Non-US Funds and "Stocks and Shares" ISAs

by Phil Hawkins

If you have ever sought advice from a UK independent financial advisor it is likely that they will have advised you to invest in non-US funds (due to the returns that can be achieved) or a stocks and shares ISA (due to beneficial UK tax treatment). Unfortunately for US citizens or green card holders the IRS might then regard you as having invested in a Passive Foreign Investment Company (PFIC) and when non-US funds are sold they can be subject to onerous tax charges.

This is attributable to the fact that the IRS does not want people investing in non-US funds and accumulating the income within the fund and then, when the fund is sold, for it to be treated as a capital gain.

A PFIC is defined as any foreign corporation which meets one of the following tests:

i. 75% or more of the gross income of such corporation for the taxable year is passive income, or

ii. The average percentage of assets held by such corporation during the taxable year which produces passive income or which are held for the production of passive income is 50% or more.

In broad terms, passive income means non-trading or investment income such as rents, interest or dividends. Therefore an investment in a non-US fund (be that held in a stocks and shares ISA or independently) would fulfill either one or both of these tests.

Under PFIC rules, where a US shareholder is invested in a PFIC, at any time during the holding period of the shares, (a) any gain recognized by the US shareholder on the disposition of stock in the PFIC, will be subject to tax at ordinary income rates (rather than long-term capital gains rates), and (b) any such gain is then also subject to a penalty interest charge that is designed to put the US shareholder in essentially the same position they would have been in had they earned the income personally over the holding period. Therefore in summary, the UK tax benefits of investing in an ISA for example, are simply canceled out by the US income tax and interest charge.

Reporting Requirements

PFICs are reported on an annual basis by filing a separate Form 8621 "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund" for each PFIC investment (i.e. each non-US fund), which is attached to and filed with the tax return by the due date (inc. extensions).

Taxpayers owning PFICs treated under the Mark-To-Market or Qualified Electing Fund rules are required to file a Form 8621 on an annual basis to report the annual income from the PFIC. Individual taxpayers owning a PFIC treated under the excess distribution (default method) must file a Form 8621 to:

i. Report an election (i.e. QEF or MTM), distribution from the PFIC or a disposition of an interest in the PFIC; or

ii. Report certain non-income information in the event the taxpayer's ownership in the PFIC investments exceed specific valuation thresholds.

Excess Distribution Method

(Default method) Unless you make a formal election you will be taxed on this basis and an "excess distribution" is tied to the relative frequency that the PFIC earns and distributes income as a measure of the deferral of US taxation and the amount of such distributions.

The amount of an "excess distribution" is calculated with reference to 125% of the average amount received during the three preceding taxable years (or shorter if the holding period is).

On receiving a distribution or selling a non-US fund, all of the income and gains held within the fund are taxed at the highest income tax rate (currently 39.6%). In addition to this, the income and gains are considered as being earned ratably over the term of your investment, and interest is payable on income and gains which are considered earned in earlier years. The interest is currently 3% and compounded annually.

Also, it is worth noting that losses can be disallowed.

Mark-to-Market Method

The mark-to-market method allows an owner of PFIC shares to make an election for the year in which the fund is obtained to mark gains to market at each year-end – i.e. pay tax on the difference between the fair market value of the fund at the beginning and end of the year.

Similar to the "Excess Distribution" method, gains and losses are considered as ordinary gains and losses, not capital.

Qualified Electing Fund Method

This election is not usually available to people who just have non-US funds or stocks and shares ISAs as the election is made on an investor-by-investor basis and can only be filed by the first US person that is a direct or indirect shareholder in the PFIC. Given that you cannot be certain that you are the first American in the fund you cannot make this election.

If it can ever be made, it allows the PFIC to be treated as a US based mutual fund such that any income or capital gains earned by the PFIC would be recognized currently by the US shareholder. Income recognized is picked up as ordinary, while capital gains are classified as long term. Losses generated by the PFIC cannot be passed through to the US shareholder.

A US investor increases his or her basis in the QEF's stock for any income inclusions and reduces his or her basis in the stock upon receipt of distributions of previously taxed income so there are no double tax issues.

Conclusion

As you can see being invested in funds or a stocks and shares ISA can potentially have severe US tax consequences but there are ways to mitigate the liability and we can assist you in this process. ★

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