

Expat Tax Notes:

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



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If you are a US citizen or a US permanent resident who has been living and working outside the US and investing your savings through a non-US financial institution, you need to learn what a Passive Foreign Investment Company (PFIC) is very quickly. Why? Because the Obama Administration and its allies in Congress are pushing through legislative and administrative changes designed to increase tax compliance among American citizens living abroad. For the typical American expatriate who is properly reporting and paying taxes on their global income, the impact of the legislation will be minimal, with one potentially very consequential exception: taxation of investments in non-US mutual funds, hedge funds, and any other type of 'pooled investment.' Non-US incorporate pooled investments typically meet the definition of what the tax code defines as Foreign Passive Investment Companies. Although too complex to fully elaborate on here, the tax treatment of PFICs is extremely punitive compare to the tax treatment of similar 'pooled 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 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 (35%). 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.

The most interesting and important aspect of this story is that of the estimated hundreds of thousands of Americans that own PFICs in their investment portfolio, very few of them are aware of it. Ownership is most common among expatriate Americans, many of whom employ accountants who specialize in tax preparation for Americans abroad. But hiring an expatriate tax specialist is no 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 fund or hedge fund 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 simply preparing the complicated IRS form 8621 required for PFIC disclosure is estimated to take at least nine hours. (The IRS further estimates the necessary record keeping will consume an additional 13 hours). Finally, because the PFIC rules have been so rarely enforced over the years, many expatriate tax specialists are simply unfamiliar with them.

Indeed, until now, individuals who failed to declare and pay the onerous tax on PFIC investments have had little to fear. The IRS faced many obstacles to enforcing the rules and lacked the resources to go after filers on this issue. But this part of the story is changing fast. The Obama administration's plans to crack down on Americans shielding income abroad will dramatically increase the reporting requirements

by non-US financial institutions that service accounts owned by U.S citizens. The plan includes the hiring of 800 new IRS tax inspectors just for international tax enforcement. Already steep penalties for non-reporting of foreign investment accounts are slated to be doubled. These measures are primarily designed to draw out wealthy individuals who are knowingly evading U.S. taxation, but the effect will also be to dramatically increase the IRS's ability to obtain the information necessary to enforce the PFIC rules on the thousands of American investors who are unwittingly not in compliance with them.

Americans who realize they own PFIC investments should work with a qualified accountant to determine the best strategy to purge the investments from their portfolios and resolve any resulting tax issues. Fortunately, the IRS is known to deal sympathetically with taxpayers who voluntarily bring themselves into compliance, especially if the tax transgression was unintentional in the first place. That is certainly the case with most taxpayers who are currently running afoul of the PFIC rules.

Finally, this issue serves to demonstrate an important point that all American expatriates need to understand. The PFIC rules are just one of many reasons that American investors need to keep their investment funds in US accounts, even if they are investing globally. A thorough analysis of the tax, cost, reporting and security issues invariable leads to the conclusion that when it comes to wise and efficient investing, there is still no place like home for American citizens.

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