

NAVIGATING THE WATERS OF FOREIGN MUTUAL FUNDS & THE OFFSHORE VOLUNTARY DISCLOSURE INITIATIVE

U.S. persons who own foreign mutual funds can sometimes be in for an unpleasant surprise when it comes to filing their taxes. The tax treatment of overseas funds differs considerably from those of domestic funds under the Internal Revenue Code's rules for "Passive Foreign Investment Companies" (PFICs). Passive income includes dividends, interest, gains from the disposition of stocks and securities, and gains from commodities trading. A foreign company is considered a PFIC if at least 75% of its gross income is passive income and/or if at least 50% of its assets produce passive income.

Because most of the income of a mutual fund consists of items that can be defined as passive income, nearly all overseas mutual funds are PFICs. A foreign mutual fund might escape classification as a PFIC if a majority of its holdings consists of large shares of other corporations whose income would be classified as "active" and not passive income.

A. The Rationale Behind the PFIC Rules

To avoid certain excise taxes, U.S. based mutual funds generally distribute earnings and capital gains to their shareholders.¹ These amounts are then reported annually to the IRS on a Form 1099. Foreign investment companies are not subject to U.S. taxes or to these disclosure rules. As a result, prior to the passage of the PFIC rules as part of the Tax Reform Act of 1986, U.S. investors in overseas funds would only have taxable income when they sold their stock or received a dividend. This gave investors in overseas funds significant advantages over similarly situated investors in domestic funds.

Such investors not only avoided current taxation, but income that would be defined as ordinary income if received currently also became characterized as capital gain income, and received favorable tax treatment as a result. The PFIC rules were

¹ Under I.R.C. §§ 852 and 4982, Registered Investment Companies must distribute 98% of capital gains and 98% of ordinary earnings to avoid an excise tax of 4% on the undistributed amount.

designed to restrict the ability of U.S. persons to defer tax on income from foreign investments.

B. How Does PFIC Ownership Arise?

For many, such mutual funds were acquired while living abroad or through an inheritance from foreign relatives. Others may have purchased the funds based on advice from financial planners. Notwithstanding, many taxpayers encountered PFIC issues for the first time in the process of coming forward under one of the Treasury Department's voluntary disclosure programs for undisclosed foreign financial accounts. Often, these taxpayers ceded control of their foreign assets to overseas bank personnel, and were not fully aware that they owned foreign mutual funds.

C. Filing PFIC Taxes

U.S. investors report their PFIC holdings on Forms 8621 – *Return by Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, which are filed with their annual return. A separate Form 8621 is filed for each PFIC investment required to be reported in a given year.

D. How PFIC's are taxed

With the enactment of the PFIC rules in 1986, U.S. shareholders of overseas funds were given a choice of two taxing mechanisms. For the 1998 tax year, Congress made a third option available. In order of preference to the taxpayer, the three possible methods now are 1) Qualified Electing Fund 2) Mark-to-market or 3) Excess Distributions.

1. Qualifying Electing Fund (QEF)

PFICs that meet certain Treasury Department reporting requirements can be elected as QEFs that are taxed as if they were U.S. investments.² Thus, gains or losses are calculated as the difference between the purchase cost and the amount received upon disposition of the stock. Any income is taxed as long or short-term capital gain. Among the prerequisites for QEF eligibility is a requirement that the PFIC provide its

² See IRC §1295. Treas. Reg. 1.1295-1 et seq.

U.S. shareholders with a “*PFIC Annual Information Statement*” that contains or allows the calculation of the taxpayer’s share of the corporation’s ordinary earnings and net capital gain for the taxable year.³ Further, a copy of the Statement must be attached to the Form 8621 and filed along with the taxpayer’s annual return. In reality, very few foreign mutual funds provide the documentation necessary to allow a QEF election.

2. *Mark-to-Market (MTM)*

Recognizing that few shareholders had been able to obtain the information necessary to make a QEF election, in 1997, Congress enacted the Mark-to Market election. Under the MTM method, you compute tax at the end of *each year* on the difference between the fair market value (FMV) of the shares at the beginning of the year, and the FMV at the end of the year. The MTM method may be used for investments in PFICs that meet the definition of “marketable stock”.⁴ Generally, this means that the mutual fund must be regulated by a government agency and listed on a national securities exchange that publishes the price of the fund’s shares at least weekly.⁵ However, the deadline for making such an election is the due date, including extensions, of the electing person’s U.S. income tax return for the year.⁶

3. *Excess Distributions*

When neither the QEF nor MTM elections are available, the Excess Distributions method is used. Under the Excess Distributions method, taxes are paid when you sell the stock or receive an “excess distribution”, i.e. an extraordinary dividend.

An excess distribution is defined as an amount distributed in excess of 125% of the average amount received by the investor over the immediately preceding three-year period.⁷ In other words, a mutual fund will give rise to an excess distribution when it pays you dividends during the tax year that are at least 25% greater than the average that it paid you for the previous three years. Thus, for each of your fund investments you

³ Treas. Reg. 1.1295-1(g)(1).

⁴ IRC 1296(e).

⁵ Treas. Reg. 1.1296-2(d).

⁶ Treas. Reg. 1.1296-1(h).

⁷ IRC § 1291(b).

would file a Form 8621 in each year that you sold all or part of your holding as well as potentially be required to file a Form 8621 in years dividends were distributed.

For example:

A taxpayer owns a PFIC investment that distributes a dividend worth \$10 per share in each of years 1, 2, 3, 4, and 5. In years 6, 7, 8, and 9, the investment distributes \$13 per share. Finally, the PFIC owner sells the PFIC in year 10.

Excess Distribution Method

Year	Distribution /Dividend	3 year average	Excess distribution
1	\$10		No
2	\$10	\$10*	No
3	\$10	\$10*	No
4	\$10	\$10	No
5	\$10	\$10	No
6	\$13	\$10	Yes
7	\$13	\$11	No
8	\$13	\$12	No
9	\$13	\$13	No
10	PFIC sold	\$13	Yes

* Under §1291(b)(2)(ii), if the taxpayer's holding period is less than 3 years, the average distribution for the holding period is used.

In this case, the taxpayer had excess distributions in years 6 and 10 and would file Forms 8621 in those years.

To determine the amount of tax payable, the excess distribution or gain on sale is spread over the shareholder's holding period. Amounts allocated to the taxable year are treated as ordinary income. Any gain allocated to years before the taxable year will be charged at the highest ordinary income rates in effect for those years.

In addition to the tax, there is an interest charge applied to the gains from years prior to the taxable year. The interest is compounded daily and computed at the IRS' rates for underpayment of tax, which are revised quarterly. The rate is currently set at

4% and has varied between 4% and 8% since 2000.⁸ The high tax rate for prior years in combination with the compounded interest tends to make it the least favorable option for the taxpayer.

E. Alternative Resolution for Voluntary Disclosure Participants

The IRS offered participants in their most recent Offshore Voluntary Disclosure Initiative (OVDI) a special MTM method for calculation of their PFIC taxes. Without the opportunity of this “alternative resolution”, affected taxpayers would be forced to use the Excess Distributions method for their prior year amended returns as the deadline for regular MTM or QEF elections would have lapsed.

The alternate resolution MTM calculation operates much the same as the regular MTM method under I.R.C. §1296 but with two key differences. First, the tax on the gain for all years is computed at a standard rate of 20% regardless of the taxpayer’s tax bracket in that year. Second, in lieu of an interest charge on the underpayments for the prior years’ returns, an additional 7% is due for the first tax year in the program (usually 2003).

F. Conclusion

U.S. taxpayers should be clear when purchasing foreign mutual funds given the potentially detrimental tax treatment they may face at the time of filing. Those who already own overseas funds would benefit from professional advice to determine their tax liability and to evaluate whether they should make calculation method elections. Also, one should keep in mind that ownership of an aggregate of \$10,000 or more in foreign accounts (including PFIC value) will trigger FBAR reporting requirements.

⁸ See Rev. Rul. 2010-21. Internal Revenue Bulletin 2010-39.