

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



First published in June 2009, Updated April 2012

By: David Kuenzi

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 (PFIC) is very quickly. Why? Because the passage of the Foreign Account Tax Compliance Act (FATCA) in 2010 is ushering in a new era of dramatically heightened enforcement by the U.S. of 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 the new IRS Form 8938, which starting in 2011 will be required filing for Americans abroad with a total of more than \$300,000 of financial assets held outside the U.S. (for Americans resident in the US, the threshold is only \$50,000). Form 8938 requires not only 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."

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 would be a mistake and the consequences of making this mistake are about to become very significant.

## About Thun Financial Advisors

*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.*

Thun Financial Advisors, LLC  
3310 University Ave, Madison, WI 53705

608-237-1318  
Skype: thunfinancial  
[www.thunfinancial.com](http://www.thunfinancial.com)

PFICs are simply “pooled investments” registered outside of the United States. This includes almost all foreign mutual funds, hedge funds and many insurance products. It might even encompass your bank account if that account is a money-market fund rather than just a straight 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.

Although too complex to be fully elaborated on here, the tax treatment of PFICs is extremely punitive compared 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 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 (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.

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 fund, hedge fund, 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 fund distributions). It does not take long to realize that filing form 8621 for three to four PFIC investments (or more) that many Americans abroad commonly hold 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, however. 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. 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 by 2014. While it may seem hard to believe that foreign financial institutions would willingly comply with such reporting requirements, the fact is that industry observers expect nearly universal compliance with the new rules by banks, brokerages, insurance companies, mutual funds (anything “financial”) around the world, because of the severe sanctions the FATCA law imposed on non-compliant financial institutions. The point is that all U.S. citizens must assume that as of 2014, 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.

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 U.S. accounts, even if they are investing globally. A thorough analysis of the tax, cost, reporting and security issues invariably leads to the conclusion that when it comes to wise and efficient investing, savvy American investors keep their wealth invested globally, but through U.S. financial institutions.

David Kuenzi, CFP®, Thun Financial Advisors  
April, 2012

Copyright © 2012 Thun Financial Advisors

**DISCLAIMER FOR THUN FINANCIAL ADVISORS, L.L.C., THE INVESTMENT ADVISOR**

Thun Financial Advisors L.L.C. (the “Advisor”) is an investment adviser licensed with the State of Wisconsin, Department of Financial Institutions, Division of Securities. Such licensure does not imply that the State of Wisconsin has sponsored, recommended or approved of the Advisor. Information contained in this brochure is for informational purposes only, does not constitute investment advice, and is not an advertisement or an offer of investment advisory services or a solicitation to become a client of the Advisor. The information is obtained from sources believed to be reliable, however, accuracy and completeness are not guaranteed by the Advisor.

The representations herein reflect model performance and are therefore not a record of any actual investment result. Past performance does not guarantee future performance will be similar. Future results may be affected by changing market circumstances, economic and business conditions, fees, taxes, and other factors. Investors should not make any investment decision based solely on this presentation. Actual investor results may vary. Similar investments may result in a loss of investment capital.