Pass-through or conduit entities present multiple treaty policy challenges. An assumption underlying treaty provisions is that when a source country reduces source basis taxation on an item of income, the residence country will tax that item. For conduits, this is not necessarily the case. If income arising in the source country is not taxed by the residence country either because the resident country recipient is tax-exempt or not subject to tax because it is a pass-through entity, the source country may argue that it does not have to relieve source basis taxation under a treaty because there is no possibility of double taxation.[120] Since the income of a pure pass-through entity is taxed at the owner level and not at the entity level, should the residence of the entity that earned the income or the residence of the entity's owner determine treaty benefits?

A *sine qua non* of being a resident eligible for treaty benefits is being *liable to tax*.[121] Since a RIC avoids entity-level tax to the extent it distributes its income and capital gains, it could be argued that a RIC is *not* subject to tax and therefore should not be eligible for treaty benefits. If a RIC is eligible for treaty benefits, but can pass the source and character of all of its income through to its shareholders, there is a concern that foreign investors that are residents of a country without a treaty with the source country could invest in a U.S. RIC and indirectly garner treaty benefits that they could not otherwise obtain had they invested directly in the RIC's underlying securities.

Both the United States and the OECD focused on the similar issue of the treaty treatment of partnerships and partners during the 1990s[122] and

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[119] This is also true in the case of a country that does not permit a resident to credit source basis taxes because after-tax cash is increased.

[120] ORG. FOR ECON. CO-OPERATION & DEV. [OECD], COMMENTARIES ON THE ARTICLES OF THE MODEL TAX CONVENTION, para. 5, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL (2010) [hereinafter OECD Commentary] ("Where, however, a partnership is treated as fiscally transparent in a State, the partnership is not 'liable to tax' in that State . . . and so cannot be a resident . . . ."); U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006, at 9 (2006) [hereinafter U.S. Technical Explanation] ("entities that are fiscally transparent in the country in which their owners are resident are not considered to be resident of a Contracting State (although income derived by such entities may be taxed as the income of a resident, if taxed in the hands of resident partners or other owners).").

[121] U.S. Technical Explanation, *supra* note 120, at 13.

[122] *See* ORG. FOR ECON. CO-OPERATION & DEV. [OECD], ISSUES IN INTERNATIONAL TAXATION, NO. 6 THE APPLICATION OF THE OECD MODEL TAX CONVENTION TO

amended their respective model treaties to address issues arising from the receipt of income by fiscally transparent (pass-through) entities.[123] Additionally, in 1997, the United States enacted section 894(c), which denies a foreign person treaty benefits for income derived through a partnership if (1) the income is not treated as income of the foreign person under foreign law, (2) the treaty does not specifically address pass-through entities, and (3) the foreign country does not tax a distribution of such income from the entity to the person.[124] As a result of these changes, a partnership is not generally eligible for treaty benefits; instead, a partner is potentially eligible for treaty benefits to the extent that partner is taxed on his or her share of the partnership's income, as determined under the laws of the partner's country of residence.[125] Thus, each foreign partner must demonstrate his or her entitlement to treaty benefits.

The United States has pursued a different policy for RICs. U.S. treaty policy over the last twenty years has been to treat U.S. RICs as treaty residents. Not all countries, however, have adopted the same policy. In response to the significant increase in assets invested globally by investment companies — denominated in treaty argot as collective investment vehicles (CIVs)[126] — the OECD published in 2009 detailed studies of the treaty issues raised by cross-border investments by CIVs.[127]

PARTNERSHIPS (1999).

[123] *See* U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006 art. 1, para. 6 (2006) [hereinafter U.S. Model Treaty], https:// www. treasury.gov/ press-center/ press-releases/ Documents/ hp16801. pdf; OECD Commentary, *supra* note 120 (the partnership amendments are primarily found in paras. 2–6.7).

[124] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1054(a), 111 Stat. 788, 943; I.R.C. § 894(c).

[125] *See, e.g.*, U.S. Model Treaty, *supra* note 123, art. 1, para. 6.

[126] The OECD limits CIVs "to funds that are widely-held, hold a diversified portfolio of securities and are subject to investor-protection regulation in the country in which they are established." Org. for Econ. Co-operation & Dev. [OECD], *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles*, para. 4 (May 31, 2010) [hereinafter OECD, Treaty Benefits CIVs], https://www.oecd.org/tax/treaties/45359261.pdf. Under this definition, hedge funds and venture capital funds would not be CIVs.

[127] Org. for Econ. Co-operation & Dev. [OECD], Rep. of the Informal Consultative Group on the Taxation of Collective Investment Vehicles & Procedures for Tax Relief for Cross-Border Investors on the Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles (Jan. 12, 2009), https:// www.oecd.org/ tax/ treaties/ 41974553.pdf; Org. for Econ. Co-operation & Dev. [OECD], Rep. of the Informal Consultative Group on the Taxation of Collective Investment Vehicles & Procedures for Tax Relief for Cross-Border Investors on Possible Improvements to Procedures for Tax Relief for Cross-Border Investors (Jan. 12, 2009) [hereinafter OECD, Possible Improvements],

The final 2010 report proposed changes to the Commentary on Article 1 of the OECD Model that were subsequently adopted.[128]

The OECD recently revisited the treaty treatment of CIVs as part of its comprehensive program to develop international tax measures to combat the shifting of profits by multinationals to low or no-tax locations.[129] CIVs are addressed in the measures focusing on treaty shopping.[130] The OECD provided various possible provisions covering CIVs in its proposed limitations on benefits article.[131] The proposals largely follow the recommendations and conclusions in the 2010 CIV report, and it appears the BEPS project will not recommend any additional modifications.[132]

CIVs present distinct challenges for tax administrators to design rules that neither impede cross-border investments by imposing multiples levels of taxation on investment income nor encourage tax avoidance through abusive treaty shopping. First, in some countries, CIVs are separate corporate entities such as RICs, whereas in others, CIVs are trusts, and in

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https://www.oecd.org/tax/treaties/41974569.pdf; Org. for Econ. Co-operation & Dev. [OECD], *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles, Public Discussion Draft* (Dec. 9, 2009), https://www.oecd.org/fr/ctp/conventions/44211901.pdf; OECD, Treaty Benefits CIVs, *supra* note 126.

128 Org. for Econ. Co-operation & Dev. [OECD], *The 2010 Update to the Model Tax Convention*, at 4–12 (July 22, 2010) [hereinafter OECD, Model Commentary], http://www.oecd.org/tax/treaties/45689328.pdf (adding new paragraphs 6.8 to 6.34 to the Commentary on Article 1). The subject of the taxation of cross border investment funds has long been the focus of international practitioners and the OECD. *See* Patricia A. Brown, *Fifty Years of Tax Uncertainty: The Problem of International Neutrality for Collective Investment Vehicles*, *in* THE TAX TREATMENT OF COLLECTIVE INVESTMENT VEHICLES AND REAL ESTATE INVESTMENT TRUSTS 19, 19–22 (Hein Vermeulen ed., 2013).

129 The OECD base erosion and profit shifting (BEPS) program is presented in ORG. FOR ECON. CO-OPERATION & DEV. [OECD], ACTION PLAN ON BASE EROSION AND PROFIT SHIFTING (2013) [hereinafter BEPS Action Plan].

130 *Id.*

131 ORG. FOR ECON. CO-OPERATION & DEV. [OECD], PREVENTING THE GRANTING OF TREATY BENEFITS IN INAPPROPRIATE CIRCUMSTANCES, at 41–46 (2014) (discussing the CIV provisions in the proposed limitation-on-benefits (LOB) article). This draft was further revised in Org. for Econ. Co-operation & Dev. [OECD], *Revised Discussion Draft, BEPS Action 6: Prevent Treaty Abuse*, at 7–8 (May 22, 2015), http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf.

132 Org. for Econ. Co-operation & Dev. [OECD], *Revised Discussion Draft, BEPS Action 6: Prevent Treaty Abuse*, at 8 (May 22, 2015), http://www.oecd.org/tax/treaties/revised-discussion-draft-beps-action-6-prevent-treaty-abuse.pdf. The OECD proposals to limit treaty shopping by CIVs are discussed *infra* Part IV.E.

others they are joint ownership vehicles.[133] Some countries tax the CIV itself whereas in others, the CIV owners are taxed on their share of the CIV's income whether or not it is distributed. Tax transparency — a single level of tax on the CIV's income — is achieved in various ways, such as outright exemption of the CIV's income or de facto exemption through deductions for distributions as in the case of RICs.[134] While many issues of international taxation involve two countries — the source country (where the income arises) and the residence country (where the owner of the income is resident) — CIVs may involve three or more countries: the source country, the country where the CIV is formed, and the country where the CIV owner is resident.[135] Finally, for CIV income that is subject to source basis taxation, various mechanisms could be used to relieve double taxation, but many raise significant administrative burdens for funds, their investors, and tax administrators.

Given the disparate national approaches to taxing CIVs and their owners, the OECD did not proffer a definitive solution for the treatment of CIVs under treaties. The CIV amendments to the Commentary on Article 1 of the Model Treaty establish a consensus position for many important treaty issues, lay the groundwork for resolving other issues, and will, at the least, be an important impetus to treaty negotiators to explicitly consider and address in negotiating new treaties or modifying existing treaties. They are also generally consistent with U.S. RIC treaty policy.

A. Are RICs Residents Under Treaties?

Treaties provide benefits only to "persons" that are "residents" of the signatory countries to a treaty.[136] A person includes a "company," and a company is "any entity that is treated as a body corporate for tax purposes according to the laws of the state in which it is organized."[137] Since a RIC must be a U.S. corporation, it would certainly be considered a person for U.S. treaty purposes.[138] This policy is consistent with the CIV Benefits

[133] OECD, Treaty Benefits CIVs, *supra* note 126, paras. 21–23.

[134] *See* Brown, *supra* note 128, at 26 (summarizing five models for fund taxation).

[135] If the CIV is acquired through an intermediary, such as a bank or securities firm, there could be four or more countries involved.

[136] *See, e.g.*, U.S. Model Treaty, *supra* note 123, art. 1, para. 1 ("This Convention shall apply only to persons who are residents of one or both of the Contracting States, except as otherwise provided in the Convention.").

[137] *Id.* art. 3, para. 1(b).

[138] *See* I.R.C. § 851(a) ("[T]he term '[RIC]' means any domestic corporation . . . .").

Report, which concludes that a CIV should qualify as a *person* for treaty purposes if it is treated as a body corporate for tax purposes but not if it is merely a form of joint ownership.[139]

A *resident* is a person who is "liable to tax" by reason of, inter alia, its place of incorporation. The tax policy of the United States for the last twenty years has been to treat RICs not as fiscally transparent like partnerships but instead as corporate entities liable to tax, even though almost virtually all RICs distribute annually all of their ICTI and NCGs and thus pay no U.S. tax.[140] The rationale for this policy is that RICs will be liable to tax if they do not satisfy certain distribution, organization, and investment requirements.[141] All recent U.S. treaties ensure that U.S. RICs are treaty residents.[142]

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[139] OECD, Treaty Benefits CIVs, *supra* note 126, para. 25. The treatment of trusts is unclear. In common law countries, trusts are generally recognized as persons and entitled to treaty benefits. *See, e.g.*, U.S. Model Treaty, *supra* note 123, art. 1, para. 1(a) ("'person' includes . . . a trust . . . ."). In the United States, trusts are subject to tax but may deduct certain amounts distributed to beneficiaries. *See* I.R.C. § 641 (subjecting a trust to tax on its taxable income under section 1(e)). Some civil law countries, however, do not recognize trusts. *See* Anna Nemenova, *Tax Treatment of Trusts in Civil Law Countries and Application of Double Tax Treaties to Trusts (Part I),* 43 TAX PLAN. INT'L REV. 20, 21 (Mar. 2016).

[140] *See* U.S. DEP'T OF THE TREASURY, UNITED STATES MODEL TECHNICAL EXPLANATION ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF SEPTEMBER 20, 1996, at 13 (1996) ("[RICs and real estate investment trusts (REITS)] that are nominally subject to tax but that in practice are rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits.").

[141] U.S. Technical Explanation, *supra* note 120, at 13 ("Although the income earned by [RICs] normally is not subject to U.S. tax in the hands of the entity, they are taxable to the extent that they do not currently distribute their profits, and therefore may be regarded as 'liable to tax.' They also must satisfy a number of requirements under the Code in order to be entitled to special tax treatment."). *See also* Rev. Rul. 2000-59, 2000-2 C.B. 593 (concluding that investment entity subject to RIC-like tax regime was liable to tax under treaties identical to 1996 Model Treaty but noting that the entity's distributions to foreign interest holders were subject to tax regardless of the source of the entity's underlying income).

The regulations under section 894 treat an entity as fiscally transparent if under the laws of the entity's jurisdiction an interest holder must take into account on a current basis its share of the entity's income, *whether or not distributed to the interest holder*, and the character and source of the item of income are determined as if such item were realized directly from the source which realized by the entity. Treas. Reg. § 1.894-1(d)(3)(ii) (as amended in 2013) (emphasis added). A RIC thus would not be treated as fiscally transparent.

[142] *See*, *e.g.*, U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND GOVERNMENT OF THE UNITED KINGDOM OF GREAT BRITAIN AND NORTHERN IRELAND FOR THE

The "liable to tax" criterion was especially challenging for the OECD because of the disparate domestic approaches to taxing CIVs and their owners. Domestic legislation generally aims to impose similar tax burdens on the income of CIV investors whether it is earned directly or indirectly. As the CIV Benefits Report states: "Thus, the intent is to ensure neutrality between direct investments and investments through a CIV, at least when the investors, the CIV and the investment are all located in the same country."[143]

One aspect of neutrality is that a CIV's income be subject to only one level of tax, which is achieved by various methods. Some countries treat CIVs as fiscally transparent, like U.S. partnerships, whereas others nominally tax a CIV's income but permit a deduction for distributions to the CIV owners, as is the case of RICs. Some countries tax a CIV's income at a low rate or provide for exemption of the CIV's income in the investors' hands or permit imputation of the CIV taxes paid at the owner level.[144]

The CIV Benefits Report concludes that a CIV will be a resident provided that it is potentially liable to tax even if a CIV does not actually pay tax, because, for instance, the CIV can deduct distributions in determining its taxable income.[145] If, however, a CIV is actually exempt from tax or fiscally transparent, it will not qualify as a resident. This approach is consistent with U.S. tax policy. Not all countries, however, agree that CIVs satisfy the liable-to-tax criterion since CIVs are specifically structured so that they do not pay tax and very few actually pay tax.[146]

AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL GAINS 16 (2013) [hereinafter "U.S.-U.K. Technical Explanation"].

[143] OECD, Treaty Benefits CIVs, *supra* note 126, para. 27.

[144] *Id.* para. 28.

[145] *Id.* paras. 29–30 (treating a CIV as opaque and as a resident subject to tax even if it receives a deduction for dividends paid to investors, but noting that some countries do not view such an entity as being "liable to tax"). This conclusion is consistent with paragraph 8.5 of the Commentary to the OECD Model. *Id.* para. 30.

The CIV Benefits Report also addresses whether a CIV is the beneficial owner of its income, that is, whether ownership in a CIV is equivalent to ownership of the underlying assets. *Id.* paras. 31–35. If it were not, the CIV would not be eligible for treaty benefits with respect to its income. *Id.* para. 31. The CIV Benefits Report concludes that a CIV is the beneficiary of its income because "[t]he investor has no right to the underlying assets. . . . [I]t is the manager of the CIV that has discretionary powers to manage the assets on behalf of the holders of interests in the CIV." *Id.* paras. 32–33.

[146] *See, e.g.*, Letter from Keith Lawson, Senior Counsel, Inv. Company Inst., to Byung-Cheol Kim, Dir. Corp. Tax Div., Korean Ministry of Strategy and Fin. (Apr. 13, 2012),

Once a CIV qualifies as resident, it is highly likely that it will be eligible for treaty benefits. In contrast, if RICs were subject to the treaty rules for partnerships, each RIC shareholder would have to qualify separately for treaty benefits. Given the great number of shareholders in a typical RIC, this would be an administrative nightmare, and many shareholders, especially those with small investments, would simply forego claiming treaty benefits because of the cost and administrative burdens.[147] In addition, this policy obviates the need to attempt to assign source basis taxes imposed on a RIC's income to a particular shareholder when the RIC distributes the income.

The concept of neutrality, however, has its limits. True neutrality is achieved only if a CIV's income is subject to a single level of tax *and* the character of its income passes through to its owners. The CIV Benefits Report does not focus on the character of a CIV's income in the hands of its owners. The drafters may have been concerned that by insisting on pass-through treatment of the character of the income, it would have been difficult to distinguish between partnerships and CIVs.

B. Are RICs Qualified Persons Under Treaties?

In all U.S. treaties negotiated within the last thirty years, a resident under Article 4 must also generally be a "qualified person" under the Limitation of Benefits (LOB) article to be eligible for treaty benefits.[148] The LOB article is intended to prevent treaty shopping, that is, the use of an entity formed in one of the signatory countries to receive income or transact business in the other signatory country but that is owned by (or whose income is substantially attributable to) residents of a third country that does

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https://www.ici.org/pdf/26044.pdf. The U.S.-Korea treaty was signed in 1976 and does not specifically address RICs. Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and the Encouragement of International Trade and Investment, U.S.-Korea, June 4, 1976, 30 U.S.T. 5253.

[147] If a taxpayer is eligible to claim treaty benefits to reduce source basis taxes but elects not to, he may not claim a credit for the foreign taxes that could have been reduced or refunded, since the foreign taxes may be treated as a "noncompulsory amount" under Treas. Reg. § 1.901-2(e)(5)(i) (as amended in 2013).

[148] *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 23, paras. 1–2. Some older U.S. treaties do not contain an LOB provision. *See* Jeffrey L. Rubinger, *Tax Planning with U.S. Income Tax Treaties Without LOB Provisions*, 36 TAX MGM'T. INT'L J. 123 (2007); Jeffrey L. Rubinger, *Treaty Shopping: Is it Still a Viable Option?*, May 2007 CORP. BUS. TAX'N MONTHLY 15, 17 (noting that there are twelve treaties without LOB provisions).

not have a treaty with the United States.[149] All modern U.S. treaties include a detailed LOB provision, but many of our trading partners do not share the same restrictive view of treaty shopping. The rationale for expansive LOB provisions is to limit the unilateral bestowal of treaty benefits on third-country residents and thereby encourage these countries to enter into treaties with the United States so that the United States too can obtain benefits for its residents.

How a RIC would be a "qualified person" under an LOB article is not entirely clear, and the inquiry has not received much commentary.[150] A U.S. corporation may be a qualified person in various ways. First, a U.S. corporation is a qualified person if the principal class of its shares is regularly traded on one or more recognized stock exchanges.[151] The LOB article treats a U.S. corporation as satisfying the LOB provisions if, inter alia, the corporation is publicly traded in the United States.[152] Closed-end funds and ETFs should generally qualify as publicly traded. Open-end RICs would probably *not* satisfy the publicly traded exception since the shares are not publicly traded on one or more U.S. stock exchanges.[153]

Another basis on which a U.S. corporation can be a qualified person is pursuant to the so-called base-ownership and base-erosion tests. These tests are satisfied if a U.S. corporation is 50%-or-more owned (by vote) by qualified persons for at least half of the taxable year *and* less than 50% of the corporation's gross income is paid in the form of deductible payments

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[149] U.S. Model Technical Explanation, *supra* note 120, at 63 ("Article 22 contains anti-treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries."). The third country owners could be residents of a country that has a treaty with the source country but the terms of which are less favorable than the treaty in which the entity is formed.

[150] *See* Brown, *supra* note 128, at 34 n. 26.

[151] *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 23, para. 2(c)(i). The criteria for "regularly traded" and "recognized stock exchange" can be found in paragraph 7 of the LOB article. *See id.* paras. 7(a) (defining recognized stock exchanges), 7(e) (defining shares as regularly traded if 6% or more of the average shares outstanding are traded on the applicable exchange during the prior taxable year).

[152] *See* U.S. Model Treaty, *supra* note 123, art. 22, para. 2(c).

[153] For the United States, a recognized state exchange includes NASDAQ and any stock exchange registered with the Securities and Exchange Commission. U.S. Model Treaty, *supra* note 123, art. 22, para. 5(a). In actual treaties, this clause is typically drafted so that a U.S. company is a qualified person where its shares are traded and not where they are registered. *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 23, para. 2(c)(i).

to persons who are not residents of the United States or the other signatory country.[154]

Probably all U.S. RICs satisfy the base-ownership prong given that foreign investors likely constitute a small percentage of RIC's shareholders.[155] If, however, shares of a RIC are held through intermediaries such as brokerage houses, it is impossible to know with certainty whether the RIC satisfies the base-ownership prong.[156]

If a RIC satisfies the base ownership test, it likely also satisfies the base erosion test. First, since open-end RICs cannot issue debt securities,[157] a RIC could not adjust its capital structure so that significant portions of its income could be paid to non-treaty residents in the form of tax-deductible interest. But since distributions of NCG, ICTI, and tax-exempt interest are deductible, such distributions would probably be treated as deductible payments for purposes of the base erosion test. Given that a RIC generally has only one class of stock[158] and no non-bank debt, and a RIC distributes

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[154] U.S. Model Treaty, *supra* note 123, art. 22, para. 2(e). For these purposes, a U.S. person includes a U.S. individual, federal, state or local government, or publicly traded U.S. company. *Id.* art. 3, para. 1(a). The aim of the second prong of this test is to prevent nontreaty residents from capitalizing a company organized in a treaty country with a significant amount of debt (held by the nontreaty residents) and a small of amount of equity held by qualified persons. If the debt were substantial, a company could pay out its income as deductible interest to the nontreaty debt holders.

[155] In a recent submission to the Korean government, the Investment Company Institute stated that RICs are generally owned "almost exclusively by U.S. investors" because of the unfavorable tax treatment of foreign investors and the fact that RICs are almost never registered for sale outside of the United States. *See* Letter from Keith Lawson, Senior Counsel, Inv. Company Inst., to Byung-Cheol Kim, Dir. Corp. Tax Div., Korean Ministry of Strategy and Fin., *supra* note 146, app. at 3.

[156] For a discussion, see U.S. DEP'T OF THE TREASURY, FED. RESERVE BANK OF N.Y., FOREIGN PORTFOLIO HOLDINGS OF U.S. SECURITIES 10–11 (Apr. 2015). The same issue arises in the case of tax-exempt shareholders such as IRAs that invest in a fund through an intermediary. *See* Colon, *supra* note 18, at 830 n. 248.

[157] 15 U.S.C. § 80a-18(a). However, open-end companies may borrow directly from a bank to finance a portion of their portfolio purchases. *Id.* § 80a-18(f)(1) (an open-end company may not directly issue debt securities, but it may borrow from a bank if immediately after such borrowing, the company has an asset coverage of at least 300%). Closed-end funds may issue debt securities and preferred stock under limited circumstances, in addition to borrowing from banks to fund portfolio purchases. *Id*. § 80a-18(a)(1) (requiring that immediately after such issuance of debt, a fund have asset coverage of at least 300%); *id.* § 80a-18(a)(2) (requiring that immediately after such issuance of preferred stock, a fund have asset coverage of at least 200%).

[158] Prior to 2010, a RIC generally had to distribute dividends pro rata. *See* I.R.C. § 562(c). This rule was repealed for publicly offered RICs in The Regulated Investment

generally all of its income, if qualified persons hold 50% of the votes, it generally will not be possible for 50% or more of the RIC's gross income to be paid to persons who are not residents of the U.S. or the other signatory country.[159] Given that many open-end RICs have currently begun to limit sales of shares to non-U.S. residents, whether a RIC is a qualified person under the base erosion/ownership tests may become an increasingly moot issue.[160]

Finally, many recent U.S. treaties permit the competent authorities of each country to agree to grant treaty benefits with respect to an item of income if it is determined that the "establishment, acquisition or maintenance" of the entity "and the conduct of its operations did not have as one of its principal purposes the obtaining of [treaty] benefits."[161] Given

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Company Modernization Act of 2010, Pub. L. No. 111-325, § 307(a), 124 Stat. 3537, 3550. The Investment Company Act of 1940 contains limitations on the capital structure of an open-end RIC. *See, e.g.*, 15 U.S.C. § 80a-18(f)(1)–(2).

[159] Since gross income is income reduced by expenses, and a RIC's income is generally distributed proportionately to share holdings, third country residents could never receive more than 50% of the RIC income (which is less than gross income) without owning more than 50% of the payor RIC. The base erosion test was certainly not envisioned to apply to an entity like a RIC that deducts payments to equity holders. Apparently treaty benefits have not been denied for failure to qualify under an LOB provision. *See* Brown, *supra* note 128, at 34 n. 26.

[160] *See, e.g.*, Laura Saunders, *Fidelity Bans U.S. Investors Overseas From Buying Mutual Funds*, WALL ST. J. ONLINE (Jul. 1, 2014, 7:07 PM), http://www.wsj.com/articles/fidelity-bans-overseas-investors-from-buying-mutual-funds-1404246385. In informal conversations with the author, professionals in the industry have stated that funds have begun to restrict sales to foreign residents because of the concern that such sales could be treated as a public offering under foreign law.

There are other ways a company can be eligible for treaty benefits even if it is not a qualified person, but these will generally not apply to RICs. Under the equivalent beneficiary provision, a company will be entitled to treaty benefits if, inter alia, 95% or more of a company's shares are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries. *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 23, para. 3(a). A RIC would not qualify under this provision because of the large number of its shareholders. This provision is discussed *infra* Part. V.D. Even if the recipient of an item of income is not a qualified person under the LOB article, the resident can obtain treaty benefits if he is engaged in the active conduct of a trade or business in the residence country and the income derived in the source state is "is derived in connection with, or is incidental to, that trade or business." U.S. Model Treaty, *supra* note 123, art. 22, para. 3. A RIC cannot qualify under this provision because the business of making or managing investments for its own account is excluded unless the activities are banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer. *Id.*

[161] U.S. Model Treaty, *supra* note 123, art. 22, para. 4.

the significant regulatory burdens imposed on U.S. RICs, if an open-end U.S. RIC were to become majority-owned by foreign investors who are not treaty residents, the RIC should be able to show that it was not established or maintained to obtain treaty benefits. Furthermore, if an open-end RIC permits any foreign investor to acquire shares, the RIC should be able to show that the acquisition did not have a principal purpose of obtaining treaty benefits. A RIC established solely for the non-treaty investors, however, might be problematic. There are no published rulings on the criteria that competent authorities apply to make this determination in the case of an investment company.

If a RIC is treated as a qualified person under an income tax treaty, it is entitled to treaty benefits with respect to dividends, interest, and capital gains arising in the source country. The maximum dividend rate generally depends on the RIC's ownership interest in the distributing corporation. Tax treaties generally limit dividend source basis taxation to 15%, but this rate is reduced to 5% if the beneficial owner of the dividends is a company that owns 10% or more of voting power of the company paying the dividend.[162] In recent treaties, the United States generally negotiates to include a 0% rate if the dividend recipient is a pension or a company that owns 80% or more of the voting power of the company paying the dividend.[163] It is highly unlikely that a RIC would qualify for the 0% rate because of the tax and securities law diversification requirements.[164]

In addition to a reduced treaty rate on dividends, if a RIC were a qualified person for treaty purposes, any interest that was subject to source basis taxation in the absence of a treaty would likely be tax-exempt in the hands of the RIC, as most treaties generally provide for a 0% rate on source basis interest.[165] Finally, any capital gains or derivatives income that is otherwise subject to source basis taxation is generally exempt.[166]

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[162] U.S. Model Treaty, *supra* note 123, art. 10, para. 2.

[163] *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 10, paras. 3(a)–(b).

[164] The reason is that investments in any one issuer above a certain percentage of a fund's assets or the issuer's voting shares are not counted for purposes of the diversification tests of a mutual fund. *See* I.R.C. § 851(b)(3)(A)–(B).

[165] *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 11, para. 1 (interest is only taxable in state of residence). Some few treaties permit source basis taxation of interest. *See* Rubinger, *Tax Planning with U.S. Income Tax Treaties Without LOB Provisions*, *supra* note 148, n.18.

[166] *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 13, para. 5 (gains other than gains from real property are only taxable in the residence country); art. 22 (other income, which includes income from derivatives, is exempt from source basis taxation).

C. Special U.S. Treaty Rules for RIC Dividends

The above analysis has focused on whether a RIC is a qualified person for purposes of a tax treaty. Although U.S. treaty policy has not explicitly focused on the issue of whether a U.S. RIC is a qualified person, recent U.S. treaties have included special provisions that apply to dividends paid by a RIC to a foreign treaty resident. These provisions prevent a foreign investor from exploiting a RIC's quasi pass-through regime and garnering a reduced rate on dividends paid by a RIC that it could not otherwise obtain if it invested directly in the RIC's assets.

In treaties containing these special provisions,[167] the 15% and 0% dividend rates apply to dividends paid by RICs only in limited circumstances. Under the 2006 U.S. Model Treaty, a foreign RIC shareholder is not entitled to the 5% dividend rate regardless of the shareholder's ownership percentage of the RIC; the 15% rate applies unless the recipient is a pension plan, in which case the 0% rate applies.[168] The Technical Explanation to the 2006 U.S. Model Treaty states that these limitations are intended to prevent a treaty resident who desires to hold a diversified U.S. portfolio from purchasing 10% or more of the shares of a RIC holding a diversified U.S. portfolio, making the dividends paid by the RIC subject to the 5% rate rather than the 15% rate that would apply if the treaty resident invested directly in the underlying shares.[169]

In actual tax treaties, the dividend limitation applies to entities denominated "pooled investment vehicles" (PIVs). A PIV is a person whose assets consist wholly or mainly of real estate or stock, securities, currencies or derivatives, whose gross income consists wholly or mainly of dividends, interest, capital gains, rents, and other income and gains from real property, and who is either exempt from tax, subject to tax at a special rate, or is entitled to a deduction for dividends in computing income or gains.[170] RICs are considered to be PIVs.[171]

In the U.S.-U.K. treaty, for example, a dividend paid by a U.S. RIC (a PIV under the treaty) to a U.K. resident is not eligible for the 5% rate, regardless of the percentage of the RIC's shares owned by the U.K.

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[167] All recent treaties contain this provision.

[168] U.S. Model Treaty, *supra* note 123, art. 10, para. 4(a). Special rules also apply to dividends paid by REITs. *Id.* para. 4(a)(i)–(iii).

[169] U.S. Technical Explanation, *supra* note 120, at 36.

[170] *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 10, para. 10(b) (defining PIV).

[171] *See, e.g.*, U.S.-U.K. Technical Explanation, *supra* note 142, at 41.

resident.[172] A dividend paid by a RIC to a U.K. pension is eligible for the 0% rate, provided the RIC's assets consist wholly or mainly of shares, securities, currencies, or derivatives of such assets.[173] The Technical Explanation to the U.S.-U.K. treaty echoes the justification given in the U.S. Model Technical Explanation for the limitation of the 5% rate for U.K. investors in U.S. RICs. The dividend rate limitation is designed to prevent a passive U.K. investor from converting a 15% tax on U.S. source dividends to a 5% tax by purchasing a 10% or greater interest in a RIC that holds a diversified portfolio of U.S stocks.[174]

The justification for this special treatment given in the U.S. Model Technical Explanation and other treaties is somewhat questionable. The U.K. Technical Explanation strangely equivocates when it states: "[i]f the RIC is a pure conduit, there may be no U.S. tax costs to interposing the RIC."[175] To the extent that a RIC holds only U.S. stocks and the RIC earns only capital gains and U.S. source dividends, this statement is accurate, and the provisions prevent converting the 15% tax on those dividends to 5%. But as a description of a RIC's fiscal taxonomy under current law, a RIC is not a pure conduit for either U.S. or foreign investors, especially with respect to a RIC's foreign source income. Since a RIC is *not* a pure conduit, there are tax costs to interposing the RIC for foreign source income: the RIC's foreign source income that would otherwise be exempt from U.S. tax now becomes subject to a 15% tax for treaty investors.

Finally, it is somewhat strange that recent treaties treat payments by

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[172] U.S.-U.K. Treaty, *supra* note 118, art. 10, para. 4, *amended by* Protocol Amending the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, Signed At London on 24th July 2001, U.S.-U.K., art. II, July 19, 2002, T.I.A.S. No. 13,161.

[173] *Id.* The provisions dealing with REITs follow the 2006 Treaty Model and limit the availability of the 15% rate (for nonpensions) and 0% (for pensions). *Id.*

[174] U.S.-U.K. Technical Explanation, *supra* note 142, at 42.

[175] *Id.* This same rationale is found in other treaties, although its formulation differs slightly. *See, e.g.*, U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION TO THE CONVENTION BETWEEN THE GOVERNMENT OF THE UNITED STATES OF AMERICA AND GOVERNMENT OF IRELAND FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND ON CAPITAL GAINS SIGNED AT DUBLIN ON JULY 28, 1997, AND THE PROTOCOL SIGNED AT DUBLIN ON JULY 28, 1997, art. 10 (1997) ("Since the RIC may be a pure conduit, there may be no U.S. tax costs to interposing the RIC in the chain of ownership."). The special rule for withholding rates on dividends paid by RICs and REITs is contained in thirty-seven U.S. income tax treaties.

PIVs specially and all note that RICs are PIVs, but there is no discussion of how a RIC or PIV is a qualified person under the LOB article. Perhaps the drafters rely on an unstated assumption that nonpublicly traded RICs are qualified persons because they would likely satisfy the base ownership and base erosion tests.

D. Treaty Shopping and Foreign Investors

Unlike the U.S. Model Treaty, the OECD Model Treaty does not contain a separate LOB article, as many countries have not historically shared the same concern with treaty shopping as the United States.[176] The OECD's recent BEPS project is firm evidence that this laissez-faire attitude is certainly on the wane.[177] Treaty shopping refers generally to the strategy employed by a resident of a country that does not have an income tax treaty with the source country (the country of origin of interest, dividends, gains, etc.) to obtain treaty benefits by using an entity formed in a country with which the source country has a treaty.[178] If the country in which the entity is formed has a benign tax regime for extracting source country income, e.g., a dividend exemption system or lax rules on income stripping, a foreign investor from a non-treaty country can significantly improve his or her after-tax returns by investing through a treaty-qualified entity. By excluding all foreign source income from qualifying as qualified interest or dividend income in the final foreign RIC legislation, Congress ensured that all foreign source income would be subject to an additional 30% U.S. tax when distributed (or less if a foreign shareholder's country of residence had a treaty with the United States), whether or not the RIC's foreign source income actually benefits from a U.S. treaty.

Because RICs do not pay tax on their distributed income, they could

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[176] The OECD Model Commentary to article 1 discusses possible approaches to treaty shopping, including adopting a LOB provision similar to the typical U.S. LOB treaty provisions. OECD Model Commentary, *supra* note 120, para. 20.

[177] *See* BEPS Action Plan, *supra* note 129.

[178] It also describes a situation where an investor is from a country that has a treaty with the source country but uses an entity formed in a country that has more favorable treaty provisions with the source country than the residence treaty. For example, if under the investor's treaty with the source country, the dividend rate is 15%, but under the treaty of a third country, the rate is 10%, it may be advantageous to interpose an entity formed in the third country to make investments in the source country. This structure is dependent on being able to extract the income from the third country with little or no additional tax imposed by the third country or being able to receive a credit against residence taxation for any tax imposed by the third country.

potentially be vehicles for treaty shopping. The CIV Benefits Report focuses extensively on this issue,[179] which is arguably the key to understanding why the foreign RIC provisions do not provide look-through for foreign source income.

CIVs with foreign investors present a formidable challenge for treaty policy. It is difficult to accommodate under the current international tax regime the competing goals to tax CIV investors, both foreign and domestic, under domestic law on the same basis as if they had earned their share of the CIV's underlying income (a pass-through approach), but also to treat CIVs as treaty residents with access to reduced treaty rates on their foreign source income (an entity approach). The combination of these two policies can result in a foreign investor being able to achieve a lower rate (or zero rate) on a CIV's foreign source income than he could obtain if he invested directly. The desire of the United States to prevent treaty shopping probably leads it to reject a look-through approach for a RIC's foreign source income. As demonstrated below, however, this concern is probably exaggerated, and foreign investment in global RICs is unnecessarily discouraged.

To focus on how these conflicts arise, assume two investors, one U.S. and one foreign, each owning 50% of the shares of a RIC that earns $100 of foreign source interest and $100 of foreign source dividends. The RIC distributes all of its ICTI. The foreign source interest is not subject to withholding by the source country (as is typical for most portfolio-type interest), but dividends are subject to a 30% withholding tax unless reduced by a treaty. When a treaty applies to a dividend, the withholding tax is 15%.

The following scenarios compare the tax consequences of earning foreign source investment income through a RIC and earning the same income directly (or equivalently through a partnership), and take treaties into account. For income earned through a RIC, the relevant treaties are the treaty between the source country and the United States and the treaty between the foreign shareholder's country of residence and the United States. For income earned directly, the relevant treaty is that between the foreign investor's country of residence and the source country. Finally, for each scenario below, it is assumed that if the RIC makes the section 853 election, the foreign shareholder is only taxed on the dividend actually received and not the dividend grossed up for foreign taxes.[180]

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[179] OECD, Treaty Benefits CIVs, *supra* note 126, paras. 52–57.

[180] I.R.C. § 853(b)(2)(A). If foreign shareholders are taxed on a RIC's foreign taxes, the analysis does not change. In fact, there is an even greater disparity between the tax

1. Scenario 1: No Treaty Applies

In the absence of any tax treaty, the RIC's income is $200 and the source country withholds $30 (30%*$100). If the RIC elects not to pass through the foreign taxes but instead deduct them, each shareholder receives $85.[181] If the RIC elects to pass through the foreign tax credit, the foreign and U.S. shareholder receive an $85 dividend, but the U.S. shareholder reports an additional $15 of income on which it can claim a credit.[182]

If the dividends received by the RIC are qualified dividends, the dividend paid to the U.S. shareholder is taxed partially as ordinary income and partially as qualified dividend income.[183] For the U.S. shareholder, earning the foreign source income through the RIC leaves the shareholder in roughly the same position had the shareholder earned directly his or her share of the underlying income, provided the fund makes the foreign tax credit election.[184]

The foreign shareholder is taxed at 30% on the $85 RIC dividend,[185] leaving the shareholder with $59.5 on a pretax return of $100, which results in an effective tax rate of 40.5% (($15+$25.5)/$100). Note, this rate is higher than either the source country tax rate or the U.S. tax rate. This results from treating the foreign taxes as a deduction at the RIC level, i.e., they reduce income distributed to the foreign shareholder.

If the foreign investor had earned the foreign source income directly, it would have paid $15 (30%*$50) of taxes on the dividend and $0 on the

consequences of direct investment and investing through a RIC.

[181] *See supra* note 62.

[182] *See* I.R.C. § 853(a)(1); § 901(a).

[183] I.R.C. § 1(h)(11)(C)(ii) (qualified dividend is a dividend from stock readily tradable on an established securities market in the United States). If the dividends are not qualified, the entire RIC dividend is taxed as ordinary income.

[184] *See supra* note 62. Even if the foreign tax rate on the dividend income (30%) is higher than the shareholder's U.S. rate, most U.S. shareholders should be able to credit the entire $15, since the average rate on foreign source income is 15% (50%*30% + 50%*0%). In foreign tax credit parlance, since all of the income is in same basket, the passive basket, it is possible to average the foreign taxes. Since a RIC can deduct investment expenses against ICTI, *see* I.R.C. § 852(b)(2)(A), a RIC shareholder may be slightly better off earning income through a RIC since those expenses could probably not be deducted if the shareholder incurred them directly. *See supra* Part II.B.

[185] *See* I.R.C. § 871(a)(1) (taxing U.S. source FDAP income of nonresident aliens at 30% tax); I.R.C. § 881(a) (taxing U.S. source FDAP income of foreign corporations at 30% tax).

interest, leaving $85 after-tax income, which is an effective tax rate of 15%. If, however, the foreign investor's country of residence had a treaty with the source country, the withholding tax would have been reduced to $7.5 (15%*$50).

2. Scenario 2: U.S. Treaty Applies to Source Country Income

In this scenario, the United States has a treaty with the source country, but the residence country does not have a treaty with either the United States or the source country. The RIC's source basis taxes are reduced from $30 to $15 (15%*$100), and each investor receives $92.5. If the RIC elects to pass through the foreign taxes, the U.S. investor will have income of $100, but may claim a foreign tax credit of $7.5. Again, the U.S. investor is roughly in the same after-tax position had he or she earned the foreign source income directly.

The foreign shareholder is taxed at 30% on the $92.5 RIC dividend leaving $64.75, which results in an effective tax rate of 35.25% (($7.5+$27.75)/$100). Again, this rate is higher than either the source country tax rate (15%) or the U.S. tax rate (30%) because the source taxes reduce the RIC dividend paid to the foreign shareholder.

If the foreign investor had earned the foreign source income directly, he or she would have paid $15 (30%*$50) of taxes on the dividend and $0 on the interest, leaving $85 of after-tax income. If, however, the foreign investor's country of residence had a treaty with the source country, the withholding tax would have been reduced to $7.5 (15%*$50).

3. Scenario 3: U.S. Treaty Applies to Source and Residence Country Income

In this scenario, the United States has a treaty both with the source country and the foreign investor's country of residence. This reduces the dividend rate to 15%, and each investor receives a RIC dividend of $92.5. If the RIC elects to pass through the foreign taxes, the U.S. investor is taxed on $100, but receives a foreign tax credit of $7.5. The U.S. investor is roughly in the same after-tax position had he or she earned the foreign source income directly.

The foreign investor pays tax of $13.88 (15%*$92.5) on the RIC dividend leaving $78.63, which results in an effective tax rate of 21.38% (($7.5+$13.88)/$100). As in the previous examples, this rate is higher than either the foreign or U.S. tax rate because the foreign taxes are in essence deducted at the RIC level rather than credited at the investor level.

In the absence of a treaty with the source country and in the case of direct investment, the foreign investor would have paid $15 (30%*$50) of taxes on the dividend and $0 on the interest, leaving $85 after-tax income. If the foreign investor's country of residence had a treaty with the source country, the withholding tax would have been reduced to $7.5 (15%*$50).

Table 1[186] summarizes and compares the tax consequences to the foreign investor of investing through a RIC and earning the foreign source income directly.

TABLE 1

	RIC			DIRECT	
	SCENARIO 1	SCENARIO 2	SCENARIO 3	NO TREATY	TREATY
FS DIV & INT	100	100	100	100	100
SOURCE WH TAX	(15)	(7.5)	(7.5)	(15)	(7.5)
RIC INC	85	92.5	92.5		
US WH TAX	(25.5)	(27.75)	(13.88)		
ATCF	59.5	64.75	78.6	85	92.5
ETR	40.5%	35.25%	21.38%	15%	7.5%

For treaty shopping to be a viable strategy,[187] the total taxes paid to both the source country and intermediate country (in this example, the United States) must be less than the source country taxes that the investor would have paid if he or she had earned the source country income directly (or through a partnership). Because the United States taxes a RIC's foreign source income when distributed to a foreign investor, the foreign investor is always worse off investing through a RIC than earning the foreign source income directly.

In various bills that preceded the enactment of the foreign RIC

[186] In the following tables, "FS Div & Int" refers to foreign source dividend and interest; "ATCF" refers to after-tax cash flow; and "ETR" refers to effective tax rate.

[187] The source country might view the granting of treaty benefits to a RIC with foreign investors as a type of treaty shopping, especially in the case where the third-country investor would not be entitled to treaty benefits if he or she invested directly. In such case, the source country foregoes the 15% tax on source country dividends, but the U.S. gets the residual 15%, even though the dividends are paid to foreign investors. That is to say, had the third-country investor earned the foreign source dividends directly, the source country would have earned $15 of tax revenue. By a foreign investor investing indirectly through a RIC, the $15 tax is reduced to $7.5 because of the U.S. treaty, but the United States collects an additional $6.375 of tax (if the third-country investor is treaty eligible) or an additional $12.75 (if the third-country investor is not treaty eligible).

provisions, foreign source interest income that was exempt from source basis taxation without regard to a treaty would have constituted a qualified interest dividend and therefore been exempt from U.S. tax when distributed to a foreign investor. Under that approach, tax-exempt foreign source income would have been eligible for look-through treatment and would have been tax-exempt when paid by a RIC to a foreign investor. Other foreign source income, however, would not have been eligible for look-through and would have been treated as a U.S. source dividend when distributed.

The potential benefits to foreign investors if the United States had adopted a look-through regime for foreign source income can be seen by comparing the after-tax cash flows to a foreign investor in the above scenarios with the after-tax cash flows a foreign investor would have earned had the United States adopted complete look-through for foreign source income. In the case of look-through treatment for foreign source income, any dividend distributed, to the extent it was attributable to a RIC's foreign source income, would have been exempt.[188]

In Scenario 1, where the foreign source dividend is taxed at 30% by the source country, the RIC would receive $170 of after-tax foreign income, and there would be no additional U.S. tax when it was distributed to a foreign investor. The foreign investor would receive $85, the same amount he or she would have received had the investor directly earned the source country income. If, however, the foreign investor's country of residence had a treaty with the source country, the investor would end up with $92.5.

In Scenario 2, the source country would impose a 15% tax on the $100 dividend paid to the RIC. When the RIC distributes $92.5 to the foreign investor, there would be no additional U.S. tax. If the foreign investor would have been entitled to treaty benefits with respect to the source country dividend, the foreign investor would be in the same after-tax position had he or she invested directly.

If, however, a foreign investor would *not* have been entitled to treaty benefits for source country dividends had he or she invested directly, by investing through the RIC, the foreign investor would succeed in using a U.S. treaty to lower source basis taxes. In this scenario — full pass-through treatment of foreign source income and investment in a RIC by a non-treaty foreign investor — a foreign investor can use a U.S. treaty to obtain indirect

[188] This also assumes that income earned by a RIC that is sourced by the residence of the recipient, e.g., swap income, would be treated as if it were earned directly by the foreign shareholders.

benefits for which he or she would not be eligible if the investor had invested directly (or through a partnership). This is a classic example of treaty shopping.[189]

The results in Scenario 3 are similar to Scenario 2: since there is no U.S. tax on the RIC dividend, the existence of a U.S. treaty with the residence country is irrelevant. Consequently, the foreign investor is in the same after-tax cash position as if he or she invested directly with treaty benefits. If the investor were not eligible for treaty benefits, investing directly would leave him or her with less cash after-tax than investing through a RIC.

Table 2 summarizes and compares the tax consequences to the foreign investor of investing through a RIC under a full look-through regime with directly earning the foreign source income. One can see the potential for treaty shopping by comparing the after-tax cash flows in Scenario 2 with the after-tax cash flows in a direct investment with no treaty scenario. By investing through a RIC entitled to treaty benefits, a foreign investor improves his or her after-tax cash position compared to when the investor invests directly.

TABLE 2

		RIC		DIRECT	
	SCENARIO 1	SCENARIO 2	SCENARIO 3	NO TREATY	TREATY
FS DIV & INT	100	100	100	100	100
SOURCE WH TAX	(15)	(7.5)	(7.5)	(15)	(7.5)
RIC INC	85	92.5	92.5		
US WH TAX	0.0	0.0	0.0		
ATCF	85.0	92.50	92.5	85	92.5
ETR	15.0%	7.5%	7.5%	15%	7.5%

Finally, it is instructive to compare the above results with the tax consequences to a foreign investor had the foreign RIC provisions provided look-through only for untaxed foreign source interest. This approach would have eliminated the potential for treaty shopping for foreign source interest earned through a RIC, because the interest income would be tax-free for a

[189] This would also be the case if the foreign investor's country of residence had a treaty with the source country but the dividend rate was greater than the dividend rate under the U.S. treaty with the source country. If foreign source income were passed through to a foreign investor, there would be no additional U.S. tax when the foreign source income was distributed by the RIC. The foreign investor would thus get the benefit of the lower U.S. treaty rate on the foreign source income.

foreign investor whether earned through a RIC or earned directly.[190] A foreign investor would generally be worse off earning foreign dividends through a RIC because of the additional layer of U.S. tax when the RIC distributed the income. Thus, global fixed income RICs would have benefitted under such a regime, but global equity RICs would have been penalized.

To illustrate, in Scenario 1, where there is no source or residence treaty, there would still be a source tax of $15 on the foreign dividend, but the U.S. withholding tax would be reduced to $10.5 (($50-$15)*30%) because the part of the dividend that was attributable to foreign source interest would qualify as an IRD. The total taxes paid would be $25.5. In contrast, a direct investment by a non-treaty foreign investor would generate foreign taxes of $15 ($50*30%), and $7.5 ($50*15%) in the case of a treaty investor.

In Scenario 2, where there is a U.S. treaty with the source country, the RIC would receive $185 ($200 reduced by a 15% tax on a $100 dividend). When the RIC distributes $92.5 to the foreign investor, the United States would collect another $12.75 ($42.5*30%), for total foreign taxes of $20.25. If the foreign investor had invested directly, he or she would have paid source country tax of $15 ($50*30%) without a treaty and $7.5 ($50*15%) with a treaty. Direct investment still dominates indirect investment because there is U.S. tax imposed on the foreign source dividend.

In Scenario 3, where there is a U.S. treaty with the residence country, the RIC would receive $185 ($200 reduced by 15% tax on $100 dividend). When the RIC distributes $92.5 to the foreign investor, the United States would collect another $6.38 (15%*$42.5), for a total tax paid by the foreign investor of $13.88. If the foreign investor had invested directly, he or she would have paid source country tax of $15 (30% of $50 of dividend income) without a treaty and $7.5 with a treaty.

Table 3 summarizes and compares the tax consequences to the foreign investor of investing through a RIC under a look-through regime for tax-exempt foreign source interest with earning the foreign source income directly. Table 3 demonstrates that a foreign investor can improve his or her

[190] In a submission to the Committee on Ways and Means, U.S. House of Representatives, the Investment Company Institute noted that this language would "eliminate the U.S. withholding tax barrier to foreign investment in U.S. funds" while limiting the potential for treaty shopping. *Impact of U.S. Tax Rules on International Competitiveness: Hearing Before the H. Comm. on Ways & Means*, 106th Cong. 200 (1999) (statement of the Investment Company Institute).

after-tax cash flow by earning foreign source dividends through a RIC where the foreign investor's country of residence does not have a treaty with the source country but has a treaty with the United States (and the United States has a treaty with the source country).

TABLE 3

	RIC			DIRECT	
	SCENARIO 1	SCENARIO 2	SCENARIO 3	NO TREATY	TREATY
FS DIV & INT	100	100	100	100	100
SOURCE WH TAX	(15)	(7.5)	(7.5)	(15)	(7.5)
RIC INC	85	92.5	92.5		
US WH TAX	(10.5)	(12.8)	(6.38)		
ATCF	74.5	79.75	86.13	85	92.5
ETR	25.5%	20.25%	13.88%	15%	7.5%

E. Is Treaty Shopping by RICs a Real Concern?

In the case of look-through treatment for all foreign source income (or only tax-exempt foreign source income), a foreign investor may be able to improve his or her after-tax cash flows by investing through a RIC instead of investing directly. One can see this by comparing the after-tax cash flows in Scenario 2 in Table 2 and Scenario 3 in Table 3 with the respective after-tax cash flows accruing to an investor resident in a country that does not have a treaty with the source country. The reason that the after-tax cash flows are greater in Scenario 2 in Table 2 is that the source basis tax on dividends is reduced because of the U.S. treaty, and there is no residual U.S. tax on the RIC dividends. In Table 3, the source basis tax on dividends is reduced because of the U.S. treaty, and U.S. tax is imposed only on the *after-source-tax* amount of the foreign source dividends. In essence, the (reduced) source taxes are deducted prior to the application of U.S. tax, and the sum of the source and U.S. taxes is slightly less than the source taxes that would have been imposed in the case of direct investment without a treaty.

The treaty shopping potential highlighted in Tables 2 and 3 may be more illusory than real. In Table 3 (pass-through treatment only for untaxed foreign source income), investing through a RIC improves after-tax cash flows compared to direct investment *only if* the foreign investor's country of residence has a treaty with the United States but not with the source country. This is unlikely given that many European trading and investment partners have entered into a significantly greater number of treaties than the United States. The Netherlands, for example, has entered into over 100 tax treaties compared with over sixty for the United States.[191]

More importantly, the above scenarios ignore the residence country treatment of the foreign taxes paid and focus solely on comparing the after-tax cash flows of a foreign investor, which implicitly treats all foreign taxes as expenses. To the extent a foreign investor can credit any *direct* foreign taxes paid (both U.S. taxes imposed on RIC dividends and source taxes paid in the case of direct investment) against his or her residence basis taxes, the treaty advantages garnered by investing through a RIC largely disappear, and a foreign investor will always be better off by investing directly than through a RIC.

To illustrate, assume that a foreign investor pays a 15% residence tax on RIC dividends and on all direct investment income. In a regime in which only untaxed foreign interest is passed through (Scenario 3 in Table 3), the foreign investor will receive $86.13 of cash from the RIC ($92.5 less U.S. tax of $6.38) and will owe residence tax of $13.88 ($92.5*15%). He or she can credit against the residence liability the U.S. tax of $6.38, leaving $78.63 of cash ($86.13 less $7.5 of residence tax liability). In contrast, direct investment would leave the foreign investor with $85 of cash — the source country tax is $15 and since the residence liability is also $15, the investor receives a credit of $15, leaving $85.

In a regime in which all foreign source income is passed through (Scenario 3 in Table 2), the foreign investor will receive $92.5 of cash from the RIC and will owe residence tax of $13.88 ($92.5*15%). This leaves $78.63 of cash. In contrast, direct investment would leave the foreign investor with $85 of cash — the source country tax is $15, and since the residence liability is also $15, the investor receives a credit of $15, leaving $85.

When a foreign investor can fully credit any direct source basis taxes against his or her residence tax liability, investing directly yields higher tax cash flows than investing through a RIC. If we assume that investors are rational, treaty shopping should not be a concern.

The legislative history to the foreign RIC provisions is silent on why

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[191] *See Overview of Treaty Countries*, BELASTINGDIENST [TAX & CUSTOMS ADMINISTRATION], http:// www.belastingdienst.nl /wps / wcm / connect / bldcontenten / belastingdienst/individuals/tax_arrangements/tax_treaties/overview_of_treaty_countries/; United States Income Tax Treaties - A to Z, THE INTERNAL REVENUE SERVICE (SERVICE), https://www.irs.gov/Businesses/International-Businesses/United-States-Income-Tax-Treaties—-A-to-Z.

look-through treatment was not adopted for foreign source income, including tax-exempt foreign source interest. Hence it is difficult to know with certainty why it was not part of the final legislation. The above examples demonstrate that the treaty shopping concern is probably overblown in the case of untaxed foreign source income.

In a regime that provides for full look-through for all foreign source income, the analysis is slightly more complex. A foreign investor benefits by investing through a RIC only in cases where the residence country does not allow a credit for direct foreign taxes or the foreign investor is not subject to residence taxation. An investor could be tax-exempt if either the entity was a pension or charity or the residence country did not tax the foreign source investment income of its residents.

For the pensions and charities, one can probably assume that such entities do not invest in RICs or that they could avoid source basis taxation if they invested directly.[192] If, however, they are subject to the same source basis taxation as other foreign investors and do not benefit by a treaty, investing through a RIC could improve their after-tax cash flows since such entities are not taxable and any taxes are truly expenses.

Certain countries, e.g., the Cayman Islands, do not tax the foreign source income of entities formed under their laws.[193] If a full look-through regime for foreign source income were adopted, foreign investors that invest through entities formed in these countries could invest in a RIC and obtain the benefits of U.S. treaties to lower their after-tax cash flows, even though the investors may not have been able to obtain the same benefits had they directly invested.

There is unfortunately no precise data on the value of shares of U.S. RICs held by residents of (or entities formed in) such countries or a breakdown of the type of RICs held by foreigners. Thus one cannot know whether foreigners currently avoid global funds or invest in such funds regardless of the U.S. tax treatment, whether foreigners migrated to U.S.-focused funds when the foreign RIC provisions were enacted, or whether non-treaty residents would migrate to foreign funds if the U.S. were to enact a full look-through regime.

The total value of shares in *open-end* funds held by all foreign

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[192] *See, e.g.*, U.S.-U.K. Treaty, *supra* note 118, art. 10, para. 3(b) (0% tax rate on dividends paid to a pension).

[193] *http://www.dci.gov.ky/portal/page/portal/ivbhome/doingbusiness* ("The government does not impose personal or corporation income taxes and there are no taxes on profits and gains from investments.").

investors at the end of 2014 was $606 billion, which represents an increase of roughly 379% since the end of 2005.[194] During this same period, foreign investors' percentage ownership of all RIC shares increased from 2.69% to 4.8%, an increase of 78%.[195] At the end of 2014, foreign investment in open-end mutual funds represented 3.15% of the sum of direct foreign investments in open-end RICs, U.S. corporate equities, U.S. corporate bonds, U.S. Treasury securities, and Agency- and Government-Sponsored Enterprise (GSE)-backed securities. This represents an increase of 64% from the end of 2004.[196] These data suggest that the foreign RIC provisions may have stimulated investment in RICs.

According to data of the Federal Reserve Bank of New York, as of June 30, 2014, *all* foreign investors held $1.039 trillion of shares of funds, including mutual funds.[197] Treaty investors held $609 billion, or about 60%. The Federal Reserve data, however, includes hedge funds, and it is consequently difficult to draw any definitive conclusions about the current ownership of RICs by investors from treaty countries.[198]

Congress may have eschewed look-through if it were concerned with a RIC potentially foregoing treaty benefits to benefit foreign investors at the expense of U.S. investors. For example, assume that a RIC earns some interest from Country A that is taxed at 10% without any treaty benefits and some interest taxed at 0% with treaty benefits. If a RIC were composed primarily of foreign investors from countries with no U.S. treaty, it could be beneficial for the RIC to forgo the treaty rate reduction so that the foreign

194 *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FEDERAL RESERVE STATISTICAL RELEASE: Z.1 FINANCIAL ACCOUNTS OF THE UNITED STATES, FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS, HISTORICAL ANNUAL TABLES 2005–2014, 102 tbl.L.132 (2015). Note, this data does not include money market mutual funds, closed-end funds, or ETFs. Money market funds held by foreign investors totaled $113.4 billion at the end of 2014, up from $23 billion in 2005. *Id.*

195 *See id.*

196 *See id.*

197 U.S. DEP'T OF THE TREASURY, FED. RESERVE BANK OF N.Y., & BD. OF GOVERNORS OF THE FED. RESERVE SYS., FOREIGN PORTFOLIO HOLDING OF U.S. SECURITIES, 18–19 tbl.13, A-24 tbl.A4. The data includes open-end funds, closed-end funds, money market funds, and hedge funds. *Id.* at 18.

198 The country with the greatest value of fund assets, $164 billion (15.8% of the total), was the Cayman Islands, which is a well-known country for hedge-fund formation. *Id.* at 19 tbl. 13. Another popular *situs* for hedge fund formation, the British Virgin Islands, invested $39 billion (3.8% of the total) and was number 8 on the list. *Id.* at A-24 tbl.A4. If a hedge fund is formed in the Cayman Islands and is taxed as a partnership, certain partners of the fund may be eligible for treaty benefits. *See supra* Part III.E.

investors could receive the interest free of U.S. tax as a QII dividend.[199] If, however, the RIC elected treaty benefits, the interest would be taxed at 0% at the RIC level, but subject to a 30% U.S. withholding tax when distributed.

Another reason Congress did not adopt look-through may have been to bolster the U.S. treaty policy of treating RICs as treaty residents,[200] regardless of any LOB provision. A withholding tax on distributions of foreign source income supports both the argument that a RIC is not a pure pass-through entity because the foreign source income is not treated as foreign source income when distributed and the argument that a RIC cannot be used to treaty shop. This position has been advanced by the OECD[201] and the ICI in submissions to foreign governments.[202]

This concern is a slightly novel twist on traditional U.S. concerns with treaty shopping. U.S. tax authorities are generally concerned with foreign investors attempting to obtain treaty benefits with respect to *U.S. source* income by investing through an entity organized in a country with which the United States has an income tax treaty.[203] The United States is

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[199] Under some bills introduced before the enactment of enactment of sections 871(k) and 881(e), the definition of QII included foreign source interest "other than interest that is subject to tax imposed by a foreign jurisdiction if the amount of such tax is reduced (or eliminated) by a treaty with the United States." *See, e.g.*, H.R. 1669, 108th Cong. § 2(a) (2003) (proposing new section 871(k)(1)(E)(ii)). Consequently, if the treaty interest provision were not invoked, the interest would have been subject to a tax, but since the tax would not have been reduced or eliminated by a treaty, it would have constituted QII. It is possible that the Service would not have agreed with this interpretation of the statute. For U.S. investors, the failure to elect treaty benefits could reduce the foreign tax credit, since the foreign taxes may be treated as a "noncompulsory amount" under Treas. Reg. § 1.901-2(e)(5)(i) (as amended in 2013).

Congress also may have eschewed look-through because it could have been difficult to show that a 0% rate on interest was pursuant to domestic law and not pursuant to a treaty, especially if a fund earned both tax-exempt portfolio interest and taxable interest. In such case, a fund could opt not to invoke the treaty to preserve the 0% rate on the portfolio interest.

[200] *See* U.S. Technical Explanation, *supra* note 142, at 13 ("[RICs and REITS] that are nominally subject to tax but that in practice are rarely required to pay tax also would generally be treated as residents and therefore accorded treaty benefits.").

[201] OECD, Treaty Benefits CIVs, *supra* note 126, para. 6.20 (a CIV whose distributions to foreign investors are subject to a withholding tax presents less danger of treaty shopping).

[202] *See* Letter from Keith Lawson, Senior Counsel, Inv. Company Inst., to Byung-Cheol Kim, Dir. Corp. Tax Div., Korean Ministry of Strategy and Fin., *supra* note 146, app. at 3 (describing the significant adverse tax effect of non-U.S. investments in RICs).

[203] U.S. Model Technical Explanation, *supra* note 120, at 63 ("Article 22 contains anti-

concerned that in the absence of impediments to treaty shopping, foreign countries that do not have a treaty with the United States will not have an incentive to enter into a treaty with the United States (and thus give up their source basis revenues and enhance residence basis taxation) if their residents can obtain treaty benefits with the United States by merely using the treaty of a third country. Thus, treaty shopping has generally been concerned with protecting U.S. tax on *U.S. source* income.[204] In fact, with respect to foreign source income earned by U.S. persons, the United States generally benefits from U.S. investors lowering foreign taxes through tax planning, including treaty shopping, because a reduction in foreign taxes increases residence basis taxes.[205]

The foreign RIC provisions have a decidedly different focus and effect. By subjecting the foreign source income of RICs to U.S. tax, the United States is not protecting U.S. taxes on U.S. source income but rather foreign tax on foreign source income. In addition, the benefits of such protection do not inure to the source country but rather to the United States.

The OECD considered this issue at length and proposed various mechanisms to address treaty shopping.[206] In general, the OECD provisions focus on limiting a portion of a CIV's treaty benefits at the source country level based on the composition of a CIV's owners. In essence, these proposals move towards treating a CIV, for treaty purposes, as a partnership rather than as a separate legal entity.

One OECD proposal would limit a CIV's treaty benefits in proportion to its ownership by equivalent beneficiaries.[207] Another would limit a CIV's treaty benefits in proportion to the percentage of the CIV's owners that are residents of the CIV's country of residence.[208] Recognizing that both of these approaches would impose substantial administrative burdens

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treaty-shopping provisions that are intended to prevent residents of third countries from benefiting from what is intended to be a reciprocal agreement between two countries").

204 *See, e.g.*, Aiken, Indus., Inc. v. Comm'r*,* 56 T.C. 925 (1971); N. Ind. Pub. Serv. Co. v. Comm'r, 101 T.C. 294 (1993), *aff'd*, 115 F.3d 506 (1997). The conduit financing regulations, which permit an intermediate entity to be disregarded in certain financing transactions, generally apply to determine the U.S. tax liability of a U.S. corporation. *See* Treas. Reg. § 1.881-3 (as amended in 2012).

205 For purposes of the business purpose test of section 355, the reduction of foreign taxes is a valid business purpose. *See* Rev. Rul. 89-101, 1989-2 C.B. 67.

206 OECD, Treaty Benefits CIVs, *supra* note 126, paras. 52–57. The relevant revisions to the OECD Model Commentary addressing treaty shopping are found in OECD, Model Commentary, *supra* note 128, art. 1, paras. 6.19–6.32.

207 OECD, Model Commentary, *supra* note 128, art. 1, paras. 6.21–6.24.

208 *Id*. art. 1, para. 6.26.

on a CIV to determine precisely the tax residence of its shareholders, the OECD suggested that contracting states could consider adopting a provision that would grant treaty benefits in their entirety to a CIV if at least a certain percentage of the CIV's shares were owned by equivalent beneficiaries or residents of the CIV's country of residence.[209]

Current U.S. tax treaty policy endeavors to treat all RICs as qualified persons, which ensures that their income, in its entirety, is eligible for treaty benefits.[210] The OECD proposals, which limit treaty benefits in proportion to the identity of a CIV's owners, may not currently be viable options for the United States for two reasons. First, the withholding tax on a RIC's foreign source income paid to foreign investors ensures that RICs are not viable treaty shopping vehicles.[211] Second, it is unclear how the OECD proposals, which would treat a CIV's income as partially qualified for treaty benefits, would work in connection with the distribution of the CIV's income. For instance, if a CIV earns $100 and 80% of the investors are equivalent beneficiaries (or U.S. residents) eligible for a 15% withholding tax, under the OECD proposal, the 15% rate will apply to $80 of the income paid to the CIV. When the CIV distributes all of its income, how are the treaty benefits supposed to be allocated between the equivalent beneficiaries (or residents) and nonequivalent beneficiaries (or nonresidents)? Under U.S. law, there is currently no mechanism to make such an allocation. Without a mechanism to allocate separately the treaty benefits to the equivalent beneficiaries, the OECD proposals fall short of "serv[ing] the goal of neutrality."[212]

Another weakness of the OECD approaches is that it is well nigh impossible to know the identity of owners of shares held through financial intermediaries. Furthermore, even if a CIV could determine that an owner was, for instance, a U.K. person (individual or legal entity), it would be quite burdensome to determine whether the person was actually a qualified resident for treaty purposes. Also, the identity of the CIV's owners changes between the time the CIV receives the income and when the income is distributed. The OECD recognized that daily tracing would be impossible and impractical and suggested that contracting states accept practical approaches that would not require daily tracing.[213]

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[209] *Id*. art. 1, para. 6.27.

[210] Nonpublicly traded RICs are treated as qualified residents in a *sotto voce* manner. *See* discussion *supra* Part IV.B.

[211] OECD, Model Commentary, *supra* note 128, art. 1, para. 6.20.

[212] *Id*. art. 1, para. 6.23.

[213] *Id*. art. 1, para. 6.29.

At least one U.S. treaty has adopted a look-through approach in determining whether a CIV is entitled to treaty benefits. The 2006 protocol to the U.S.-Germany treaty amended the LOB article to provide that a German Investment Fund would be granted treaty benefits only if at least 90% of the shares were owned by German residents or equivalent beneficiaries.[214] The reason apparently is that such funds exempt the foreign source income from German tax when distributed to foreign investors.[215] The technical explanation to the protocol states that the competent authorities in determining indirect ownership may use statistically valid sampling techniques.[216]

Recognizing the important role that financial intermediaries play in the custodianship of financial assets and the challenges of applying treaty benefits to income earned on assets nominally held by such intermediaries, the OECD put forth an implementation package in 2013 to allow intermediaries to claim treaty benefits on a "pooled basis" on behalf of customers.[217] The proposals aim to eliminate the need for individual investors to apply for reduced source basis withholding by allowing the intermediary to do so on their behalf without requiring the intermediary to disclose the identity of its beneficial owners.[218]

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[214] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains to Certain Other Taxes, U.S.-F.R.G., Aug. 29, 1989, S. Treaty Doc. 101-10, *amended by* Protocol Amending the Convention Between the United States of America and The Federal Republic of Germany for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains to Certain Other Taxes, Signed on 29th August 1989, U.S.-Ger., art. XIV, art. 28, para. 6, June 1, 2006, S. Treaty Doc. 109-20 [hereinafter "U.S.-German Treaty"].

[215] BROWN, *supra* note 128, at 41.

[216] U.S. DEP'T OF THE TREASURY, TECHNICAL EXPLANATION OF THE PROTOCOL SIGNED AT BERLIN ON JUNE 1, 2006 AMENDING THE CONVENTION BETWEEN THE UNITED STATES OF AMERICA AND THE FEDERAL REPUBLIC OF GERMANY FOR THE AVOIDANCE OF DOUBLE TAXATION AND THE PREVENTION OF FISCAL EVASION WITH RESPECT TO TAXES ON INCOME AND CAPITAL GAINS TO CERTAIN OTHER TAXES art. XIV [hereinafter U.S.-Germany Technical Explanation].

[217] Org. for Econ. Co-operation & Dev. [OECD], *Trace Implementation Package for the Adoption of the Authorised Intermediary System* (Jan. 23, 2013), http://www.oecd.org/ctp/exchange-of-tax-information/TRACE_Implementation_Package_ Website.pdf. The implementation package follows recommendations from OECD, POSSIBLE IMPROVEMENTS*, supra* note 127, at 33–37 and OECD, TREATY BENEFITS CIVS*, supra* note 126, at paras. 38–40.

[218] *Id.* The Trace Implementation Package provides a series of model agreements that would be entered into by the financial intermediary and source country, and model

To date, no U.S. intermediary has entered into an authorized intermediary agreement.[219] If a RIC is treated as a qualified person for treaty benefits, these agreements would probably not be necessary since the RIC would be entitled to treaty benefits. But if a source country views a RIC as a pass-through and extends treaty benefits only to the extent that the RIC's owners are U.S. residents or equivalent beneficiaries, such an agreement may be necessary to permit a RIC to obtain treaty benefits on behalf of its investors.

F. Summary

The current U.S. tax regime penalizes foreign investors in U.S. RICs to the extent a RIC earns foreign source income, as a foreign investor is almost always worse off by earning foreign source income indirectly through a RIC rather than earning it directly (or through a partnership).[220] Treaty shopping may be an illusory concern if one makes reasonable assumptions about the residence basis taxes paid by foreign investors. The final section discusses how the foreign RIC provisions could be modified to better reflect their pass-through nature but without RICs becoming vehicles that foster treaty shopping.

V. OPTIONS FOR FOREIGN MUTUAL FUND INVESTORS

This last part explores various options for foreign mutual fund investors under current law and considers how Congress could modify current law to reflect better the pass-through nature of RICs but still mitigate treaty-shopping concerns. Given the large number of shareholders of a typical RIC, certain options may not currently be administratively viable.

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agreements on CIVs under existing treaties. *See, e.g.*, *id.* at 19; *id.* at 113. This reflects the different approaches to treaty shopping discussed in OECD, Treaty Benefits CIVs, *supra* note 126, paras. 6.21–6.24, 6.26.

[219] The OECD has stated that "implementation of the recommendations of the TRACE project was important for the practical application of [the conclusions in the CIVs Benefits Report]." *Revised Discussion Draft, BEPS Action 6: Prevent Treaty Abuse, supra* note 132, at 8.

[220] The only scenario in which a foreign investor is not penalized is when the foreign source income is tax-exempt in the hands of the RIC and the foreign investor can avail himself or herself of the benefits of a treaty with the United States so that the income is taxed at 15%; but if the investor had earned the income directly from the foreign country, it would have been taxed at 30%.

A. Living with the Current RIC Regime

Under the current foreign mutual fund regime, foreign investors are afforded look-through treatment for U.S. source interest and capital gains, but not for foreign source income, which is subject to U.S. tax when distributed. The obvious strategy is for foreign investors to avoid RICs with foreign source income. This is not necessarily an easy task. While some funds clearly have a mandate to invest in U.S. assets, e.g., a fund that holds only U.S. treasuries, or foreign assets, e.g., an Asia or emerging markets fund, others may invest in both U.S. and foreign assets, the respective percentages of which can vary over time. Although mutual funds must disclose their holdings quarterly, it is not always obvious whether a particular issuer is foreign or domestic.[221] Given the importance of this issue for foreign investors, consideration could be given to require funds to disclose periodically the percentage of foreign assets they hold or foreign income they earn.[222]

Another more complicated self-help option is to trade around a fund's dividend distributions. A RIC that invests primarily in equities generally pays dividends quarterly or yearly. The directors of the fund establish a *record date*, which is the date on which an investor must be a shareholder in order to receive a dividend. On the *ex-dividend date*, the fund's NAV is reduced by the distribution. This date is generally the date following the record date. The shareholder of record receives the dividend on the *payment date*, which is the generally the ex-dividend date.[223]

The goal of this strategy is to avoid being a shareholder on the record date. By selling before the record date, a shareholder in essence turns dividend income into capital gain (loss).[224] For an open-end fund, a simple strategy is to request redemption on the day before the record date and then to reinvest on the record date. Since redemptions and contributions are generally done at the fund's NAV at day end, an investor following such a

[221] The fund prospectus may disclose whether the fund may invest in foreign securities.

[222] For the funds that disclose the amounts of QII and IRD, one can roughly determine the percentage of foreign assets by examining the historical percentage of dividends that constituted QII and IRD. In addition, in a fund's financial disclosures, an investor can observe the quantity of swap and securities lending income.

[223] For publicly traded companies, there is generally a time lag between the record date and payment date.

[224] The exact amount depends on the appreciation or depreciation in the RIC shares, which depends on the economic gains or losses of the fund since the shareholder purchased his shares.

strategy would not be a shareholder on the record date.[225]

One downside to this strategy is the loss of any gains accruing on the record date. This tradeoff may be acceptable if the distribution (and corresponding tax avoided) is large and infrequent, say quarterly or annually.[226] The efficiency of this strategy is diminished if the fund imposes a redemption fee for short-term trading. Redemption fees typically range from 0.75% to 2.00% with look-back periods of between seven and ninety days.[227] Given an ordinary dividend distribution of 1.5%, a 1.5% redemption fee is equivalent to a 100% tax and eliminates any benefit to trading around the dividend distribution.

To avoid a redemption fee, a shareholder could remain on the sidelines and forego any expected returns over the fee period. An alternative is to trade out of the particular fund immediately before the record date and invest the proceeds immediately in a similar fund.[228] Since most equity funds are well diversified and have similar risk profiles, the returns of the new fund would probably track closely the returns of the sold fund.[229] To the extent a fund pays more frequent dividends, this strategy becomes more administratively burdensome and the loss of expected returns greater (although the potential tax savings may be greater). This strategy is riskier in the case of ETFs, as it requires selling and purchasing ETF shares on an exchange. These purchases generate trading costs, such as brokerage fees and selling at the "bid" price and purchasing at the "ask" price. These costs may not be insignificant.

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[225] The board resolution authorizing payment of dividend generally authorizes payment of dividends to shareholders of record *at the opening of business on record date.* Thus, a shareholder who purchases shares on a particular day becomes a shareholder as of the end of close of business and is therefore not a shareholder of record on that day for purposes of dividends.

[226] Assume that a fund has an expected annual return of 7% or an expected daily return of 2.69 basis points, which is derived by solving the following equation: [((1+r)^252)-1=.07], where 252 corresponds to the number of days during the year a shareholder can redeem from an open-end fund. On an investment of $100,000, this corresponds to an *expected* daily return of $26.90. For this strategy to be viable, the taxes avoided must be greater than this amount.

[227] For a list of funds and redemption fees see ALERUS, *Funds Charging Fees* (May 12, 2014), www2.alerusfinancial.com/arsws/feegrid.pdf.

[228] If the investor wanted to invest in the original fund, it could withdraw from the new fund and reinvest in the original fund once the redemption fee period expired.

[229] The traditional measures of a fund's risk are Beta and R^2, which is a measure of how much of a fund's return is attributable to exposure to a particular index. These are available from commercial vendors of mutual fund information, such as Morningstar.

Even if these strategies enhance a foreign investor's after-tax returns, they are burdensome and should not be encouraged. Buying and selling over the record date requires constant monitoring of dividend declarations by boards and may generate trading costs that will diminish if not eliminate any tax savings. It certainly is not economically viable for smaller shareholders. The buying and selling of shares of open-end mutual funds impose unnecessary tax and administrative costs on other shareholders, as the fund may have to liquidate part of its holdings to satisfy redemption requests, generating fund income that is taxed to all shareholders.[230]

B. Full Pass-Through for Untaxed Foreign Source Income

Although various bills would have exempted from U.S. tax any untaxed foreign source interest received by a RIC, Congress ultimately rejected including this proposal as part of the final foreign RIC provisions. For fixed income RICs, this would substantially mitigate the double taxation of foreign source interest income. It also prevents treaty shopping, since it applies look-through treatment only to income that does not benefit from a U.S. treaty.

As shown in Table 3 above, under this proposal there would have been an additional layer of U.S. tax on a RIC's foreign source dividends and swap income, regardless whether the income was actually subject to source basis taxation, and on any interest subject to source basis taxation. Thus, for RICs that invest in foreign equities the combination of source basis taxation and the additional U.S. tax on foreign source dividends would still make RICs relatively tax inefficient vehicles for foreign investors. If such a proposal were again considered, look-through treatment should be extended for other income that is exempt from source basis taxation, such as swap income or even dividends that were not subject to source basis taxation.[231]

C. Full Pass-Through for All Income

In a world in which there were no treaties and source investment income were taxed at the same rates, adopting a complete pass-through regime for a RIC's foreign source income would significantly reduce

[230] This occurs if redemption requests are greater than contributions. If contributions are greater than redemption requests, a fund can satisfy the redemption requests with the contribution proceeds.

[231] The United Kingdom, for example, does not impose withholding taxes on dividends paid to foreign residents.

double taxation of investment income and move towards tax neutrality of investing through a RIC and investing directly.[232] When a treaty applies, however, a treaty resident gets the benefits of the treaty provisions, e.g., lower source basis taxation. Since a RIC is a treaty resident, treaty benefits inure not to the RIC but to the RIC shareholders who benefit from the reduced source basis taxes. If a RIC shareholder is a foreigner, the shareholder gets the benefits of a U.S. treaty whether or not the foreigner is a resident of a country with a treaty with the source country. This scenario raises the specter of treaty shopping and appears to be the primary reason Congress did not adopt full pass-through for foreign source income. Similarly, a foreign RIC shareholder could pay source taxes by investing through a RIC if the United States did not have a treaty with the source country but the shareholder's country of residence did.

Given that treaty benefits apply (or do not apply) at the RIC level and not the shareholder level, currently the only somewhat crude mechanism to prevent treaty shopping by foreign shareholders is for the U.S. to impose tax on a RIC's foreign source income when it is distributed.

Although treaty shopping is theoretically possible, the concern with treaty shopping is probably overblown. First, most interest on publicly traded portfolio debt is exempt from source basis taxation in the United States and Europe.[233] Swap income is also generally exempt from source basis taxation. Consequently, a RIC's foreign investors do not need the benefit of a treaty to obtain a 0% rate on portfolio interest or swap income. For these types of income that are exempt from source basis taxation, there is no risk of RICs being used to treaty shop by third-country investors.

Second, if one assumes that most foreign investors in a RIC can avail themselves of a treaty with the source country if they invest directly,[234] given the similarity of treaty rates on dividends, interest, and swap income (15%, 0%, and 0% respectively), the possibility of treaty shopping may be remote: a treaty foreign investor is taxed at the same rate on such income whether he or she invests directly or indirectly through a RIC.

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[232] A foreign investor could be slightly better off investing through a RIC with respect to U.S. source income because investment expenses are deductible in computing ICTI but are not deductible against FDAP income. *See supra* Part II.B. This is still the case under current law.

[233] *See supra* Part III.A.

[234] For 2011, roughly 90% of U.S. source dividends were paid to residents of a country with which the United States had an income tax treaty. *See* Luttrell, *supra* note 53, at tbl.2. This data may overstate the percentage of dividends received by treaty residents if the recipient is not a qualified person under a particular treaty.

Furthermore, as shown above, for a foreign investor who is subject to residence basis taxation and can credit direct foreign taxes against residence basis taxation, there are virtually no circumstances in which a foreign investor is better off by investing through a RIC than investing directly.

Finally, treaty shopping generally occurs in highly structured transactions. A RIC's foreign shareholders typically have little ability to control the RIC's investment decisions and direct the RIC to make investments that are designed to enhance the after-tax returns for any particular group of foreign investors.[235] The RIC diversification requirement generally ensures that RICs hold a relatively diversified portfolio. Consequently, no one issuer or group of issuers will likely constitute a significant percentage of a RIC's portfolio, and it is therefore unlikely a foreign investor will significantly benefit from any potential treaty shopping.

One potential consequence of adopting a full pass-through regime for all of a RIC's income is that U.S. treaty partners may argue that RICs should be treated as pass-through entities for treaty purposes, which would require each RIC shareholder to demonstrate that it was entitled to treaty benefits. Alternatively, U.S. treaty partners could argue that a RIC's entitlement to treaty benefits should be limited based on the percentage of foreign shareholders.[236] It is possible, however, to implement a full pass-through regime for RIC income if it were limited to treaty investors.

D. Full Pass-Through for Income of Treaty Investors

To both address concerns with treaty shopping by foreign investors and ensure that investing through RICs remains tax-neutral, Congress could consider modifying the current regime to permit full pass-through of foreign source income (including income that would be foreign source if directly received by a foreign investor) solely for investors that are eligible for U.S. treaty benefits. Two assumptions underlie this proposal. First, an

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[235] It is possible that a fund family could establish a fund designed to provide benefits for investors from a particular country (or countries). The circumstances in which this makes sense are probably relatively limited. The OECD notes that justification for treating publicly traded entities as being qualified residents is based on the fact that the owners cannot individually exercise control over the entity. *See* U.S.-Germany Technical Explanation, *supra* note 216, at art. XIV ¶ 6., *see* OECD, TREATY BENEFITS CIVS, *supra* note 126 at para. 57 and OECD, MODEL COMMENTARY, *supra* note 128, art. 1, para. 6.32.

[236] For a discussion of the OECD proposals to limit treaty shopping based on the identity of a CIV's owners, see supra Part IV.D.

investor resident in a treaty country is probably not investing through a RIC to garner untoward treaty benefits, since it is likely that the investor's country of residence has a similar treaty with the source country. Second, since the United States has terminated its treaties with pure tax havens, the countries with which the United States has treaties generally tax their residents' worldwide income.[237] Thus, the RIC's distributions will be taxed on a residence basis.

Full pass-through of a RIC's foreign source income for treaty investors could be implemented in various ways. The simplest approach would be to provide pass-through treatment for all foreign source income (and income that would be treated as foreign source if directly received by a foreign investor) for investors resident in a country with a U.S. treaty. Foreign investors in a RIC would only pay tax generally on the portion of a RIC's dividend that was attributable to U.S. source dividends.[238]

Precedent for such an approach can be found in treaties that extend U.S. benefits to entities that are formed in a treaty country but owned by residents of a third country who qualify as e*quivalent beneficiaries*. Because of the third-country ownership, such entities may not otherwise be qualified persons under an LOB article.[239]

An equivalent beneficiary is generally a resident of a EU country or NAFTA signatory that is entitled to the benefits of an income tax treaty between the beneficiary's country of residence and the source country.[240] In addition, for interest and dividends, the rate under the equivalent beneficiary's treaty and the source country must be as least as low as the rate under the treaty between the United States and the source country.[241] For example, if the treaty of the entity receiving a U.S. source dividend has rates of 0%, 5%, and 15%, but the treaty of the equivalent beneficiary with the United States has only dividend rates of 5% and 15%, the equivalent beneficiary is only entitled to the 5% or 15% rate.[242]

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[237] For entities that are tax-exempt in the residence, such as charities and pensions, the evolving treaty policy is that these entities should also be exempt from source basis taxes. Consequently, for these entities, treaty shopping should not be a concern.

[238] There could be other relatively minor categories of U.S. source income that would be taxable.

[239] *See, e.g.* U.S.-U.K. Treaty, *supra* note 118, art. 23, para. 3(a).

[240] *See, e.g.* U.S.-U.K. Treaty, *supra* note 118, art. 23, para. 7(d)(i)(A), as amended by the Protocol, art. IV (defining equivalent beneficiary).

[241] *Id.* art. 23, para. 7(d)(i)(B), as amended by the Protocol, art. IV.

[242] *See, e.g.,* U.S.-U.K. Technical Explanation, *supra* note 142 (explaining art. 23, para. 3).

The equivalent beneficiary provision is a type of derivative benefits test that extends treaty benefits if the indirect recipient would have been entitled to treaty benefits had he or she received the income from the source country directly. The policy rationale behind an equivalent beneficiary provision is that an entity formed in a treaty country that is owned by equivalent beneficiaries was neither formed nor availed of to treaty shop, because had the equivalent beneficiaries used an entity formed in their countries or directly earned the income from the United States, they would have been entitled to equivalent treaty benefits. In essence, the equivalent beneficiary provision creates a multilateral treaty network based on bilateral treaty relationships.

There are some important differences, however, between this proposal and the operation of the derivative benefits provisions of current tax treaties. Derivative benefits provisions generally apply only to entities that are owned by seven or fewer equivalent beneficiaries. By limiting derivative benefits to seven or fewer persons, the provision is much easier to administer. In the case of a RIC, however, there may be tens or hundreds of thousands of potential equivalent beneficiaries. The derivative benefits provision generally applies to income arising in the source country and paid to an entity owned by equivalent beneficiaries residing in up to seven countries. In contrast, a RIC's dividend income may arise from companies that are residents of numerous countries and is paid to shareholders who are residents of numerous countries.

Under the simple version of the full pass-through proposal, the foreign investor would merely have to be resident of a country that had a treaty with the United States; the foreign investor would not have to demonstrate that it would have been eligible for treaty benefits with the source country. Thus, it is possible that some RIC investors may not be true equivalent beneficiaries in that they would not be entitled to treaty benefits with the source country had they invested directly, or they may not be entitled to a rate as low as the U.S. source country rate.

Although this is a reasonable objection, it does not appear to present the potential for inappropriate results in most cases. First, the treaty rates applicable to portfolio dividends, interest, and swap income are generally uniform across treaties, since most treaties follow the OECD Model Treaty. Thus, it is unlikely that a foreign investor would get more beneficial rates under the U.S. treaty than under a treaty with the source country. In addition, because the United States has entered into fewer treaties than many of the countries that supply capital to the United States, it is more likely that a RIC foreign investor would be a resident of a country that has a treaty with the source country than with the United States. Furthermore, under this proposal, look-through would only apply if the foreign investor had a treaty with the United States and not with the source country. Some foreign investors would therefore be denied treaty benefits even though had they invested in the source country, they would have been entitled to treaty benefits.

An alternative approach that is consistent with the derivative benefits provisions in current treaties but more complicated and administratively burdensome would extend full look-through only to a treaty resident who is an actual equivalent beneficiary, but extend the term to include any person who would be eligible for source country treaty benefits. To implement such an approach, the RIC would first have to apportion among separate countries the foreign taxes it has paid and assign them to the appropriate income categories, e.g., dividends or interest. For interest and dividends, this is certainly manageable at the RIC level. When a RIC makes a distribution to a foreign shareholder, the shareholder would have to demonstrate that he or she was entitled to the benefits of a source country treaty, i.e., that he or she was eligible for equivalent benefits for each country's taxes. For an equity RIC that earned dividends from fifteen or twenty European countries, this would require a foreign shareholder to demonstrate that he or she was eligible for derivative benefits for those fifteen or twenty countries. Who would be responsible to confirm his eligibility for derivative benefits, the RIC? A RIC could be required to withhold at 30% when it distributes a dividend, and the foreign shareholder could be required to demonstrate to the Service that it was entitled to derivative benefits to receive a refund of U.S. withholding taxes.[243] This approach would impose costs on foreign shareholders, which could be quite significant, especially for smaller shareholders. It is not entirely clear how the Service could determine whether a foreign shareholder was actually entitled to derivative benefits.[244]

Since both of these approaches are applied at the RIC shareholder level, they differ from those considered by the OECD, which generally

[243] This is generally how the U.S. collects tax from foreign sellers of U.S. real property interests. *See* I.R.C. § 1445.

[244] Foreign countries often withhold tax on payments to a U.S. person at regular rates and require the recipient to demonstrate that it was a treaty resident. The U.S. person must request the Service to certify treaty residence on Form 6166, which is requested by filing Form 8802. If such an approach were adopted for foreign shareholders, each shareholder would probably have to supply a similar treaty certification for each country. There is currently a filing fee of $85 for U.S. taxpayers.

would allow a CIV treaty benefit to the extent that it is owned by equivalent beneficiaries or residents of the CIV's country of residence.[245] The OECD approaches would harm a RIC's shareholders who are not equivalent beneficiaries or residents of the CIV's country of residence because there is no mechanism under Subchapter M to apply treaty benefits solely to such shareholders when a RIC distributes its income.[246]

It is not currently administratively feasible to require a foreign investor to demonstrate that he or she is entitled to derivative benefits with respect to foreign source income of a RIC, but it is easy and feasible to require a foreign shareholder to show that he or she is entitled to U.S. treaty benefits. Although this approach may extend look-through for shareholders who are not true equivalent beneficiaries, it implements pass-through taxation while protecting against treaty shopping. This proposal, coupled with the lack of any credit for source basis taxes paid by a RIC, virtually ensures that foreign investors would not invest through a RIC to treaty shop.

E. Pass-Through of Foreign Taxes

Even if Congress were to exempt from U.S. tax a RIC's foreign source income for treaty investors, such investors may still be economically worse off by investing through a RIC than investing directly if the RIC's foreign source income is subject to source taxation. A RIC only distributes to a foreign shareholder its after-foreign-tax income.[247] Assuming the investor's country of residence does not permit a credit for source basis taxes levied on the RIC's income, a foreign investor gets only the benefit of a deduction for source basis taxes paid by the RIC.

To illustrate, if a RIC earns $100 of foreign source dividend income on which $15 of taxes are withheld by the source country, the RIC will distribute only $85 to the foreign investor. Provided that there is no additional U.S. withholding tax, the foreign investor would be subject to residence basis tax on the $85 but would not receive a credit for the $15 source basis tax. Since the investor would only be taxed on $85, he or she

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[245] *See supra* Part IV.E.

[246] Taxable shareholders of a RIC that makes a section 853 election may be indifferent because they will merely have a larger foreign tax credit. Tax-exempt shareholders, such as pensions or 401(k) accounts, will be harmed because the RIC's NAV will be reduced by the higher source country withholding taxes, which tax-exempt shareholders cannot use.

[247] Under current law, foreign shareholders of a RIC that makes the foreign tax credit election under section 853 may also be subject to U.S. tax on the foreign taxes paid by the RIC. *See infra* Part III.B.

receives in essence the benefit of a deduction for the source taxes, and there is double taxation of the RIC's income.

Under current law, when the RIC distributes $85, an additional 15% (or 30%) U.S. withholding tax is levied, and the $85 is subject to residence basis tax.[248] Since the withholding tax is a direct tax, the foreign investor should be able to credit it against his or her residence tax liability. Thus, there is no double taxation of the $85 distributed, but again, the investor is only receiving a deduction and not a credit for the source basis taxes paid by the RIC.

Allowing a credit for source basis taxes may also be a possible mechanism to mitigate the double taxation of foreign source income earned through RICs. If the foreign investor were to receive a credit for source basis tax and any U.S. tax, double taxation would be mitigated, and the foreign investor would be in the same economic position as if the investor had directly earned the income.[249] Using the same numbers in the above examples, the foreign investor would have $100 of income and a potential credit of $15 if the United States did not tax the RIC dividend and $27.75 if the United States taxed the $85 RIC dividend at 30%.[250]

A residence country could unilaterally implement such a rule, but it is not clear whether a residence country would permit its residents to credit the foreign taxes paid by a corporation of which they are shareholders.[251] The United States permits its residents to credit foreign taxes paid by RICs, but generally does not permit taxes paid by a corporate entity to be credited by individual shareholders.[252] In contrast, foreign taxes paid by lower-tier partnerships are passed through to a U.S. partner when the partner includes in income the distributive share of the lower-tier partnership's income.

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[248] Since withholding taxes are direct taxes, it is assumed that a foreign investor is subject to residence basis taxation on the pre-tax amount of the dividend. If there were no residence basis taxes, the residence country would presumably not permit a credit for any foreign taxes.

[249] Double tax would be mitigated but not eliminated unless the residence country gave an unlimited credit for the total foreign taxes. Under U.S. law, for instance, a U.S. taxpayer can only credit foreign taxes levied at a rate equal to or less than the U.S. rate on the foreign source income. *See* I.R.C. § 904. The foreign investor is also not exactly in the same position had he or she invested directly because of the additional layer of U.S. tax.

[250] The $72.25 is grossed up by $12.75 U.S. tax and $15 foreign tax paid by the RIC.

[251] There would have to be some mechanism for the RIC to provide the information to foreign shareholders.

[252] Certain corporate shareholders are permitted to credit taxes paid by other corporations when the corporate shareholder receives a dividend. *See* I.R.C. § 902 (indirect tax credit).

The OECD addressed this issue and suggested that it could be solved by including in the treaty between the CIV's country of residence and the investor's country of residence a provision that would require the investor's country of residence to grant a credit for the source taxes imposed on the CIV's income.[253] After noting various possible objections — the measure would be an incomplete bilateral solution for a multilateral problem; reciprocal benefits may not be provided by the source country; the residence country could be required to grant relief greater than if an investor had directly invested — the OECD indicated that investors had not expressed an interest in making such claims.[254] This could change if OECD proposals in the OECD become widely implemented. Resolving this issue will probably require a multilateral approach.

VI. CONCLUSION

The foreign RIC provisions mitigate tax inefficiencies to foreign shareholders for a RIC's U.S. source income, but the failure to adopt look-through for foreign source income means that many RICs continue to be tax-inefficient investment vehicles for foreign investors. The current regime is thus inconsistent with the pass-through nature of RIC taxation, unnecessarily penalizes foreign investors in global RICs, and deprives the United States of tax revenue from RIC-related income, such as trading and management fees. Although treaty shopping may have been the primary rationale for not adopting pass-through for foreign source income, those concerns are largely illusory: a foreign investor potentially only benefits from a treaty between the United States and the source country if there is no residence taxation or the residence country does not credit U.S. taxes. By limiting look-through to treaty residents, a clearly second-best option, treaty shopping concerns should be entirely ameliorated and foreign investment in U.S. RICs facilitated.

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[253] OECD, Treaty Benefits CIVs, *supra* note 126 at paras. 41–47.

[254] *Id.* at paras. 46 and 47. For a discussion see Gijs Fibbe, *The 2010 Update of the OECD Commentary on Collective Investment Vehicles*, *in* THE TAX TREATMENT OF CIVS AND REITS 67–71 (Hein Vermeulen ed., 2013).