Shore to Shore
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Technically Speaking

Part 2

What every foreign mutual fund manager should know regarding US taxation of a foreign mutual fund. By **Mark Merric**

Part I of this Article provided an outline of the various methods of taxation that a US investor in a foreign mutual fund (hereinafter referred to as the "Fund") may be subject to. While many foreign mutual managers (hereinafter referred to as "Manager") take the position that it is up to a US investor to determine the US tax effects of investing in a Fund, most US investors do not know the options available to them and need guidance in this area. In the event that a US investor is unaware of his US tax options, generally a US investor will be taxed under the Excess Distribution Method (previously defined in Part I of the article). Many times such US investor will have purchased 'accumulation units' which reinvest all income of the Fund. Since the US investor did not receive any distributions of income from the Fund, in most cases, he will not have reported any income from the Fund until he sells his shares. At the time he sells his shares, he is shocked to find out how much tax is owed, which depends on how long he has held his shares. Depending on the number of years that he has held shares in the Fund, the following table depicts the effective tax rate to the US investor:

Holding Period	Tax Rate
Four Years	46%
Seven Years	57%
Fifteen Years	84%

As noted in the above table, a U.S. investor who held shares in the Fund for a period of eight years would be subject to a fifty-seven per cent (57%) effective tax rate. Since the U.S. investor was contemplating a twenty percent (20%) capital gain rate, he is more than disappointed to learn that he is subject to the Excess Distribution Method. Had the US investor known, there were more favorable tax elections that were possible.

Background:

As detailed in Part I, a Fund will be classified for U.S. tax purposes as either a partnership or a passive foreign investment corporation (PFIC). If the fund is classified as a PFIC, it will be taxed under one of three possible alternatives:

1. The Excess Distribution Method;
2. The Mark to Market Method; or
3. The Qualified Electing Fund Method (PFIC QEF Method).

A diagram depicting the alternatives is detailed in **Figure 1.**

Also, as noted in Part I, if the Fund is classified as a PFIC, a US.investor must make an affirmative election to take advantage of either the PFIC QEF Method or the Mark to Market Method. Further, in regard to the PFIC QEF Method, a U.S. investor cannot make this election unless the Fund computes its income and deductions based on US tax principles. The same is true for the Partnership Method, the Fund must compute its income and deductions based on US tax principles. In the case of both the PFIC QEF Method and the Partnership Method, computing the Fund's income and deductions on US tax principles will result in an 'additional accounting cost' to the Fund. The additional accounting cost to prepare the books under US tax principles must be compared to the tax saved by US investors to determine whether it would be advantageous to prepare the books under US tax principles.

After-Tax Internal Rate of Return to a US Investor

Due to the different treatment of capital gains, possible interest charges, and the timing of the income, there are substantial differences in how much tax a US investor pays based on the method of taxation. The different treatment of how income is taxed to a US investor under the various methods was discussed in Part I of this Article. The amount of tax paid also affects the effective tax rate and the after-tax internal rate of return of the investment. For example, assume an investor invests one million dollars in accumulation units in a Fund for a period of eight years. The Fund generates a twelve per cent annual rate of return comprised of the following three elements:

1. Dividend income, interest income, and short-term capital gain	7.5 %
2. Long-term capital gain	2.5 %
3. Fund appreciation	2.0 %
Rate of Return of the Fund	12.0 %

A summary table of the total US taxes paid, the effective tax rate, and the after-tax internal rate of return of different US taxation methods is depicted in **Figure 2.** As can be seen from **Figure 2,** in addition to saving the U.S. investor over $350,000 >

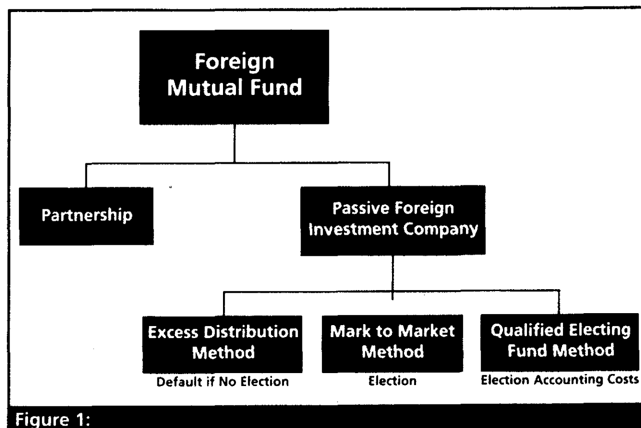

Figure 1:

Method of Taxation		Amount of Tax Paid	Tax Rate	After-Tax Internal Rate of Return
Excess Distribution Method		**$835,508**	**57%**	**7.33%**
Mark to Market Method	**$359,510**	**$584,481**	**40%**	**8.15%**
Partnership Method	**Difference**	**$527,382**	**36%**	**8.80%**
PFIC QEF Method		**$475,998**	**32%**	**9.29%**

Figure 2

compared to the Excess Distribution Method, a passive foreign investment company (PFIC) whose shareholder has elected to be taxed under the PFIC QEF method of taxation yields the highest after-tax rate of return. It should be noted, the longer a US investor invests in the Fund, the greater the difference in the amount of taxes paid, effective tax rates, and after-tax internal rates of return between the different methods. Not only does the PFIC QEF Method save the US investor $350,000 in taxes over the Excess Distribution Method, in the aforementioned example, the PFIC QEF Method saved the US investor over $51,000 over the next best method of taxation, the Partnership Method. However, there is an additional accounting cost which must be incurred by the Fund in order for a U.S. investor to report income under either the Partnership Method or the PFIC QEF Method. The Fund must prepare its books and records using US tax principles.

Cost/Benefit of US Tax Principles

Many Funds have very few US investors. Further, these US investors may have invested very small amounts. In these cases, it generally will not be economical for the Fund to prepare its books under US tax principles for a small number of US. investors. On the other hand, what if there is one large U.S investor in the Fund? In the aforementioned example, the US investor invested one million dollars. What if a US investor invested four million dollars in a Fund, the Fund was classified as a PFIC for tax purposes, and the Fund did not prepare its books under US tax principles? In this situation, the US investor has two options: (1) He could let the default rules apply and be taxed under the Excess Distribution Method or (2) He may elect to be taxed under the Mark to Market Method. In the aforementioned example, had the US investor invested four million dollars in the Fund, the Mark to Market election would have saved him over one million dollars in taxes compared to the default method, the Excess Distribution Method. At this point, the Fund has not incurred any accounting costs to prepare its book under U.S. tax principles, and the mere knowledge of the Mark to Market election has saved the US investor over one million dollars.

In the event the Manager decided to incur the accounting cost to prepare its books under U.S. tax principles and the U.S. investor elected to be taxed under the PFIC QEF Method, the U.S. investor would have saved an additional $434,000 over the Mark to Market Method. Therefore, the total savings of the PFIC QEF Method to the US investor investing four million dollars over the default Excess Distribution Method is over 1.4 million dollars, while the incremental savings over the Mark to Market Method is $434,000.

Typically, the annual accounting and administrative cost for a Fund to prepare its books and records using U.S. tax principles is approximately $50,000 a year. In a very simple economic model, the break-even point in the aforementioned example is roughly when a Fund has four million dollars of US investment. At this point, the incremental annual savings to US investors over the Mark to Market Method is approximately $54,000 per year ($434,000/8 years). This $54,000 amount saved by US investors is slightly greater than the annual additional accounting cost to the Fund of $50,000.

Unfortunately, there is an equity issue between the US investors and the non-US investors. The Manager will need to raise the management fee of the Fund to cover the additional accounting cost which benefits only US investors. Assuming that the size of the Fund is ten million dollars (including the four million dollar US investment), the Manager will need to increase its management fee by one-half of one per cent. This will reduce the before-tax rate of return of the Fund from twelve per cent to eleven and one-half percent. The one-half of one per cent decrease in the before-tax rate of return of the Fund may not be acceptable to the Manager, even though an economic break-even point has theoretically been computed. Fortunately, the larger the Fund, the less affect the additional accounting cost has on the before-tax rate of return of the Fund. A graph depicting this relationship is provided in **Figure 3.**

This graph shows the affect of the additional accounting cost on the before-tax rate of return of the Fund is almost insignificant once the Fund has grown to over 30 million dollars. Therefore, there are the following two major factors a Manager must look at when deciding whether to incur the additional accounting cost: (1) The dollar amount invested by US investors, and (2) The dollar size of the Fund. For a Fund that has a before-tax rate of return of twelve per cent, the break-even point will be around four million U.S. dollars invested. Once the break-even point is reached, a Manager must look at the affect of the additional accounting cost on the before-tax rate of return of the Fund. Generally, if the Fund is greater than thirty million dollars, the additional accounting cost is insignificant. >

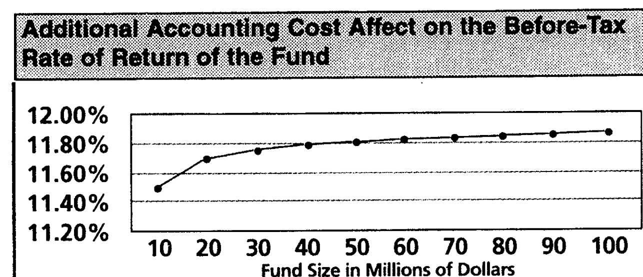

Figure 3

Partnership Method May Not Be A Viable Option:

At the beginning of this Article, it was noted that a Fund could be classified as either a Partnership or a PFIC. Assuming that the Fund has been structured so that it is classified as a partnership for tax purposes, the Partnership Method may not be a viable option. This is because a Fund will be classified as a master limited partnership for US tax purposes. Under the master limited partnership tax rules, generally when a publicly traded partnership exceeds three hundred members, it is classified as a corporation for tax purposes. While many Funds currently have less than three hundred members, if the Fund grows to more than three hundred members, it would be classified as a corporation (i.e., a PFIC). At the time the Fund changed from being a partnership to a PFIC, the Internal Revenue Service could construe the transaction to be a constructive liquidation of the partnership followed by a contribution of the partnership assets to a foreign corporation. Under IRC ß367, gain is almost always recognized on any appreciation in assets contributed to a foreign corporation. Further, even if there is some exception under IRC ß367, gain may still be recognized under IRC ß721(c) when the foreign partnership is liquidated. Obviously, US investors are going to be unhappy if they discover that they must report gain on any appreciation in the Fund just because the Fund exceeded three hundred investors. Therefore, due to the master limited partnership tax rules, for most Funds, the Partnership Method will not be a viable option.

However, even if the partnership never exceeds the permitted number of investors, the additional accounting cost to prepare the books under US tax principles for a partnership usually is slightly greater than for a PFIC. This statement is contrary to what many international attorneys believe. Many international attorneys are under the misimpression that the PFIC QEF Method accounting costs are more than the Partnership Method.

From experience with accounting firms who have done both the Partnership Method and the PFIC QEF Method, I have found that the annual accounting cost of both methods is approximately the same, with the Partnership Method usually being slightly higher. This is because both methods require the entire accounting system be set up to reflect US tax principles. Under the PFIC QEF Method, this means that earnings and profits must be restated to reflect U.S. tax principles, gain or loss from the sale of securities are recorded on the FIFO basis of accounting, long-term capital gains are appropriately segregated, and currency translations are done in accordance with the Treasury Regulations. Under the Partnership Method, in addition to the reporting requirements of the PFIC QEF Method, dividends, interest, short-term capital gain, and accounting and management fees (2% Itemized Miscellaneous Deductions) must be segregated. Therefore, contrary to many international tax planners' opinions, the Partnership Method is generally slightly more expensive than the PFIC QEF Method.

Irrespective of the slightly higher accounting cost to the Fund and the master limited partnership rules, there is a third reason why the PFIC QEF Method may be a better choice. The PFIC QEF Method results in a higher after-tax internal rate of return when compared to the Partnership Method. This is because under the Partnership Method, a US investor is limited in deducting management fees, accounting fees, trustee fees, and investment advice (Fund Expenses). These Fund Expenses are commonly referred to as miscellaneous itemized deductions and are deducted on Schedule A of an individual US tax return. A US investor may deduct his share of miscellaneous itemized deductions only to the extent that it exceeds two per cent of the U.S. investor's adjusted gross income. However, these Fund Expenses are fully deductible by a US investor under the PFIC QEF method of taxation. This partial non-deductibility of Fund Expenses results in the higher tax and the lower after-tax internal rate of return when the Partnership Method is compared to the PFIC QEF Method.

Conclusion:

There are the following four possible methods a US investor may be taxed under when they invest in a Fund: (1) the Partnership Method; (2) the Excess distribution Method; (3) the Mark to Market Method; and (4) the PFIC QEF Method.

A Manager determines how a Fund is legally structured, which in turn determines whether the Fund will be classified as a partnership or a PFIC. If the Fund is classified as a partnership, only the Partnership Method of taxation may be utilized. However, if the Fund is classified as a PFIC, a US investor may make the Mark to Market election. Further, if the Fund is willing to incur the additional accounting cost to prepare its books under US tax principles, the US investor may elect the PFIC QEF Method of taxation.

Generally, the Partnership Method of taxation is not the most advantageous choice as far as US investors are concerned. There are three reason for this. First, generally when the Fund grows to more than 300 investors, it will be classified as a corporation for tax purposes (i.e., a PFIC). At that time, gain on any appreciation in the Fund will probably be recognized for US tax purposes. Second, the additional accounting cost to prepare the Fund's books on US tax principles is slightly greater under the Partnership Method than the alternative, the PFIC QEF Method. Finally, the Partnership Method has a lower after-tax internal rate of return than the PFIC QEF Method.

The PFIC QEF Method of taxation results in the greatest tax savings and the highest-after tax internal rate of return to the US investor when compared to all of the other methods of taxation. The PFIC Excess Distribution Method results in the lowest after-tax internal rate of return and, in many cases, the imposition of punitive taxes. The Excess Distribution Method is the default method unless the US investor makes an affirmative election to be taxed under either the Mark to Market Method or the PFIC QEF Method. As mentioned before, in order for a U.S. investor to be able to make the PFIC QEF election, the Fund must incur the additional accounting cost to prepare its books under US tax principles.

For a Fund with a twelve per cent before-tax rate of return, it will reach a break-even point when there is approximately four million US dollars invested. However, whether the Manager will decide to incur the additional accounting cost so that the US investors may make the PFIC QEF election will depend on the Fund size. For Funds with 30 million or greater assets, generally the additional accounting cost will be insignificant.

It is very important that Managers of foreign mutual funds understand the options available to their US investors. This is particularly true because most Funds will be classified as a PFIC for US tax purposes, and if the US investor is unaware of his options, the default method of taxation for a PFIC is the Excess Distribution Method.

The unwary US investor who ends up trapped in the Excess Distribution Method of accounting could easily spend hundreds of thousands of dollars in excess US taxes. ■