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FATCA Must Not Undercut the Advantages That U.S. ETFs Offer Global Investors

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In recent months, ICI has continued to engage closely with regulators to share our concerns and suggestions for implementing the Foreign Account Tax Compliance Act (FATCA). Our most significant concern for the U.S. fund industry involves FATCA's impact on the competitiveness of U.S. exchange-traded funds (ETFs).

We addressed this issue in a recent letter to the Treasury Department and the Internal Revenue Service, but let's take another look.

A Hypothetical: Two ETFs

To understand the competitiveness issue facing U.S. ETFs, it is helpful to review U.S. tax rules in the context of a simple hypothetical.

The United States imposes withholding tax—at a 30 percent rate (often reduced by tax treaty to 15 percent)—on specified U.S.-sourced payments, such as dividends, to non-U.S. investors.

For our hypothetical, let's say we have two ETFs: one organized in the United States and one organized in an offshore location. Both funds invest only in Korean stocks, trade on global exchanges, and are available to both U.S. and non-U.S. investors.

The non-U.S. investor in the U.S. fund will incur U.S. withholding tax on the fund's Korean investments because all distributions by a U.S. fund are treated, under U.S. tax law, as having a U.S. source. The non-U.S. investor in the offshore fund, by contrast, will not incur any tax because the fund's income retains its Korean source under the offshore location's tax law.

Despite this tax disadvantage, many non-U.S. investors presently choose to invest in U.S., rather than offshore, ETFs. One reason is that the withholding tax is not imposed on a fund's distributions of long-term capital gains to non-U.S. investors or on the gains realized by these investors when they sell U.S. securities. Other reasons include the high liquidity, robust regulation, strong management, and very competitive fees offered by U.S. funds.

The Problem That FATCA Causes for U.S. ETFs with Non-U.S. Investors

As written, FATCA makes U.S. ETFs significantly less attractive to non-U.S. investors. How? FATCA imposes several requirements on non-U.S. financial institutions and their non-U.S. investors that, if not followed, can result in 30 percent withholding on all income, gains, and sales proceeds (including initial investments) from U.S. securities such as U.S. ETFs. This withholding can be imposed if the non-U.S. investor or the financial intermediary encounters any problem with documenting the account.

For non-U.S. investors, the possibility of taking this colossal tax hit will have a significant impact on investment decisions. To return to our hypothetical, this U.S. tax hit would lead non-U.S. investors to have a pronounced preference for the non-U.S. ETF (where FATCA is not applicable), even if the U.S. fund has substantially lower fees and higher liquidity.

FATCA thus presents non-U.S. fund distributors with a tool to encourage non-U.S. investors who are seeking to gain exposure to non-U.S. markets to invest in non-U.S., rather than U.S., ETFs holding comparable securities. Global fund complexes will respond by using offshore locations to create new ETFs focusing on non-U.S. investments.

This outcome should be avoided, and not just to bolster the U.S. fund industry. Global investors will be better off if U.S. funds, with their substantial advantages, remain a viable option for them.

To address this issue, ICI has recommended that Treasury provide U.S. funds with an election to treat the portion of any payment as a FATCA withholdable payment only to the extent that such payment relates to U.S. assets in the underlying portfolio.

Learn more about FATCA at our FATCA Resource Center.

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