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

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Executive Summary

- **U.S. taxation of foreign mutual funds (PFICs) owned by U.S. taxpayers is punitive and complex**
- **PFICs encompass a wide variety of non-U.S. investment products besides mutual funds and are commonly owned by Americans abroad**
- **The Foreign Account Tax Compliance Act (FATCA) has greatly expanded the ability of the IRS to enforce PFIC rules**

Thun Financial Advisors, L.L.C. is a U.S.-based, fee-only, Registered Investment Advisor that provides investment management and financial planning services to Americans residing in the U.S. and overseas.

We maximize long-term wealth accumulation for our clients by combining an index allocation investment model with strategic tax, currency, retirement and estate planning. We guard our clients' wealth as though it was our own by emphasizing prudent diversification with a focus on wealth preservation and growth.

Introduction: Americans Should Avoid Non-US Mutual Funds

Perhaps the most common and most significant investment mistake made by Americans abroad is to buy a foreign mutual fund (including ETFs or other types of non-U.S.-based funds). The U.S. tax code categorizes non-U.S. registered mutual funds as Passive Foreign Investment Companies (PFICs). PFICs are taxed very punitively by the U.S. Furthermore, each PFIC must be reported annually on U.S. tax form 8621, which requires complex accounting and is very time consuming to complete.

For many years after the passage of the original 1986 PFIC legislation, U.S. expats could comfortably ignore the PFIC rules because the lack of cross-border financial transparency made it impossible for the IRS to collect the information needed to enforce the PFIC tax provisions. All of this changed in 2010, however, with the passage of the Foreign Account Tax

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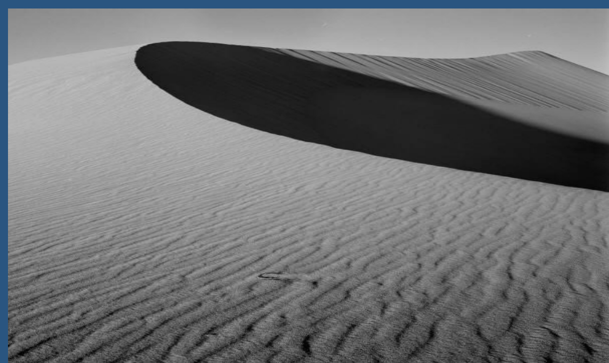
Compliance Act (FATCA) which ushered in a new era of dramatically increased cross-border tax transparency and information sharing on non-U.S. accounts held by U.S. citizens and other U.S. taxable persons. Therefore, continued failure to properly report PFICs on a U.S. tax return exposes U.S. taxpayers to a high risk that the IRS will eventually uncover the lack of disclosure and impose tax, interest and penalty that can potentially consume most of the return on investment.

What are PFICs?

The moniker "Passive Foreign Investment Company" (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, exchange-traded funds (EFTs), closed-end 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 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 likelihood that the IRS will eventually identify unreported PFICs has increased dramatically. Finally, PFIC rules apply equally to Americans abroad as well as Americans living in the U.S., although the problem is much more common among American taxpayers living abroad.



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 0-20% 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 U.S.) 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 (37.0%). In some cases, the total tax on a PFIC investment may rise to well above 50% because of the complex rules regarding the timing of PFIC income recognition. Furthermore, capital losses on PFICs can only offset other investment gains in limited circumstances.

Finally, it should be stated clearly that PFICs are foreign REGISTERED funds, not funds that invest in foreign investments. For example, an Ireland registered fund that invests in U.S. stocks is a PFIC. A U.S. registered fund that invests in European stocks is not a PFIC.

PFIC Compliance for Non-US Mutual Funds

High tax rates are not the only disadvantage of PFICs for American investors. The other major PFIC complication 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, ETFs, hedge funds, or other financial instruments. 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 is estimated by the IRS to be 22 hours per year!

As a result of the 2010 FATCA law, a separate form 8621 must be filed every year for each PFIC (previously 8621 only had to be filed in years that the fund paid distributions to the fund holders). It does not take long to realize that filing form 8621 for three or 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.

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 as a result of FATCA.

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 com-

pliance with FATCA 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 view of their holdings in foreign financial institutions. It will be easy to cross-reference direct reports by these institutions to the IRS with self-filed forms 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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Thun Financial Advisors Research is the leading provider of financial planning research for cross-border and American expatriate investors. Based in Madison, Wisconsin, David Kuenzi and Thun Financial Advisors' Research have been featured in the *Wall Street Journal, Emerging Money, Investment News, International Advisor, Financial Planning Magazine* and *Wealth Management* among other publications.

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