December 2014

What U. S. Persons investing in foreign mutual funds should know

By Olga Kocybik, CPA and AWCD member

With her special thanks to Elaine Terlinden for her review, edit, and invaluable feedback on the contents of this article. Both Olga and Elaine serve on FAWCO's Tax & Banking Committee.

For general U.S. expat tax information, new members may want to request copies of our earlier articles and/or on FAWCO.org see the T&B section (under U.S. Issues). Also feel free to contact us with your U.S. tax questions.

To answer questions we have received on this topic, with this article we provide an overview on reporting requirements for those who already invest in foreign mutual funds or plan to do so. It neither goes into passive foreign income company regulations which are very comprehensive and complex, nor provides any investment advice. For U.S. tax purposes, below references to "shareholder" refer to a U.S. Person (citizen or green card holder) taxpayer (TP) whether they reside in or outside the U.S. and, in general, a "foreign" account, asset, fund, etc. refers to those located outside the U.S.

A very common belief today is that Americans should not invest in foreign mutual funds because of the complexity of reporting and tax rules surrounding it. But why? A simple answer is: investments in the U.S. mutual funds do not trigger reporting and/or tax consequences unless such fund pays out interest or dividends or makes a distribution to its investors. On the other hand, for U.S. tax purposes, foreign mutual funds are treated as Passive Foreign Investment Companies (PFICs).

In general, a PFIC is a foreign corporation which earns at least 75% of its income from passive sources or at least 50% of its assets are held to earn passive income. It is also necessary to note that a non-U.S. mutual fund organized as a trust will not prevent its characterization as a PFIC.

There are three separate taxation regimes under the PFIC provisions: the Qualified Electing Fund (QEF) regime; the Mark to Market (MTM) regime; and, the excess distribution regime.

How to deal with PFICs and how to report them?

QEF Regime – elective regime

Generally the QEF election is made by the shareholder in the first year a PFIC stock is owned. When a QEF election is in effect, the shareholder is treated as receiving an annual distribution of their pro rata share of the PFIC's income, classified into ordinary income and net capital gain. A foreign corporation will then need to supply their U.S. investors with the profits and earnings statement, which information

will be includable in the TP’s U.S. income tax return and taxed accordingly. Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) will need to be filed every year.

MTM Regime – elective regime

When a PFIC stock is “marketable,” a shareholder may make a MTM election to treat their PFIC stock as if it were sold at the end of each year. Stock is marketable only if it is “regularly traded” on a “qualified stock exchange”. If the stock has increased in value since the prior year end, the shareholder includes the increase on their U.S. tax return, subject to tax at regular, not capital gains, rates. If the stock has decreased in value since the prior year end, the TP is permitted to deduct the resulting loss to the extent of any MTM income included in prior years. Form 8621 will need to be filed every year.

Excess Distribution Regime – default regime

Although the first two regimes are preferred, there is not always a possibility of making a timely QEF election; moreover, in most cases the PFIC shares are not marketable. This third regime is the default regime - intentionally harsh and non-economic. What is an “excess distribution”? A distribution is considered an excess distribution only to the extent the total distributions during a taxable year received by the shareholder exceeds 125% of the average distributions received in the three preceding taxable years. Moreover, any gain realized on a disposition of PFIC shares is treated as an excess distribution. In addition, the IRS takes the view that the indirect distributions - that is, if a U.S. Person owns stock in a foreign entity and, if that foreign entity sells the PFIC (an “indirect disposition”), or receives a distribution from the PFIC (an “indirect distribution”) - the TP will be treated as if they sold or received a distribution from the PFIC. Once the total amount of the excess distribution has been determined, it is allocated pro-rata to the shareholder's holding period to calculate the interest charge on the excess distribution and the deferred taxes. The TP then reports the amount of excess distributions and interest on their U.S. tax return.

What if a taxpayer realizes too late that they own shares in a PFIC? What are their options?

Many U.S. Persons, especially individuals who can benefit from lower tax rates on capital gains, would want to make a timely QEF election for PFIC shares they own. However, there are many reasons why a TP might not have made a timely QEF election. There are a few options which offer a solution: late MTM or a QEF election, or a purging election. The ability to make the former is extremely limited. The purging election, on the other hand, can be made at any time, but comes at a potentially high cost. One of the purging election options is a deemed sale, which provides for an election to recognize gain as if the PFIC stock were sold. Simultaneously the TP makes a QEF election for the stock (and will continue this treatment). The gains from the deemed sale of the stock are subject to excess distribution treatment and are explained above. Purging elections are, however, outside the scope of this article.

Proposed temporary regulations - obligatory Form 8621

Starting with years ending on or after December 31, 2013, all direct owners of PFICs must file Form 8621 with the IRS, whether or not the TP is required to file a U.S. tax return, unless the aggregate value of all of the shareholder's PFICs holdings on the last day of the shareholder's calendar year did not exceed $25,000 ($50,000 in the case of MFJ status) and the shareholder has not:

1. received distributions in the current year,
2. sold PFIC shares in the current year, or
3. made QEF or MTM elections discussed above.

In determining the value of these funds, the shareholder may rely on periodic account statements unless they have actual knowledge or accessible information that such statements do not reflect a reasonable estimate of the PFIC's value.

Required Reporting - Foreign Financial and Bank Accounts Report (FBAR or FinCEN 114) and Statement of Specified Foreign Financial Assets (8938)

FInCEN Form114 - A foreign mutual fund is considered a foreign financial account and, as such, and whether or not the U.S. Person is required to file a U.S. tax return, such mutual funds are also required to be reported to the U.S. Treasury if the aggregate value of the TP's foreign accounts (financial interest in or signatory authority over) exceeds the $10,000 FBAR filing threshold.

IRS Form 8938 - If the TP is required to file a U.S. tax return, an investment in a foreign mutual fund must also be reported if the aggregate value of their foreign financial assets exceeds the 8938 filing threshold. For TPs residing outside the U.S., the thresholds for 2013 are: Single or MFS: $200,000 at the yearend/$300,000 any time during the year, and $400,000/$600,000 for MFJ.

Noncompliant taxpayers - Streamlined Offshore Procedures and Offshore Voluntary Disclosure Program (OVDP)

As might have been expected, many of these non-compliant TPs were shareholders in PFICs, and in almost all of these cases no PFIC reporting had ever been made. In these circumstances, there was no possibility of making a timely QEF election. Moreover, in most cases the MTM election was also unavailable. In order to settle PFIC cases under the OVDP, the IRS allows TPs to elect to apply a modified version of the §1296 MTM rules, although there is no indication that the PFIC shares were required to be publicly traded in order to make this special election. Moreover, TPs must continue using the MTM method under the normal statutory rules as applicable for the PFIC investment retained beyond the voluntary disclosure period.

Failure to file penalties are severe! and a lot more so if non-compliance is determined to be 'willful'. The good news is, to help bring those who had invested in undisclosed PFIC and other foreign accounts and foreign entities into compliance with their tax paying and reporting obligations, the IRS has voluntary disclosure programs under which the TP can get complaint.

For detailed information for reporting PFICs under the OVDP, TPs should refer to #10 of the Offshore Voluntary Disclosure Program FAQs, as well as other FAQs relating to the new Streamlined Procedures. irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers.

In general, voluntary disclosure programs are also included in our Fall Radschläger article. It is important to note that (i) a TP loses any chance of amnesty if they are first contacted by the IRS; and (ii) with the help of the Foreign Account Tax Compliance Act (FATCA) and its inter-governmental agreements in force between the U.S. and most countries - including Germany - the U.S. government will identify TPs with unreported foreign accounts and assets.

In applying the provisions of this and any other tax article, it is important to understand the impact of applicable tax laws will vary between individual taxpayers. Please consult your tax adviser to determine how the tax laws discussed may affect your particular U.S. tax situation.

References

http://www.irs.gov/Individuals/International-Taxpayers/Offshore-Voluntary-Disclosure-Program-Frequently-Asked-Questions-and-Answers-2012-Revised

http://thunfinancial.com/why-americans-should-never-ever-own-shares-in-a-non-us-incorporated-mutual-fund/#sthash.p6r8yAkI.dpuf

http://www.forbes.com/sites/robertwood/2014/10/17/irs-explains-how-to-come-clean-on-offshore-accounts/

http://www.wgcpas.com/tax-alerts/292-tax-alert-new-irs-regulations-will-impact-many-holders-of-foreign-mutual-funds