Why Americans Should Never Own Shares in a Non-US Mutual Fund

Thun Financial Advisors Research 2016

Executive Summary

- **The Foreign Account Tax Compliance Act of 2010 has changed the nature of Tax Reporting for American Expatriates**
- **Formerly benign Passive Foreign Investment Companies (PFICs) have become a tax nightmare incurring significant costs in tax preparation and taxes affecting investment performance.**
- **This issue is a reminder that Americans abroad should focus on investing through American accounts.**

Introduction: Americans Should Avoid Non-US Mutual Funds

If you are a U.S. citizen or a U.S. permanent resident who has been living and working outside the U.S. and investing your savings through a non-US financial institution, you need to learn what a Passive Foreign Investment Company is very quickly. Why? Because the passage of the Foreign Account Tax Compliance Act (FATCA) has ushered in a new era of dramatically heightened enforcement by the U.S. laws regarding taxation of and reporting on investments held outside the U.S. by U.S. Citizens or U.S. permanent residents.

There has already been much discussion about IRS Form 8938, which, since 2011, has been required filing for Americans abroad with more than $300,000 of financial assets held outside the U.S (for American residents in the US, the threshold is only $50,000). Form 8938 requires not only

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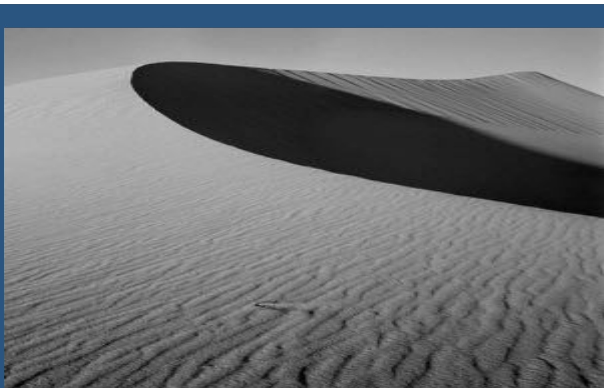
the listing of assets held outside the US, but also specifically requires a box to be checked if the assets are "Passive Foreign Investment Companies."

What are PFICs?

The moniker "Passive Foreign Investment Companies" (PFICs) sounds like some exotic and highly-specialized investment, and, as a result, many Americans automatically assume that they do not own any. For many unsuspecting Americans abroad this conclusion is a mistake, because PFICs are simply "pooled investments" registered outside of the United States encompassing mutual funds, hedge funds, insurance products and non-U.S. pension plans. A bank account might also be a PFIC if that account is a money-market fund rather than simply a deposit account, because money market accounts are essentially short-maturity fixed-income mutual funds. Furthermore, PFIC rules can and generally do apply to investments held inside foreign pension funds unless those pension plans are recognized by the U.S. as "qualified" under the terms of a double-taxation treaty between the U.S. and the host country. Due to FATCA, the consequences of this mistake have become very significant.



PFICs AND TAXES

"The tax treatment of PFICs is extremely punitive compared to... similar investments incorporated in the U.S."

The tax treatment of PFICs is extremely punitive compared to the tax treatment of similar investments that are incorporated in the U.S. For example, an American holder of a U.S. incorporated mutual fund invested in European stocks pays the low long-term capital gains rate of 15% if the fund is held for more than one year. The same American investor who buys a nearly identical fund listed in the UK or in Switzerland (or any place outside the US) will find their investment subject to the PFIC taxation regime, which counts all income (including capital gains) as ordinary income and automatically taxes it at the top individual tax rate (39.6%). In some cases, the total tax on a PFIC investment may rise to well above 50%. Furthermore, capital losses cannot be carried forward or used to offset other capital gains.

PFIC Compliance for Non-US Mutual Funds

High taxation rates are not the only big disadvantage of PFICs for American investors. The other major complicating factor of PFICs is the onerous task of simply complying with IRS reporting rules for PFICs. Ownership is most common among expatriate Americans, many of whom employ accountants specializing in tax preparation for Americans abroad. However, hiring an expatriate tax specialist does not guarantee that the proper PFIC related filings are being made and the taxes paid.

Often, the client inadvertently fails to divulge (and the tax accountant fails to request) the necessary information on the client's mutual funds, hedge funds, or other financial holdings. In other cases, if the client and the tax preparer have negotiated a fixed fee for tax preparation, the preparer may be reluctant to ask about possible PFICs because record keeping and preparation time for the complicated form 8621 (required to be filed for each PFIC investment owned) is estimated by the IRS to be 22 hours per year!

As a result of the 2010 FATCA law, form 8621 must be filed every year for separate PFIC (previously 8621 only had to be filed in years of when the fund paid distributions to the fund holders). It does not take long to realize that filing form 8621 for three to four PFIC investments (or more) might quickly run up a tax preparation bill to many thousands of dollars, no matter how much (or little) the underlying investments are worth or how well they have performed.

However, this scary picture raises an obvious question. If this is such a big trap, why has there not been more discussion of the issue and why have I never read about it before? The reason is that until now the IRS faced many obstacles to enforcing the PFIC rules and lacked the resources to go after filers on the issue. Failure to file Form 8621 and properly report PFICs has hardly ever resulted in an audit or a prosecution for tax fraud. The PFIC issue has been safely ignored until now, even by professional tax preparers. But times have changed.

PFIC TIME CRUNCH

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FATCA makes PFIC Reporting Mandatory

The FATCA legislation not only requires new self-reporting on PFICs and other foreign held financial assets, but also requires all "foreign financial institutions" to report on the assets held by U.S. citizens and U.S. permanent residents directly to the IRS. While it may seem hard to believe that foreign financial institutions would willingly comply with such reporting requirements, the fact is that industry observers have observed nearly universal compliance rules by banks, brokerages, insurance companies, mutual funds (anything "financial") around the world, because of the severe sanctions the FATCA law imposes on non-compliant financial institutions. The point is that all U.S. citizens must assume that the IRS will have a direct and easily accessible window onto their holdings in foreign financial institutions. It will be easy to cross-reference direct reports by these institutions to the IRS with self-filed form 8938 and 8621 and determine whether or not your PFIC investments have been properly reported and the tax properly calculated and paid.

PFIC Compliant Investments

Finally, this issue serves to demonstrate an important point that all American expatriates need to understand: the complications of international financial planning are magnified by the various tax regimes that the cross-border or international investor faces through their investments. PFIC rules are just one of many reasons that American investors need to keep their investment funds in U.S. accounts, even if they are investing globally. A thorough analysis of the tax, cost, reporting and security issues of foreign investments invariably leads to the conclusion that when it comes to wise and efficient investing, savvy American investors keeps their wealth invested globally, but through U.S. financial institutions to manage the myriad tax and regulatory issues.

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