Shore to Shore
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When determining the best US tax classification for a foreign mutual fund (hereinafter referred to as the fund), many foreign mutual fund managers (hereinafter referred to as the manager), are uncertain how to legally structure the fund for their US investors. Unfortunately, if a manager does not know how his fund is classified for US tax purposes, he will be unable to advise his US investors that there are various elections available. If a US investor fails to consider these various elections, the result may be disastrous.

For example, assume a US citizen or resident investor who invests $1m in accumulation units in a fund. The fund generates a 10 per cent rate of return for the next 15 years. Since the US investor purchased accumulation units, the fund did not distribute any income to the US investor. Also, since the US investor did not receive any distributions, he did not report any income for US tax purposes from the fund. At the end of fifteen years, the US investor sells his shares in the fund for approximately $5.5m, which is the fair market value of the fund assuming a 10 per cent rate of return compounded over 15 years.

Assuming that the fund is classified as something known as a passive foreign investment company (hereinafter referred to as a PFIC) for US tax purposes, the US investor will owe $3.8m in US federal income taxes. After taxes, the US investor will only receive $1.7m of the $5.5m. The result is that the US investor will have been taxed at an efficient rate of 84 per cent, and would only have received a four per cent after-tax internal rate of return over the fifteen years. Unfortunately, this is the net consequence to a US investor who invests in a fund that accumulates income for 15 years, that is classified as a PFIC, and is taxed under the Excess Distribution Method (defined below). A brief summary of the result of the aforementioned example is detailed numerically below.

Sales price of the fund	$5.5m
Federal taxes	$3.8m
After tax proceeds from sale	$1.7m
Amount originally invested	$1.0m
After tax profit after 15 years	$0.7m
Effective federal tax rate ($3.8/$4.5m)	84%
After tax internal rate of return	4%

Background

Under the Internal Revenue Code (IRC) of 1986, as amended, a fund will be either classified as a partnership or a corporation. If the fund is classified as a corporation, the fund will further be sub-classified as a PFIC.[1] It should be noted that when a fund is classified as a PFIC, US investors in a PFIC may be taxed under any one of three methods. Therefore, there are the following four possibilities of taxation for a US investor in a fund:

- Partnership Method;
- PFIC Excess Distribution Method;
- PFIC Mark to Market Method;
- PFIC QEF Method.

The following discussion assumes that a new fund is being created and the manager has the choice of determining how the fund shall be legally structured, which will determine which method and how US investors are taxed for US purposes. For established funds, generally, whether the fund is taxed as a partnership or a corporation (ie, PFIC), is already cast in stone.[2] However, even if the tax classification of the fund has already been determined to a PFIC, a manager needs to know what options are available for his US investors. Otherwise, the manager of an existing fund may well find that one of his long time US investors is subject to the Excess Distribution Method of taxation, with the aforementioned disastrous tax results.

Partnership Method

In the event that the fund is not classified as a PFIC for US tax purposes, then it will be classified as a partnership. The Partnership Method of taxation requires that all items of income and loss flow through to the individual partners. Under this method, dividends, interest, short-term capital gains and long-term capital gains are separately stated for each partner. In order for a US partner to properly report his or her share of partnership items, the fund must compute gains and losses based on US tax principles. Then the fund must allocate these gains and losses to the respective partners. In almost all cases, such a computation will require the fund to incur additional accounting expenses to prepare such information. Typically, these additional accounting expenses range from $25,000 to $100,000 a year or more. A manager must compute the cost/benefit ratio of providing such information. A detailed discussion of the cost/benefit ratio shall be covered in Part II of this article.

PFIC Excess Distribution Method

As noted above, if the fund is not classified as a partnership, it will be classified as a PFIC. Unless the US shareholder makes an election to have the fund taxed under either the Mark to Market Method or the PFIC QEF Method, the fund will be taxed under the Excess Distribution Method. Under the PFIC Excess Distribution Method, the manager does not have to compute a shareholder's income under US tax principles. Therefore, the fund avoids the additional accounting expenses. At first, this appears to be an incredible saving to the fund. However, as detailed above, if the fund accumulates income, the PFIC Excess Distribution Method creates disastrous tax ramifications for a US investor. The result is that once the US investor discovers the disastrous tax ramifications, the manager may easily lose this US investor forever.

For funds which do not distribute income to the US investors annually (ie, accumulation units), the adverse tax consequences to a US investor compounds each year the US investor remains in the fund. A table depicting the increase in tax rate for each year the investor holds shares in the fund is detailed below.

Holding Period	Tax Rate
4 years	46%
7 years	57%
15 years	84%

Under the PFIC Excess Distribution Method, generally, a US Shareholder is taxed on the income from the fund when there are distributions (ie, dividends paid to the US shareholder) or when the US shareholder sells his shares.[3] The US investor pays income tax at the highest individual ordinary rates plus a non-deductible interest charge compounded over the period of deferral.[4] The non-deductible interest

charge is computed at a 'floating rate' at the federal underpayment rate which has been approximately ten per cent over the last couple of years.

Discovering these facts is a quadruple shock to a US investor. First, all income from a PFIC under the Excess Distribution Method is taxed at the highest ordinary income tax rate. Second, a non-deductible interest charge at approximately ten per cent is charged against the value of any deferral. Third, capital gains from the fund do not flow through to the US investor. Instead, they are converted to ordinary income and taxed at the highest ordinary income tax rate. If the fund was a US mutual fund, the maximum capital gains rate would be 20 per cent instead of the 39.6 per cent highest ordinary income tax rate. Further, if the mutual fund was a US mutual fund, virtually none of these tax problems would exist.

There are three ways to avoid some and possibly all of the punitive tax effects of the Excess Distribution Method. One method is for the US investor to invest in a fund that distributes all income currently, and report such income as a dividend when received. However, this possible solution does not solve the problems that all income is taxed at the highest ordinary tax rates, that capital gains incurred by the fund are converted to ordinary income, and that any appreciation in the fund shares are also taxed as ordinary income when the shares are sold. Further, investing in a fund that distributes the income currently may not be in line with either the US investor's investment objectives or the fund's investment objectives. The second method is to make a Mark to Market election, as described below. Providing the manager is willing to incur the accounting expenses to compute the income of the fund on US tax principles, the third method is that the US investor may make a PFIC QEF election (also discussed below).

PFIC Mark to Market Method

Many funds do not have many US investors. It would be prohibitively expensive for these funds to spend approximately $25,000 to $100,000 a year in accounting expenses if the fund only has $1m invested from US investors. In this case, if the fund is classified as a PFIC, there is really only one semi-favourable election for a US investor. This is the Mark to Market election or method. Under the Mark to Market Method, a US shareholder may make an election to include in income each year an amount equal to the excess of the fair market value of the PFIC stock.[5] The amount included in income is characterised as ordinary income.[6] In the event that the fair market value of the PFIC is less than the adjusted basis of the PFIC stock, the shareholder is allowed a deduction as an ordinary loss for such amount.

The Mark to Market Method allows a US shareholder the ability to avoid some of the punitive effective tax rates of the Excess Distribution Method by electing to include in income any appreciation in the fund as ordinary income. Under this method, the US investor is taxed on all income and appreciation of the fund each year as ordinary income at the marginal tax rate of the US investor, rather than at the highest ordinary income tax rate. Also, the Mark to Market Method eliminates the non-deductible interest charge effect of the Excess Distribution Method. However, capital gains incurred by the fund and from the sale of PFIC shares are still converted to ordinary income.

Unfortunately, a US shareholder may not use the Mark to Market Method unless he or she makes the affirmative election. Generally, the US investor in a fund is completely unaware of the tax consequences of such fund and that a Mark to Market election exists. This is why the manager needs to be aware of US tax laws, so that he may advise the US investor that such an option exists. Otherwise, several years later, the manager may be dealing with a very unhappy US investor who has just realised that he is taxed under the punitive tax rates caused by the Excess Distribution Method described above.

PFIC QEF Method

For those managers who have a large dollar amount invested from US investors, such Managers will probably find that it is much easier to attract and retain US investors if the fund incurs the accounting cost to provide US investors with the income of the fund prepared under US tax principles. If this is the case, a US investor may elect to have the fund classified as a qualified electing fund (PFIC QEF).

A PFIC QEF is taxed very similar to a US mutual fund. Items of ordinary income and capital gain flow through to the US investor, and these items are taxed irrespective of whether the income is distributed by the fund. Capital gain retains its character when it flows through to the US investor, and the gain on sale of PFIC QEF shares is also a capital gain. In many ways, the PFIC QEF Method is similar to the Partnership Method. However, there are a couple of differences that will be covered in detail in Part II of this article. The PFIC QEF Method eliminates all of the tax problems of the Excess Distribution Method, and it is the most favourable method of taxation for a PFIC. However, just like with the Partnership Method, the cost/benefit relationship of computing the income of the fund under US tax principles must be compared with the US dollars invested in the fund.

Summary

For US tax purposes, a fund will be classified either as a partnership or a PFIC. The classification of a fund drastically affects the taxation to the US investor, and therefore, the after-tax internal rate of return of the fund to the US investor.

This article provided an outline of the various methods of taxation of a fund: the Partnership Method, the PFIC Excess Distribution Method, the PFIC Mark to Market Method and the PFIC QEF Method.

While the Partnership Method allowed favourable tax treatment to a US investor, the fund must compute the US investor's income based on US tax principles. The PFIC Excess Distribution Method was the worst possible result to a US investor. Unfortunately if the fund is classified as a PFIC, unless the US investor makes an affirmative election, the PFIC Excess Distribution Method is the default method of classification. The Mark to Market Method allows a US investor the ability to eliminate some of the negative aspects of the Excess

Distribution Method. However, capital gains incurred by the fund and capital gains from the sale of the PFIC shares are taxed at ordinary tax rates. The PFIC QEF Method allowed a US investor to eliminate all of the negative aspects of the Excess Distribution Method. However, just like the Partnership Method, the fund must compute the US investor's income based on US tax principles.

While this article (Part I) focused on the four methods of taxation of a US investor in a fund, Part II will outline the major factors a manager should evaluate when deciding whether the fund should be classified as a partnership or a PFIC, and the cost/benefit relationship of providing tax information computed on US tax principles. ■

Footnotes

[1] IRC §1297(a). A passive foreign investment corporation is any foreign corporation where 75 per cent or more of the gross income is passive income, or the average percentage of assets held by such corporation which produce passive income from dividends, interest, royalties, rents, annuities and gains from the sale of property that gives rise to the aforementioned income.

[2] Morrisey v. Commr., 296 US 344 (1935) established a six factor test to determine whether an entity was a partnership, corporation, or a trust for US tax purposes. The six factor test of Morrisey was adopted by the Treasury in old Treas. Regs. §301.7701-1 through §301.7701-4.The 'check the box' regulations superseded these Treas. Regs. However, for funds established prior to 1/1/97, the old regulations still apply in determining whether the fund is classified as a partnership or a corporation for US tax purposes.

[3] IRC §1291(b). Under the excess distribution, any distribution in excess of 125 per cent of the average three years past distributions is taxed currently. A sale of the PFIC stock is considered a distribution. In addition to the negative tax effects, this method also results in complex accounting for the US investor to determine which distributions are currently taxable and which are not.

[4] IRC §1291(a)

[5] IRC §1296(a)

[6] IRC §1296(c)(1)