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# Taxation of Investment Funds

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Men will find that they can prepare with mutual aid far more easily what they need, and avoid far more easily the perils which beset them on all sides, by united forces.

—*Baruch Spinoza, Ethics*

### I. Introduction

This chapter provides an approach for thinking about the income taxation of investment funds and their investors in developing and transition countries. Although this chapter focuses on investment funds, many of the same issues and considerations may apply in designing a tax regime for other investment vehicles, such as special purpose investment funds, pension funds, and different types of insurance products.

Basic decisions made in designing the overall tax system for individuals and enterprises frame the design of a tax regime for investment funds. Decisions are required on such questions as how to tax dividends and interest received by individuals and enterprises, whether to integrate the individual and enterprise tax regimes, how to tax capital gains and losses, how to tax foreign source income, and whether and how to adjust for inflation.

Within the framework defined by these decisions, the choice of tax rules for investment funds requires balancing three objectives: first, not to hamper the development of financial intermediaries, such as investment funds; second, to devise tax rules that are comparable to those that apply to other investments; and, third, to adopt tax rules that can be administered and enforced. It is difficult to offer a general blueprint for taxing investment funds and their investors. This is partly because choices made concerning the basic tax structure will strongly influence decisions on how to tax investment funds. Another reason is that factors in a particular country influence the choice of tax regime for investment funds. Given that countries differ significantly in both their basic tax structure and their administrative capabilities, it is not possible simply to adopt the tax rules that other countries apply to investment funds.

## II. Role of Investment Funds

This chapter uses the term "investment fund" to refer to an entity owned by many persons and whose primary activity is investing in operating companies. The investment fund acts as an intermediary between the individual investor and the ultimate user of the capital. Several types of investment funds exist. An "open-end" fund issues and redeems fund units from investors.<sup>1</sup> In contrast, "closed-end" funds issue a fixed number of units, and investors trade units with other investors.

The growth of financial intermediaries in developing and transition countries is not surprising. Market economies require private savings to provide capital to establish new ventures and to expand existing enterprises. Financial intermediaries allow small and medium-sized investors to invest their savings in the market. Such intermediaries may offer investors the advantages of financial expertise, economies of scale for such items as market research, portfolio management, and trading activity, and the opportunity to diversify and pool investments.<sup>2</sup> Diversification enables investors to reduce the risk inherent in holding a small number of investments without reducing the expected return of the investment. Pooling allows individuals to invest in the more liquid assets of the financial intermediary, while the intermediary can invest in less liquid and longer-term investments.

In addition to capital, investment funds may offer privatized businesses management expertise and expanded access to capital or other business relationships.<sup>3</sup> They may also serve as a check on the actions of managements and boards of directors to ensure that they remain accountable to the shareholders.<sup>4</sup> This monitoring function may be especially important in Eastern Europe, where mass privatization schemes have resulted in diffused ownership. Because of the relatively small ownership stakes distributed in privatization, individual shareholders will probably be unable to exercise effective control over the management of enterprises.<sup>5</sup>

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<sup>1</sup>See Richard Gordon & Victoria Summers, *Taxation of Investment Funds in Emerging Capital Markets: Theory, Problems and Solutions in the Case of Taiwan*, 46 Bull. Int'l Fiscal Documentation 384, 398 (Aug. 1992).

<sup>2</sup>See generally Robert C. Clark, *Federal Income Taxation of Financial Intermediaries*, 84 Yale L.J. 1603 (1975); Gordon & Summers, *supra* note 1, at 384.

<sup>3</sup>See Matthew J. Hagopian, *The Engines of Privatization: Investment Funds and Fund Legislation in Privatizing Economies*, 15 J. Int'l L. Bus. 75, 81-84 (1975).

<sup>4</sup>See generally Mark J. Roe, *Strong Managers, Weak Owners: The Political Roots of American Corporate Finance* 102-23 (1994).

<sup>5</sup>See William C. Philbrick, *The Task of Regulating Investment Funds in the Formerly Centrally Planned Economies*, 8 Emory Int'l L. Rev. 539, 541 (1994).

In some countries making the transition to a market economy, investment funds are an integral part of the privatization process.<sup>6</sup> For example, the Polish mass privatization program provided for the government to establish several investment funds to serve as active managers and the primary holders of shares of the newly privatized companies.<sup>7</sup> In other countries, investment funds developed without direct government intervention to act as intermediaries between individual investors and business enterprises. In the Czech Republic, investment funds served the dual purpose of providing liquidity for government-issued investment vouchers and providing active participation in the strategic management of companies in their portfolio.<sup>8</sup>

#### **A. Regulation of Investment Funds**

Because of the great variation among countries, this section does not focus on the specifics of the different types of investment funds and the different restrictions and requirements that countries impose. It seeks only to survey the types of restrictions on and requirements for the formation and structure of an investment fund, the types of investments and activities, the operation of a fund, and rules governing distributions to and redemptions by investors.

Countries may have separate securities and tax regulatory regimes for investment funds. Particularly when the tax law conveys tax advantages to investment funds, qualification under the securities law may be necessary, but not sufficient, to qualify for tax purposes.

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<sup>6</sup>See Hagopian, *supra* note 3, at 76-81. For an excellent review of the role of investment funds in the Czech Republic, see Helena Navratilova, *Czech Republic*, in *The Taxation of Investment Funds*, 82b Cahiers de droit fiscal international 375, 375-77 (1997)[hereinafter Cahiers].

<sup>7</sup>The 1993 Polish mass privatization program provided for the government to establish 10-20 national investment funds and to choose fund managers from a competitive tender open to international investment and consulting firms. The program further provided for one investment fund to receive 33 percent of the outstanding shares of a privatized enterprise and to act as the lead investor in the enterprise. This structure was intended to allow the lead investment fund to have significant influence on the operation of the enterprise while still requiring the consent of other shareholders for major decisions. See Hagopian, *supra* note 3, at 78-79; see also Michele Balfour & Cameron Crise, *A Privatization Test: The Czech Republic, Slovakia and Poland*, 17 Fordham Int'l L.J. 84 (1993).

<sup>8</sup>See Navratilova, *supra* note 6, at 375-77. In the former Czechoslovakia, the government issued vouchers to every citizen over the age of 18. The vouchers entitled the holders to purchase shares in state-owned companies participating in the privatization process. Holders had the option of investing their vouchers directly in shares of a specific company or exchanging them for shares in one of the approximately 400 investments funds that sprang up to act as intermediaries between the voucher holders and the privatized companies. The investment fund managers used the accumulated vouchers to acquire substantial interests in the companies they believed had the best investment potential. About two-thirds of all vouchers were transferred to investment funds for investment by fund managers. See Philbrick, *supra* note 5, at 553, 562.

Countries differ in their approaches to regulating the formation of investment funds.<sup>9</sup> There has been some movement toward standardizing the regulation of investment funds among countries. The European Union has worked on establishing a basic legal framework for investment funds with the aim of liberalizing capital flows among the member countries. It has sought to define the basic qualification requirements for an investment vehicle known as “undertakings for collective investment in transferable securities” (UCITS) and has tried to foster reciprocal agreements among member countries for the operations of these funds. *See* Philbrick, *supra* note 5, at 35. At one extreme, some countries require funds to operate in a specific legal form and adopt model bylaws that specify the rights of investors and the obligations of fund managers.<sup>10</sup> At the other extreme, investment funds have great flexibility in choosing their structure and their relationship with investors. Other issues that arise on formation include the residence of the investment funds (e.g., countries could allow only domestic investment funds or choose to allow foreign funds), the capital structure (e.g., countries could require only equity contributions or choose to allow investment funds to issue debt securities),<sup>11</sup> and disclosure of information about fund managers and officers (e.g., countries could require only names and addresses of fund managers, or they could require managers to make detailed financial disclosure).

Regulations on investment activities can cover the type of investment, the location of investments, and the amount of investments. The regulations share a common objective in seeking to protect investors from the excesses of fund managers.<sup>12</sup> Common

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<sup>9</sup>Excellent reviews of several countries' regulatory and tax regimes applicable to investment funds are set forth in *Investment Funds: International Guide to the Taxation and Regulation of Mutual Investment Funds and Their Investors* (IBFD 1996)[hereinafter *International Guide*] and in *Cahiers*, *supra* note 6.

<sup>10</sup>*See* Hagopian, *supra* note 3, at 88-90 (discussing the rationale for the use of model bylaws for investment funds in Kazakhstan, Poland, and Russia).

<sup>11</sup>*See* Philbrick, *supra* note 5, at 563. For example, the Czech investment funds law prohibits investment funds from issuing debt securities. Law on Investment Companies, Investment Funds (Czech), art. 4.1, available in LEXIS, World Library, Law File. For a discussion of the regulatory framework for investment funds in the Czech Republic, *see* Navratilova, *supra* note 6, at 377-85.

<sup>12</sup>A good example of the types of restrictions on the investment activities of investment funds is set forth in guidelines issued by The Federal Commission on Securities and the Capital Market of the Government of the Russian Federation, Interim Regulation on the Composition and Structure of Assets of Unit Investment Funds (Reg. No. 12, Oct. 1995). <sup>12</sup>*See* Hagopian, *supra* note 3, at 88-90 (discussing the rationale for the use of model bylaws for investment funds in Kazakhstan, Poland, and Russia).

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restrictions on the type of investment activity include a prohibition on investing in certain types of assets (e.g., partnership interests with unlimited liability, precious metals, commodities, options and futures contracts, and certain types of debt obligations), on holding certain nonliquid securities (e.g., the fund's portfolio is required to be substantially, or entirely, invested in publicly traded securities), or on engaging in certain types of activities (e.g., the fund's activities are limited to holding passive investment assets rather than operating assets). Some countries may require that the fund invest all or a substantial percentage of its funds in domestic enterprises. Countries also generally restrict both the percentage of a fund's assets that can be invested in any one issuer and the percentage of an issuer's stock that a fund can own.

To protect and inform investors, countries also generally impose disclosure and auditing requirements on investment funds. Also common are provisions to limit the potential for self-dealing and conflicts of interest between fund managers and the fund.<sup>13</sup>

Finally, depending on the type of investment fund and the applicable tax regime, countries have prescribed rules on distributions to shareholders and redemption requirements. For example, U.S. tax law requires that to obtain favorable tax treatment, an investment fund must distribute to investors 90 percent of certain income received during the year.<sup>14</sup> Russian law requires investment funds to redeem the interests of investors within 15 days of a request for redemption.<sup>15</sup>

## **B. Goals of Tax Regime for Investment Funds**

There are several possible goals of a tax regime for investment funds and investors, and some policymakers may place greater weight on certain goals rather than on others. Some possible goals are discussed in this section.

### **1. Encourage Development of Investment Funds**

General agreement exists that, at a minimum, tax rules should not unduly hamper or prevent development of investment funds or other financial intermediaries. In many countries, the absence of special tax rules governing investment funds would result in an investment fund being treated as a separate taxpayer—with an additional layer of tax

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<sup>13</sup>See Hagopian, *supra* note 3, at 93-94 (discussing the use of investment funds legislation to minimize potential conflicts of interest between fund managers and the investment funds).

<sup>14</sup>To qualify for conduit tax treatment under U.S. tax law, an investment fund must distribute annually at least 90 percent of its investment company taxable income (taxable interest, dividends, and the excess of short-term over net long-term capital losses and any capital loss carryforwards, net of expenses) and at least 90 percent of its tax-exempt interest income, net of expenses. Investment funds are not required to distribute any net capital gain income (excess of net long-term capital gains over net short-term capital losses and loss carryforwards). See USA IRC §§ 852(a), (b)(3).

<sup>15</sup>See Decree of the President of the Russian Federation, On Additional Measures to Increase Efficiency of Investment Policy of Russian Federation ¶ 8 (July 1995).

imposed on any income or gains recognized by the fund.<sup>16</sup> This "double tax" may be substantial enough to stunt the development of investment funds.<sup>17</sup>

Whether tax rules should explicitly favor the development of investment funds is a difficult question. It is part of a larger question of whether tax incentives should be used to encourage saving in general. It also relates to the tax treatment of alternative investment vehicles, such as pension plans and insurance products, and the need to consider comprehensively the tax regimes for all investments and not to address tax rules for specific investments in an ad hoc manner.

Section III(A) presents three variations on tax regimes that provide more favorable tax treatment to investors in investment funds than would be available to taxpayers engaged in direct investments. If a country decides to adopt one of the tax-favored regimes, it may need to consider carefully the qualification requirements for investment fund status so that tax benefits are not available to unintended beneficiaries. Policymakers may also need to estimate the revenue loss from the tax advantages so that they can consider whether the increased incentives justify the lost tax revenue.

## **2. Market Neutrality**

Economists and tax lawyers emphasize that tax rules should be as neutral as possible regarding investment and other decisions. Although almost all taxes distort behavior, policy advisors generally recommend keeping distortions as small as possible. This position rests partly on grounds of market efficiency—that economic resources should be allocated on the basis of market factors that determine the highest return, not on the basis of tax considerations. It also rests on minimizing transaction and tax planning costs. Investors should not spend their resources trying to devise schemes to minimize taxes. To the extent that all investments are taxed similarly, there will be no incentive to try to come within the scope of tax-favored treatment. Finally, if investment funds are accorded tax-favored treatment, it may be difficult to deny tax benefits to other forms of investments; consequently, the tax law will become more complicated, and tax revenue will decline.

For purposes of this chapter, market neutrality means that taxpayers should be treated the same whether they invest directly in assets, such as government securities and

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<sup>16</sup>In Russia, the Ministry of Finance has ruled that investment funds are not "entities" subject to the enterprise profits tax, but rather "asset pools without the creation of a legal person." On Several Tax Issues Arising in Connection with the Creation and Functioning of Unit Investment Funds (Jan. 1996). See also Alexander V. Tolokoushkin & Vladimir N. Zavarov, *Russia*, in Cahiers, *supra* note 6, at 723-26. Similar exemptions from treatment as an entity taxable under the corporate income tax are found in many countries, including France, Germany, and Italy. See International Guide, *supra* note 9, at 49 (France), 38 (Germany), and 58 (Italy).

<sup>17</sup>For example, assume an operating company earns a rate of return of 10 percent before tax and, after imposition of a 30 percent corporate tax, earns 7 percent after tax. If the income of the company is distributed to an investment fund that is also subject to a 30 percent corporate tax, the after-tax rate of return is further reduced to 4.9 percent.

shares of joint-stock companies, or invest indirectly in such assets through financial intermediaries, such as investment funds.<sup>18</sup> Even if one does not value this goal on independent grounds, it is helpful in examining alternative proposals to determine how the tax consequences for investors of a specific proposal for taxing investment funds differ from the tax consequences of direct investment.

One should also compare the tax rules governing investment funds with the favorable tax rules available to alternative investments. If a country's tax law exempts interest on many government and bank obligations or provides special rules for pensions or life insurance products, then the existence of these tax-favored investments may influence the basic decisions on the tax treatment of investment funds.

### **3. Administration and Compliance Considerations**

As in all areas of tax law, the laws are only as good as the administration. It makes little sense to adopt laws that, while being theoretically correct, are difficult or impossible to administer.

The tax regimes for investment funds in many countries rest on the one hand on the ability of investment fund managers to process substantial amounts of information and to allocate tax items to individual investors and on the other hand the ability of tax administrators to receive information from investment fund managers and match this information with the individual tax returns of millions of taxpayers.<sup>19</sup> The investment funds are likely to have the computer capability to process the information and allocate the tax items. The ability of the tax administration to develop a system to ensure enforcement and compliance with a tax regime that requires monitoring the tax consequences to many investors is much more problematic and, in many countries, may not be worth the expenditure of substantial administrative resources, given the amount of tax revenue involved.

Another potential compliance problem that may be associated with a special tax regime for investment funds is the ease with which taxpayers can meet the tax and regulatory requirements for investment fund status. If qualification is easy, then adopting a favorable regime for investment funds will create strong incentives for taxpayers to arrange their affairs to obtain favorable tax treatment. If qualification is difficult, then the potential tax motivation for adopting this form of organization is reduced.

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<sup>18</sup>See Gordon & Summers, *supra* note 1, at 385.

<sup>19</sup>For example, in 1995, the Internal Revenue Service received over 115 million individual income tax returns and processed over 1 billion information returns. Internal Revenue Service, Pub. No. 55B, 1995 Data Book, tbls. 7, 18 (1995).

#### **4. Revenue Concerns**

A complete examination of alternatives for taxing investment funds requires estimating their revenue consequences. To complete this task, one must gather estimates concerning the number of investment funds, the number of investors, the amount and type of fund investments, the amount and type of income and capital gains of the funds, and the potential capital gains recognized by investors on the redemption of their shares.<sup>20</sup>

- (1) the amount of dividends paid by enterprises,
- (2) the amount of tax-exempt investment in funds,
- (3) the amount and frequency of redemptions,
- (4) the amount of capital gains recognized by the funds, and
- (5) the mix of individual and enterprise investors.

If, for example, we were confident that enterprises paid little or no dividends and that individual investors could structure their redemptions from the investment funds to pay no capital gains tax, then the choice of tax regime applicable to investment funds may be of little practical significance. Similarly, the value of allowing investment funds effectively to defer paying capital gains tax until an investor redeems the investor's interest may be of little importance if the individual investor could avoid paying any capital gains tax on shares of enterprises held directly. These estimates may initially be quite speculative; hopefully, over time, the estimates will become more reliable.

### **III. Taxing Investment Funds in the Context of the Basic Tax Structure**

A major difficulty in designing a tax regime for investment funds and their investors is the number of different combinations of components that policymakers may need to consider. This section first reviews the components of a basic tax regime that make up the landscape for examining alternative tax regimes for investment funds and then seeks to catalogue the different types of investors and the different types of income of an investment fund.

#### **A. Basic Tax Structure**

Several components of the basic tax structure may influence the design of a tax regime for investment funds. These include (1) the range of tax rates for individuals and enterprises and the relationship between those rates; (2) whether individuals are taxed on dividends on a flat schedular basis or must combine their income from dividends with other sources of income and incur tax liability on a global basis; (3) the use of either provisional or final withholding for dividends; (4) whether enterprises may exclude

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<sup>20</sup>For example, it is difficult to compare the tax consequences for investors of a tax regime for investment funds with the tax consequences for investors of direct investments without making certain assumptions as to behavior of the enterprises, the investment funds, and the investors. Assumptions that may be important to consider include



dividends received from other enterprises, perhaps tied to the level of share ownership in the enterprise; (5) whether interest is taxed on a schedular or a global basis; (6) the use of provisional or final withholding for interest, and the continuation of the existing tax-exempt status of many types of interest; (7) the treatment of capital gains, in particular whether the same rules apply to individuals and enterprises, the possibility of allowing alternative cost basis approaches for determining gain for individuals, and the possibility of adjusting for inflation; (8) the rules governing tax relief for capital losses; (9) the scheme for integrating the individual and enterprise tax systems, in particular the type of integration, if any; (10) the rules for taxing foreign source income, particularly whether foreign income is excluded or whether a deduction or credit for foreign tax paid is allowed; and (11) the rules governing the taxation of nonresident taxpayers, in particular the rules for individuals and entities that are either passive investors or that receive income in connection with a domestic trade or business.

While it is necessary to reduce the number of alternative combinations from the items listed above before being able to make any definitive comments about the interaction of the basic tax structure and the design of the tax regime for investment funds, two general guidelines can be offered: (1) the more variation in the treatment of different types of income in the hands of different types of investors, the greater the pressure may be to tax the income directly at the investor level; and (2) the less the tax rules vary by type of income in the hands of different types of investors, the stronger is the argument for simply taxing all income at the investment fund level and imposing no further taxes at the investor level.

The tax treatment of capital gains presents perhaps the most complex issue in designing a tax regime for investment funds. Capital gains may arise at the fund level when the investment fund sells shares of its underlying investments, or at the investor level when the investor sells his or her interest in the investment fund, or at both levels. For countries that do not tax capital gains,<sup>21</sup> the potential for two levels of gain raises no additional problems. For a tax system that taxes capital gains, however, the potential exists for the government to collect too much or too little tax. A system can collect too much tax on capital gains if an investment fund realizes a gain on the sale of an enterprise's shares and an investor realizes a gain on the sale of his or her interest in the investment fund unless there exists a mechanism for the investor to receive credit for tax paid at the fund level. A system collects too little tax if an investor can dispose of shares in the investment fund without tax liability and thus avoid any tax on the unrealized appreciation in the assets of the investment fund.<sup>22</sup>

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<sup>21</sup>Including those that follow the German/French model of taxing only gains on substantial participations, since the regulatory constraints on investment funds would presumably require sufficient dispersion of investment so that no one investor's share in an investment by the fund would constitute a substantial participation. However, if shares are treated as business assets in the hands of the fund, then an exception would have to be made to provide for their nontaxation.

<sup>22</sup>Whether an investor is actually undertaxed depends on whether the market price for the shares of the investment fund reflects the discounted present value of the tax due when the investment fund disposes of the appreciated assets. The relative tax rates of the investor and the fund must also be taken into account.

Several alternatives exist to minimize or eliminate the double taxation of capital gains. One approach imposes capital gains at the fund level, but exempts capital gains at the investor level. Alternatively, a country could choose to tax capital gains only at the investor level, and exempt fund-level gains. A third alternative imposes tax at the fund level, unless the proceeds of the gain are distributed, in which case the capital gains are taxed to the investors. Finally, a country could choose to tax gains at both levels, but could either give the investors a credit for any tax paid at the fund level or impose tax at both levels at a substantially reduced rate.

The existence of high levels of inflation further complicates the difficulties of designing a rational tax regime. Taxing nominal gains without adjusting for inflation may result in high taxes on what are small or no economic gains, and perhaps even real economic losses. If nominal gains are taxed at both the fund level and the investor level, then the economic return required just to break even after tax may be substantial.

Tax systems can provide for inflation adjustments by allowing investors to index their tax cost for purposes of determining gain on a transaction.<sup>23</sup> Indexation provides a more accurate measure of economic gain than an unindexed tax system, but increases its complexity.<sup>24</sup> The complexity is further increased when inflation adjustments are made at both the fund and the investor level. A system of comprehensive inflation adjustment where gains are taxed at the level of the investment fund only, however, would not be so complex.<sup>25</sup>

## **B. Types of Investors**

Countries generally impose few, if any, restrictions on the types of investors that may invest in investment funds. We can separate domestic individuals by their income level: (1) individuals may have income below the threshold amount for tax liability; or (2) individuals may be subject to tax at low, medium, or high tax brackets, depending on the rate structure under the individual income tax law, the individuals' other income, and the rules for aggregating income from different sources.

Domestic enterprises may be subject to differing tax rates under the enterprise tax law, although progressive tax rates under an enterprise tax law have little or no theoretical justification. An enterprise with a relatively small ownership position in a

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Whether the tax system collects too little tax depends on whether one views the investor's sale of shares of an investment fund as a constructive disposition for tax purposes of the underlying assets.

<sup>23</sup>See vol. 1, ch. 13.

<sup>24</sup>See *id.* The major complexity arises not from the indexing of the assets for inflation, but rather from the need to index any debt obligations that are related to assets subject to indexation.

<sup>25</sup>See *id.*

particular fund can be classified as a portfolio investor; it can be classified as a substantial investor if it has a relatively large investment position.<sup>26</sup>

There may also exist a group of investors that qualifies for tax-favored or tax-exempt status. In the United States, tax-favored or tax-exempt entities, such as private pension plans and nonprofit institutions, own substantial amounts of shares and securities in enterprises and in investment funds.<sup>27</sup>

Tax rules for nonresident investors may depend on several factors. Different tax rules may apply to foreign individuals and enterprises, and the rules may vary depending on the level of ownership and the nature of the activity of the foreign person within the country. Countries also may consider offering special tax incentives to attract capital from foreign funds or foreign investors.

The tax treatment of income attributable to foreign investment funds raises additional issues, particularly with respect to qualification for relief under a country's double taxation treaties.<sup>28</sup> In many countries it may be uncertain whether investment funds qualify as a "person" for treaty purposes so that a fund could claim treaty benefits for itself or on behalf of its investors. The decision whether to extend treaty benefits to foreign investment funds is part of the larger policy question concerning the appropriate allocation of tax revenue among the country where the investment is located, the country where the fund is located, and the country where the investors reside.

### **C. Types of Income**

The income of an investment fund must be examined in three parts. The first part involves reviewing the different types of income that an investment fund may receive. The second part entails determining how the different types of income will be categorized for tax purposes. The final part of the analysis focuses on identifying those items that may involve different consequences if the income is allocated and the tax imposed at the investment fund level and at the level of the investors.

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<sup>26</sup>The classification of an enterprise as a portfolio or a substantial investor takes on great importance in those countries where the tax treatment of intra-corporate dividends differs by the level of ownership of the payee corporation.

<sup>27</sup>For example, in the United States in 1990, tax-exempt investors (nonprofit institutions, pension funds, IRAs, and Keogh plans) owned approximately \$1.2 trillion or about 37 percent of corporate equity and approximately \$750 billion or about 46 percent of corporate debt. See U.S. Dep't of Treasury, *Integration of Individual and Corporate Tax Systems: Taxing Business Income Once* 68, tbl. 6.1 (1992).

<sup>28</sup>The considerations for extending treaty benefits to foreign investment funds are set forth in Lynne J. Ed & Paul J.M. Bongaarts, *General Report*, in *Cahiers*, *supra* note 6, at 41-57.

### **1. *Possible Types of Income***

An investment fund may have the following categories of income:

- dividends from domestic enterprises;
- dividends from foreign enterprises;
- interest income from different domestic sources, with some types of interest income qualifying for tax-exempt status;
- interest income on foreign securities; and
- gains and losses from the sale of investments.

This list assumes that investment funds are limited to holding securities in operating companies and certain government securities. This simple classification also does not reflect the increased use of derivatives and synthetic instruments that makes determination of both the type of income and the source of income more difficult. To the extent that investment funds may engage in other types of activities, such as holding immovable property or direct ownership of operating assets, additional categories of income may need to be added.

### **2. *Categorization for Tax Purposes***

The second part of the analysis requires determining how these different types of income will be categorized for tax purposes. For example, a certain type of income may be subject to withholding, some types of income will qualify for tax-exempt treatment or capital gain treatment, and other types of income will be taxed under the rules governing foreign source income. To the extent that a country changes its basic tax structure, it will be necessary to determine how possible changes in the categorization of different types of income may influence decisions on the design of a tax regime for investment funds.

### **3. *Tax Items That May Require Separate Treatment***

The third part of the analysis requires identifying those types of income, deductions, losses, and credits that may be subject to different tax treatment in the hands of different types of investors. These include

- dividends and interest from fund investments, especially if the withholding rates vary by type of investor;
- gains and losses from the sale of property by the investment fund, especially if the calculation of gain differs by type of investor and if restrictions are imposed on the use of capital losses;
- income qualifying for tax-exempt status or subject to other types of preferences;
- certain expenses of the investment fund, the most important of which are management fees and the interest incurred to carry its assets; and
- credits received by the investment fund, such as foreign tax credits attributable to foreign source income or credits relating to an integration system of individual and corporate taxes.

The purpose of this review is to highlight the consequences of adopting different regimes for investment fund taxation. This allows policymakers to determine how the taxation of investment funds and their investors will differ under the prototypes examined in the next section. It may also provide guidance as to how individual taxpayers may change their behavior when the tax rules for investing through investment funds differ from investing directly in the underlying assets.

## **IV. Different Prototypes**

This section examines several different prototypes that represent different approaches to reducing or eliminating the double—or in some cases, triple—taxation of dividends, interest, and capital gains attributable to investment funds and their underlying investments. They may be useful in revising or designing a tax regime for investment funds.

### **A. Tax-Advantaged Prototypes**

Three major alternatives exist to provide tax benefits to investment funds that are not generally available to direct investment. They provide either deferral or exclusion of different types of income at either the fund or the investor level. The first alternative allows deferral of any capital gains recognized by the investment fund by not imposing tax at the investment fund level on any gain realized by the fund on the sale of its investments. The tax is effectively deferred until the investor disposes of the investor's interest in the fund through redemption or sale of shares.

The second alternative goes further and does not impose tax on the investment fund on any dividends, interest, or other income received, or on capital gains. This could be accomplished by allowing receipt of income without any withholding or by providing a refund of any withholding imposed on distributions to the investment fund. This alternative provides for deferral of all income at the investment fund level until investors redeem their shares in the fund.

The third alternative allows a deduction for amounts contributed to the investment fund and then taxes the proceeds upon redemption by the investor.<sup>29</sup> No tax is imposed while the investor holds the shares at either the investor or the investment fund level. Under certain assumptions, this approach is equivalent to excluding from taxation the income from investment in the fund.<sup>30</sup>

### **B. Pass-Through Prototypes**

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<sup>29</sup>Countries that have adopted approaches similar to the third method generally limit the amount of potential tax benefit by restricting availability to individual investors and by restricting the amount of new investment in the fund each year. *See, e.g.*, the taxation of personal equity plans in the United Kingdom and *plans d'épargne en actions* in France. International Guide, *supra* note 9, at 50 (United Kingdom) and 43 (France).

<sup>30</sup>*See* Michael J. Graetz, Implementing a Progressive Consumption Tax, 92 Harv. L. Rev. 1575 (1979).

The pass-through prototypes treat the investment fund as transparent and allocate all items of income and loss directly to investors. In its purest form, the investment fund acts simply as a reporting mechanism. This approach treats investors as if they earned the income directly and taxes them accordingly, even if the investment fund does not distribute the income to them.

A pass-through prototype requires a system for allocating all items of income and loss to the investors. One alternative provides for each item to be allocated daily over the tax year and assigns to the investors their prorated share each day.<sup>31</sup> A second alternative assigns the tax items for a particular period, for example, for a year or a quarter, to the owners of interest on the last day of the period and allows the market price for the interest to adjust for any tax consequences.<sup>32</sup>

The pass-through prototypes score high on market neutrality. Unfortunately, they score low on administrative and compliance grounds, especially as the number of investors and the number of fund investments become quite large. Therefore, no country uses this system for investment funds.

A variation of this prototype imposes tax on the investment fund on any income it receives at a rate that could be either the highest rate applicable to investors or, alternatively, the one that is most common to investors. This approach allocates to investors their share of the income of the fund and provides a credit for taxes paid by the fund allocable to that income. Investors may then file for a refund if the amount of tax paid exceeds their liability or they could be assessed additional tax if the amount paid by the investment fund is less than their tax liability. This variation also requires rules for calculating an investor's basis in his or her investment in the fund to determine whether an investor would recognize gain when shares are redeemed.

The third variation is a modified pass-through prototype. This approach aggregates all different types of income at the fund level and requires reporting only one, or perhaps two or three types of income to the investor.<sup>33</sup> Again, this variation could allow for the withholding of taxes at the fund level and for a procedure to provide refunds to investors whose tax rate is below the withholding rate.

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<sup>31</sup>The United States has adopted such a system for allocating items of income for certain qualifying small business corporations, known as "S" corporations. The shareholders generally take into account their respective prorated shares of income, deductions, and other separately stated items on a prorated, per share daily basis. USA IRC § 1366(a)(1).

<sup>32</sup>See U.S. Dep't of Treasury, Blueprints for Basic Tax Reform 70-71 (1977). The allocation proposal in Blueprints used an annual record date for allocating tax items to shareholders and designated the shareholders on the first day of the tax year to be the shareholders of record.

<sup>33</sup>For example, the approach adopted by the United States for separate treatment of only certain types of income of widely held partnerships. *See generally* U.S. Dep't of Treasury, Widely Held Partnerships: Compliance and Administrative Issues (1990).

The pass-through prototypes come closest to achieving market neutrality between direct investment and investment through investment funds. They do, however, impose substantial administrative burdens on both investors and the taxing authorities to ensure collection of taxes and compliance with the tax rules.

### **C. Surrogate Prototypes**

The surrogate prototype changes the focus of taxation from the investor to the investment fund. Surrogate taxation can take many forms. One extreme imposes a tax on the fair market value of the assets of an investment fund in lieu of any income tax at the level of either the investor or the investment fund.<sup>34</sup> A more common surrogate prototype imposes tax on any income received by the investment fund at the fund level and collects tax without regard to the tax characteristics of the investors. It could impose tax on both dividends and interest paid to the investment fund, as well as on any capital gains realized by the fund on the sale of its property.

One variation of this prototype collects no further tax at the investor level on either sale or redemption of the investor's share in the investment fund or, if a fund is allowed to make distributions, on any distributions made by the fund. Another variation imposes a tax on any gains recognized by the investor, but allows the investor a credit for taxes paid by the investment fund with respect to his or her prorated share of the income.

The design of a tax regime for a surrogate model depends largely on the country's rules governing the taxation of dividends and capital gains. A country that imposes schedular taxation of dividends with withholding at the enterprise level requires no special rules for taxing dividends distributed to an intermediary. The tax rules could provide for the funds to be distributed to the individual investors without additional tax liability if they are able to show that tax with respect to the distribution was withheld at the enterprise level.<sup>35</sup>

Compared with the other prototypes discussed in this section, the surrogate approach is probably the easiest to administer and the one that will result in the highest level of tax compliance. To the extent that the rate imposed on the income of the investment fund differs from the rate that would be imposed on investors if they received the income directly, then this approach would violate market neutrality. If the tax rate on the investment fund exceeds an investor's tax rate, then investors may be overtaxed on

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<sup>34</sup>For example, Italy imposes a tax on the net asset value of certain types of investment funds in lieu of an income tax. International Guide, *supra* note 9, at 60-61 (Italy). Sweden imposes tax on 1.5 percent of asset values in lieu of capital gains tax for investment funds; investment companies pay tax on an imputed income of two percent of asset values in lieu of capital gains tax. *See generally* Cecilia Gunne, *Sweden*, in Cahiers, *supra* note 6, at 778-79.

<sup>35</sup>The tax regime of the Czech Republic provides a good example of this approach. *See* Navratilova, *supra* note 6, at 385-86.

their income.<sup>36</sup> Conversely, if the tax rate on the investment fund is less than an investor's tax rate, then this should encourage the development of these types of funds, perhaps at the cost of lost tax revenue.

#### **D. Distribution-Deduction Prototype**

The distribution-deduction prototype taxes the investment fund on any undistributed income and taxes the investors on any income distributed to them. Countries generally achieve this result by treating the investment fund as a taxable entity, but allowing the investment fund to deduct from its income any amounts distributed to investors. The prototype could provide for the investors to receive credit for taxes paid at the fund level with respect to their prorated share of income.

Countries that follow this approach generally require funds to distribute a substantial portion of their income each year. For example, the United States generally requires qualified funds to distribute annually 90 percent of their investment income, other than net long-term capital gains. One reason the United States has adopted this approach is because taxpayers aggregate dividends and interest received with their other income and then pay tax at progressive rates on their total income. The United States also has a sophisticated reporting and matching system that allows taxing authorities to monitor the payment of distributions to investors.

When an investment fund distributes less than its total income for a year, distribution-related prototypes may require rules for determining which income is deemed to be distributed. Such "stacking rules" could, for example, provide for a fund to designate the types of income being distributed, or for income to be deemed distributed in a particular order (e.g., first, dividends and interest received from domestic corporations; second, dividends and interest received from foreign investments; and third, capital gains income) or for a deemed pro-rata distribution of the different types of income.

Distribution-related prototypes could also provide for investment funds to treat amounts as being distributed without requiring an actual distribution to investors. These deemed distributions would be treated as reinvested by the investors.<sup>37</sup> A "deemed-distribution" option allows for an investment fund to avoid potential double taxation on certain income without requiring the fund to liquidate investments in order to make actual cash distributions.

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<sup>36</sup>Whether investors in a low tax bracket are worse off because of the higher tax rate imposed on their share of investment income depends on how the market price of the shares of investment funds under a surrogate tax approach would compare with the market price of the funds under a pass-through approach. Low-bracket taxpayers may be better off under the surrogate approach if there are enough investors in a high tax bracket to bid up the price of the investment funds.

<sup>37</sup>Alternatively, funds could stand ready to make distributions upon request but could allow investors to elect to instead reinvest the amount of the distribution in additional fund shares. Many investors would presumably make the election in order to avoid the inconvenience of dealing with distribution payments.



## **V. Conclusion**

This chapter has set forth a framework for examining issues in the taxation of investment funds and their investors and a survey of the different approaches countries use in taxing income attributable to investment funds. It is not surprising that countries use different approaches in taxing investment funds and their investors. The investment fund tax rules are dictated largely by a country's overall tax regime for individuals and enterprises, and these tax regimes vary substantially among countries. Administrative and compliance considerations also influence the choice of tax rules.

The absence of an ideal structure requires policymakers to balance competing goals. As discussed in section II, these goals could include (1) not discouraging the development of investment funds, (2) achieving market neutrality between direct and indirect investments, (3) designing a regime with low administrative costs and high compliance, and (4) not decreasing, and perhaps increasing, the tax revenue base.

Which prototype for investment fund taxation makes sense in a particular country depends largely on the country's basic tax structure. If a country's tax system has (1) similar tax rates for individuals and corporations, (2) final withholding on dividends and interest (and no variation in withholding rates by taxpayer), (3) no threshold level for excluding capital gains (and similar rules for all taxpayers for taxing capital gains), (4) exclusion of foreign source income, and (5) no special rules for foreign investors, then the surrogate prototype may be preferable because of the substantial administrative and compliance advantages it offers.

To the extent that a country's basic tax regime differs significantly from the above structure and contains highly differentiated treatment of various types of income for particular types of taxpayers, the surrogate prototype loses much of its attraction. Particularly if substantial weight is given to the goal of market neutrality, then a pass-through prototype or distribution deduction prototype merits serious consideration.