WILLKIE FARR & GALLAGHER LLP

CLIENT MEMORANDUM

NEW TAX LEGISLATION WOULD MAKE MUTUAL FUNDS MORE ATTRACTIVE TO NON-U.S. INVESTORS (FOR A LIMITED TIME ONLY)

The American Jobs Creation Act of 2004 (the "Act") has now been approved by both houses of Congress, and President Bush is expected to sign the measure into law. The Act makes major changes to a variety of Federal income tax laws, including the taxation of mutual fund dividends paid to non-U.S. shareholders. Specifically, the Act makes it possible for mutual funds no longer to withhold on dividends to non-U.S. shareholders where such dividends derive from interest income and short-term capital gain recognized by the fund.

The Problem: A Mutual Fund's Interest Income and Short-Term Capital Gains

Under current law, it is more tax-efficient for a non-U.S. person to hold debt securities of a U.S. issuer directly instead of indirectly through a mutual fund. The reason is that while interest paid to a non-U.S. person is technically subject to a U.S. withholding tax, such interest is often exempt from such tax under the "portfolio interest" exception. Under this exception, if a person directly holds debt issued by a U.S. entity and the person is unrelated to that U.S. entity, the interest can generally be paid free of withholding taxes.

However, dividends paid by a mutual fund to non-U.S. shareholders are subject to withholding tax. Thus, whenever a mutual fund pays a regular dividend to a non-U.S. shareholder, the dividend is subject to withholding even where such dividend is derived from interest income that would have qualified for the portfolio interest exception had it been received by the non-U.S. shareholder directly. (A non-U.S. shareholder may be eligible for a reduction in the rate of withholding tax under an applicable income tax treaty, but such treaties generally only reduce the rate of withholding on dividends paid to a non-U.S. shareholder of a mutual fund from 30% to 15%.)

Similarly, with certain exceptions, a non-U.S. person is not subject to U.S. tax on capital gain recognized on the disposition of stock or securities issued by U.S. corporations. (An exception is the sale of stock of a U.S. real property holding company, the proceeds of which are subject to withholding taxes.) Generally, a mutual fund may elect not to withhold on properly-designated distributions of "net capital gain." "Net capital gain" is the net long-term capital gains recognized by the mutual fund less its net short-term capital losses. Importantly, however, if a mutual fund has net short-term capital gains in excess of net long-term capital losses, the mutual fund generally must withhold on its distributions attributable to this excess.

In summary, before the effectiveness of the Act a non-U.S. person who invests in a mutual fund finds that interest income and short-term capital gain, which might have been exempt from U.S. tax if recognized directly, generally is subject to withholding tax if the non-U.S. person derives that income or gain indirectly through an investment in a mutual fund.

The Fix, Part 1: Interest-Related Dividends

Under the Act, no withholding tax is required for an "interest-related dividend" paid by a mutual fund to a non-U.S. shareholder. The total amount of such dividends that a mutual fund may pay each year is limited to the amount of "qualified interest income" received by the fund during that year, less the amount of fund expenses properly allocable to such interest income. For this purpose, qualified interest income includes, among other things, interest on obligations of a U.S. issuer unless earned on an obligation issued by an entity that is owned 10% or more by the mutual fund or, in certain situations, contingent interest. A mutual fund must designate a dividend as an "interest-related dividend" by written notice mailed to its shareholders not later than 60 days after the close of its tax year.

Naturally, there are exceptions. For example, a mutual fund must withhold if the dividend is paid to a person in a foreign country that the Treasury Department has determined lacks adequate information exchange with the United States. Also, a non-U.S. shareholder must provide the mutual fund with a statement that the shareholder is a non-U.S. person in order for the dividend paid to such shareholder to qualify as an "interest-related dividend."

The Fix, Part 2: Short-Term Capital Gain Dividends

Under the Act, the withholding tax generally is eliminated for a "short-term capital gain dividend" paid by a mutual fund to a non-U.S. shareholder. The amount of such dividends that a mutual fund may pay each year is generally limited to the excess of the fund's net short-term capital gains over net long-term capital losses. No reduction is made for fund expenses attributable to such net gains. A mutual fund must designate a dividend as a "short-term capital gain dividend" by written notice mailed to its shareholders not later than 60 days after the close of its taxable year.

This exemption from withholding taxes does not apply to a non-U.S. shareholder that is present in the United States for 183 or more days during the tax year, although the fund may assume that the exemption applies unless it knows the shareholder is present in the United States for such a period. Also, the exemption does not apply to the extent a dividend is attributable to gains from U.S. real property interests (including shares of stock of corporations that are treated as U.S. real property holding companies).

The New Problem: Sunset

These provisions of the Act apply to mutual fund dividends with respect to fund tax years beginning on or after January 1, 2005. However, these provisions automatically expire, or "sunset," and do not apply to dividends with respect to fund tax years beginning on or after January 1, 2008. While it is possible that Congress may delete this sunset provision in the future, until it does so mutual funds may wish to consider carefully the benefit of seeking out new non-U.S. shareholders.

Estate Tax Modification

Non-U.S. persons are subject to Federal estate tax only on their property within the United States, which generally includes stock issued by U.S. corporations and debt obligations of U.S. issuers. However, a debt obligation of a U.S. issuer is not treated as property within the United States if the interest on the obligation would be exempt from U.S. withholding tax under the "portfolio interest" exception.

Under the Act, a portion of the shares of a mutual fund held by the estate of a non-U.S. decedent is treated as property outside the United States. This portion is based on the proportion of mutual fund assets at the end of the quarter preceding the decedent's death that are "qualifying assets." For this purpose, "qualifying assets" includes portfolio debt obligations and bank deposits of the type that would be exempt from gross-basis income taxation.

The estate tax provision applies to decedents dying after December 31, 2004 and before January 1, 2008.

The Act contains other provisions that will affect mutual funds. For example, the Act (1) makes it more likely that fund investments in stock will be subject to the "straddle" rules, which, among other things, may defer the recognition of a tax loss in the stock or in a position offsetting the stock, (2) addresses the calculation of foreign taxes for purposes of determining a mutual fund's foreign tax credit, and (3) provides that net income from publicly traded partnerships will generally be qualifying income for a mutual fund.

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If you would like to discuss the new legislation, please contact Jeffrey Van Hove at (212) 728-8675 or Hillel Jacobson at (212) 728-8655.

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