PERMANENT U.S. WITHHOLDING TAX RELIEF FOR NON-U.S. INVESTORS IN U.S. MUTUAL FUNDS

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Investment Management Alert

By: Joel D. Almquist

U.S.-registered investment companies ("RICs") historically have had limited success attracting investments from non-U.S. investors, in large part due to U.S. withholding taxes on fund distributions. This has allowed funds established in many non-U.S. jurisdictions that have a more favorable tax regime (i.e., no home country withholding taxes, such as Irish or Luxembourg UCITS funds), to be preferred by foreign investors over U.S. RICs. However, on December 18, 2015, President Obama signed into law the Protecting Americans from Tax Hikes Act of 2015 (the "PATH Act"). One of the provisions of the PATH Act makes permanent the elimination of U.S. withholding taxes on certain dividends paid by RICs to foreign investors. The PATH Act could, to a large extent, level the playing field for many RICs and open opportunities for distribution to a wide variety of non-U.S. institutional and other investors.

U.S. WITHHOLDING TAXES

Non-U.S. investors are subject to withholding tax at the rate of 30 percent (or lower rates under applicable tax treaties) on dividends paid to them by U.S. corporations, including RICs (subject to an exception for distributions of the RICs' long-term capital gains). Non-U.S. investors are not subject to this withholding tax on U.S.-source interest income received directly, which qualifies as "portfolio interest" as defined for purposes of Sections 871 and 881 of the Internal Revenue Code of 1986, as amended (the "Code"). In addition, such investors are not subject to U.S. federal income or withholding tax on gain, including short-term capital gain, realized on the sale of U.S. investment assets that qualify for the trading safe harbor under Section 864(b)(2).

TEMPORARY EXEMPTION FROM U.S. WITHHOLDING TAX

For many years, the dividends paid by a RIC to non-U.S. investors were subject to the withholding tax on dividends even if the RIC's own income was comprised of portfolio interest and short-term capital gain, which would have otherwise been exempt from withholding tax if received directly by the non-U.S. investor. The fact that the portfolio interest and short-term capital gains were being paid in the form of a RIC dividend created a re-characterization of such income, which was subject to withholding tax. The American Jobs Creation Act of 2004 amended the Code to permit RICs to report "interest-related dividends" and "short-term capital gain dividends," which were exempt from U.S. withholding tax if paid to non-U.S. investors. Interest-related dividends are dividends based on a RIC's income that is qualified interest income ("QII"), which includes (i) original issue discount on an obligation payable within 183 days of issuance, (ii) interest on an obligation in registered form (other than interest on an obligation issued by an obligor in which the RIC is a 10 percent shareholder or interest that does not qualify as portfolio interest), (iii) interest on deposits, and (iv) interest-related dividends received

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from other RICs. Short-term capital gain dividends are dividends based on short-term capital gains realized by a RIC.

In order to qualify for the exemption from withholding tax, a RIC is required to calculate the percentage of its dividend that was sourced from QII or short-term capital gain. The RIC would then report this percentage to shareholders (via a website or other medium). For example, if a RIC paid a dividend to a non-U.S. investor in a given year of $100 and calculated that 90 percent of the dividend was QII and/or short-term gain, then $90 would be exempt from U.S. withholding tax. The remaining $10 would be subject to the general withholding tax rate of 30 percent ($3) or potentially less, depending on the terms of the applicable tax treaty between the United States and the investor's home jurisdiction.

Unfortunately, this amendment was enacted with sunset dates causing these provisions to terminate for fund taxable years beginning after December 31, 2007. Thereafter, the sunset dates were extended from time to time through 2009, 2011, 2013, and 2014, with such extensions sometimes being enacted retroactively. Needless to say, the uncertainty surrounding the duration of these provisions limited the opportunities for marketing U.S. income-oriented funds to non-U.S. investors based upon the benefits of the provisions.

THE PATH ACT

The PATH Act has eliminated the sunset dates for the withholding tax exemptions for interest-related and short-term capital gain dividends and, therefore, has removed the uncertainty regarding the duration of these provisions. This could serve to somewhat level the playing field from a tax perspective between RICs and certain offshore registered fund products by removing the historical tax disadvantages caused by U.S. withholding taxes, particularly for RICs whose income is sourced substantially from QII (e.g., RICs that invest their assets in U.S. government securities, which in many instances will likely be 100 percent exempt from withholding). Non-U.S. investors are still required to provide RICs with a certification as to their foreign status on the appropriate IRS Form W-8 in order to claim the exemption from U.S. withholding tax, and will also need to provide the information required under the Foreign Account Tax Compliance Act ("FATCA") in order to avoid the imposition of the 30% withholding tax under FATCA. Finally, non-U.S. investors who are individuals must not be present in the U.S. for 183 days or more during the year in which the RIC dividend is paid.

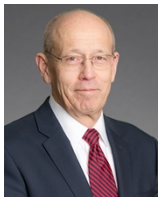
Notwithstanding the tax matters, RICs will still need to be cognizant of other issues associated with cross-border selling of their shares (such as the European Alternative Investment Fund Managers Directive (AIFMD)) and will need to comply with the local private offering and related securities laws and regulations in the foreign investor's home jurisdiction.

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If you have any questions, including questions about the potential benefits to you, please contact either of the authors listed below or one of the K&L Gates attorneys with whom you work.

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KEY CONTACTS



JOEL D. ALMQUIST
PARTNER

BOSTON
+1.617.261.3104
JOEL.ALMQUIST@KLGATES.COM

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