REQUEST FOR PFIC TAX RULES CHANGES FOR U.S. CITIZENS OVERSEAS:

A SUBMISSION TO THE SENATE FINANCE COMMITTEE

By

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[This is a further elaboration of the "PFIC rules" component of the January 17 2014 Senate Finance Committee submission entitled "Request for Tax Rule Changes for U.S. Citizens Overseas" by Richardson, Yates, and Kish]

Section A – Executive Summary

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Section A - EXECUTIVE SUMMARY

PURPOSE, CONTEXT AND RECOMMENDATION

PURPOSE

On November 19, 2013 Max Baucus, Chair of the Senate Finance Committee issued a draft discussion on International Business Tax Reform.

http://www.finance.senate.gov/imo/media/doc/Chairman%27s%20Staff%20International%20Discussion%20Draft%20Summary.pdf

The paper concluded with:

"The Chairman's staff is considering reforms to simplify the rules in this area while appropriately taxing such individuals. Comments are requested regarding the scope and mechanics of reforms in this area."

The undersigned, John Richardson and Stephen Kish (Toronto, Canada) have prepared this submission as a response to this request.

CONTEXT

On January 17, 2014, a submission entitled "Request for Tax Rules Changes for U.S. Citizens Overseas" was made to the Senate Finance Committee by John Richardson, Willard Yates, and Stephen Kish. This general submission included a short section (pages 21-24 therein) requesting changes in the PFIC (Passive Foreign Investment Company) tax rules:

http://citizenshipsolutions.ca/wp-content/uploads/2014/01/RichardsonYatesKishJan232014SFCSubmission.pdf

The **present submission**, made by Mr. Richardson and Dr. Kish (Mr. Yates is not part of this submission) **provides a detailed elaboration of the discussion and analysis of the PFIC tax rules** which we hope will be helpful to the committee.

In this specific context, on May 9, 2013, the Senate Finance Committee, as part of the process of considering tax reform, issued a report on International Competiveness which included the recognition that:

"The U.S. tax system also includes special rules for U.S. investors who own stock in a foreign corporation holding mainly investment assets, which is referred to as a "passive foreign investment company" (PFIC). The PFIC rules limit a U.S. person's ability to defer U.S. tax liability on their share of the PFIC's income."

The committee is now considering revising the PFIC rules to promote international competitiveness and to decrease harm caused by these rules to U.S. citizens abroad:

III. OTHER INTERNATIONAL BUSINESS REFORMS

1. *Repeal DISC Provision*

2. ***Reform passive investment company (PFIC) rules*** *(NY State Bar Association PFIC Reform Recommendations, Tax Notes today, 1993)*

See:

http://www.finance.senate.gov/issue/?id=0587e4b4-9f98-4a70-85b0-0033c4f14883

http://www.finance.senate.gov/imo/media/doc/050813%20International%20Competitiveness%20Options%20Paper1.pdf

RECOMMENDATION

Consistent with the recommendation made in the January 17 2014 submission noted above, we request that, **until residence-based taxation is enacted, investment and retirement vehicles or analogous entities which are located in the country of residence where the person lives must NOT be treated as PFIC.**

This change in PFIC tax rules should be accomplished no later than **by end of 1Q2015**.

We provide our discussion and analysis below:

Section B – PFIC rules punish one U.S citizen abroad

To introduce the topic of punishment caused by PFIC tax rules, consider the situation of this U.S. citizen living overseas who reports a "PFIC problem":

"When I first learned to my horror about my PFIC problem, I genuinely feared that I might have been bankrupted by the confiscatory taxation, accounting and possibly legal fees (not to mention FBAR penalties). I held close to fifty individual holdings, all with small amounts, with one PFIC holding being worth 60 cents!!!

If I'd done the OVDI, I would have probably faced accounting fees alone north of $150,000 if we're talking even a 'modest charge per 8621 of $250 x 47 x 8 (for eight years) = $94,000 without even taking into account their standard 1040 fees of at least $2000 per year; my pension fund and ISA accounts (which held most of the mutual funds) could have each all required forms 3520/3520a, adding perhaps another $25,000 in account fees if we're talking about going back eight years!!!

I would have faced confiscatory PFIC taxation probably north of $50,000 plus attorney fees north of $50,000; so now we're talking a total accounting bill north of $150,000; legal fees north of $50,000; taxation north of $50,000, especially if you also include interest and penalties; and then, of course, the OVDI miscellaneous FBAR penalty of 25% of the highest aggregate balance of my non-US accounts over that eight year period, which would have equated to at that point about 35% because of falls in the stock market; These foreign accounts were over 80% of my total worth, being permanently settled in the UK for over twenty years at the time, having been completely legally invested in what is a tax-free retirement investment vehicle there, plus a DUAL citizen.

With a total investment under $400,000, I'm guessing that I would have lost approximately $375,000 in OVDI. If the IRS or FINCEN are reading this and want to use the NSA to find me, my subsequently tax returns came to close to 1000 pages (by an excellent accountant who was prepared to effectively do almost pro bono work for me at 'merely' £25,000-$30,000 which was very reasonable considering the huge complexity)..how's that for a doorstopper???

If you feel that this dangerous for me to post, then please delete this….but I am so OUTRAGED to have faced ruin for what had been a completely unintentional mistake and omission. This sense of entrapment and betrayal was essentially why I decided to renounce.

I was literally frozen in the headlights by FATCA and had been like the frog or lobster being so slowly heated up in the pot that the water was boiling before I realized my peril. Had I known, I wouldn't have even touched local mutual funds and would have probably just used local certificates of deposit. This PFIC taxation also essentially attacks the small vs rich investors by It's very nature of mutual funds being designed as a way for the minnow to spread investment risk. It's all a racket, and I have at least till mid 2016 *before all the damn statute of limitations will have finally closed for these PFIC tax filings.*

….. Chuck Schumer has the gall to want to treat people like me as apostates with the Ex-Patriot Act… It's terrifying and even though I've renounced, realize that I won't be truly free till all the SOLs have completely closed."

The above comment was posted on February 5 2014 at:

http://citizenshipsolutions.ca/2014/02/02/pfic-taxation-and-americans-abroad/#comments

Section C – The General Law of PFICs

Part 1 - Synopsis for American Citizens Abroad

The world of PFICs is extremely complicated. Therefore, we begin with the conclusion and then will explain this topic in all its detail. The message for U.S. citizens abroad who have purchased mutual funds (and similar investment vehicles) in their country of residence is:

1. Since 2010 at least one IRS lawyer has deemed your investments in mutual funds to be PFICs.
2. When you purchased your mutual funds, no one in the tax community knew what a PFIC was.
3. The taxation of PFICs is so punitive that it can amount to confiscation of most of the gains.
4. Like the FBAR rules, the PFIC rules lay dormant for many years until they were discovered and are now being applied retroactively.
5. PFICs are owned disproportionately by Americans abroad because they participate in investment vehicles that are local to them (but "foreign" to the IRS).
6. Yet, Congress with the enthusiastic help of the tax professionals is punishing investments made years and years before "PFIC awareness in general" and "Mutual fund awareness" in particular. This follows the same narrative as the punitive application of the FBAR rules. Both PFICs and FBAR are instruments of confiscation. Nothing more and nothing less.

The obvious conclusion is that financial planning for Americans abroad lies "somewhere between difficult and impossible".

For Americans abroad:

The PFIC rules are the Title 26 equivalent of the Title 31 FBAR rules.

We explain …

Part 2 –PFIC: The End of Retirement For Americans Abroad

Prologue – In the beginning the world was:

"Yesterday I was talking to an accountant about the intricacies of PFICs, ISAs, and the entirely plausible strategy of giving up a green card to get away from the Borg that is the IRS.

She asked the entirely reasonable question, "Where can I find out more about this stuff?" Sadly, unless you are willing to delve into the Code, Regulations, and a few hard-core tax treatises, the answer is "Nowhere."

Phil Hodgen – August 3, 2011 – What is a PFIC"

Note the date of this comment – August 3, 2011. There was very little active discussion and awareness of PFIC issues prior to 2011.

Yet, the PFIC rules and associated reporting requirements:

1. Make retirement planning for Americans abroad somewhere between difficult and impossible; and
2. Virtually ensure the confiscation of retirement assets to the extent that Americans abroad were unlucky enough to have invested in PFICs.

So, what is a PFIC (See S. 1291 – S. 1298 of the IRC)?

The acronym PFIC stands for:

"Passive Foreign Investment Company"

If a U.S. person owns shares in a foreign company where either:

A. 75% of the income is investment income; or
B. 50% of the assets are held for investment income

Then it is a PFIC.

PFIC and FBAR have a lot in common – they are both instruments of confiscation.

Introduction – PFIC History

Like the FBAR, PFIC was created long ago, lay dormant for many years, has a disproportionate effect on Americans abroad and when the time was right, was unleashed in its confiscatory horror on those same Americans abroad.

FBAR was created in 1970. Very few people (tax professionals included) knew about the FBAR rules. Beginning in 2011 the IRS began to threaten Americans abroad with FBAR penalties. In many cases the threat of FBAR penalties resulted in many innocent Americans abroad entering the IRS Offshore Voluntary Disclosure programs (OVDP). Interestingly, it was through the "OVDP" program that the IRS discovered the tax and penalty revenue raising potential of the PFIC.

PFIC was created as part of the 1986 Tax Reform Rules. It was unheard of until approximately 2009, when it was dusted off and applied to the investments of Americans abroad. (With the exception of academic papers you will find very little written about PFICs prior to 2010. You will find even less about the application of PFICs to the day-to-day planning of Americans abroad.)

Most tax professionals consider foreign mutual funds (provided they are organized as corporations as opposed to trusts or partnerships) to be PFICs.

Some guidance for Americans Abroad …

The two questions are:

Q. What should Americans abroad who do NOT own foreign mutual funds do?

A. <u>They should not buy foreign mutual funds</u>. If they feel they want mutual funds (along with their associated management fees) then they should buy <u>U.S.</u> mutual funds (provided those funds won't cause a tax problem in their country of residence).

Q. What should Americans abroad who DO own foreign mutual funds do?

1. They should NOT buy any more (add to your holdings). They should understand the U.S. tax implications of BOTH owning them and selling them.
2. Americans abroad (whether U.S. tax compliant or not) should seek professional counselling to determine how to proceed. There are (at least in theory) different options for the taxation of PFICs. The stakes are VERY high.
3. **If they have held the mutual fund long enough, simply selling the fund could result in significant erosion of their capital.**

U.S. Tax Course 101 – Congressional Assumptions and Taxpayer Responses

Some Principles/Assumptions of U.S. Tax Law – The Perspective of Congress

1. U.S. tax law is hostile to the "deferral of tax" on **passive investment** income
2. U.S. tax law is hostile to all things "**foreign**"
3. U.S. tax law is about complexity, forms, penalties and acronyms
4. U.S. tax law should NOT be understandable to the taxpayer.

Some Important Considerations For U.S. Taxpayers

These important considerations include:

1. What is taxable income?
2. When is taxable income realized?
3. How is taxable income characterized? Capital gains and dividends are taxed at lower rates than ordinary income.

PFIC and consistency with the principles of U.S. tax law

What is a PFIC?

PFIC stands for "**Passive Foreign Investment** Corporation". (The inclusion of the words "passive", "foreign" and "investment" means that Americans abroad are headed for trouble.)

The PFIC rules are found in S. 1291 – S. 1298 of the Internal Revenue Code. At the present time there are NO enacted regulations clarifying what PFICs are. The IRS wrote some clarifying "Proposed Regulations" that have NEVER been passed. On December 31, 2013 the IRS passed some regulations bearing on S. 1298(f) FATCA REPORTING.

What makes something a PFIC?

In their most simple terms, the PFIC rules say:

If a U.S. taxpayer owns shares in a corporation where either:

(A) **Income Test** - 75% or more the income is passive income (interest, dividends, rents); or

(B) **Asset Test** - 50% of more of the assets of the corporation are held for the production of passive income

Then it is a PFIC.

Although the Internal Revenue Code (IRC) does not specifically refer to a mutual fund, a large majority of tax professionals interpret the definition of PFIC to include "foreign mutual funds". (In Mumbai India there are ads for Franklin Templeton mutual funds all over the city. They are certainly not advertised as PFICs.)

History and Purpose of PFIC

Helping the domestic investment fund industry – A powerful lobby

The PFIC rules were enacted as part of the Tax Reform Act of 1986. There has been at least one suggestion that the PFIC rules were the result of lobbying by the U.S. investment fund industry. U.S. mutual funds are required to distribute all the fund's earnings (whether dividends or capital gains). Non-U.S. funds often do NOT distribute the fund's earnings but reinvest the earnings resulting in "tax deferral".

Punishing Americans Abroad – A Favorite scapegoat

The PFIC rules are designed to **punish** investing in "Passive Foreign Investment Companies."

Assuming that a non-U.S. mutual fund is a PFIC (and mutual funds are an attractive investment vehicle for Americans abroad) the PFIC rules (like the FBAR rules) disproportionately affect Americans abroad. The PFIC rules are NOT and have never been about taxation. They are clearly designed as instruments of punishment and confiscation.

In terms of "punishment and confiscation":

The PFIC rules are so complex, so punitive, so draconian, so unfair and so unpublicized that they are the Title 26 equivalent of the Title 31 FBAR rules. They lie waiting for the right moment to confiscate the retirement assets of Americans abroad.

On more than one occasion, it is not surprising to **have heard tax professionals refer to PFICs as "tax cancer".**

The Metastasis of the PFIC Cancer – The evolution of the spread?

Like most, we had never heard of PFIC until after 2009. Why would we? Why would anybody?

Although citizenship-based taxation has always been a feature of U.S. tax law, its enforcement lay dormant until 2009. The IRS consciousness of citizenship-based taxation appears to have been triggered by the 2009 IRS Offshore Voluntary Disclosure Program ("OVDP"). Once the IRS and the tax community discovered (or rediscovered) citizenship-based taxation, the question became:

How are U.S. citizens abroad to be taxed? How do U.S. citizens abroad engage in retirement planning? This often includes investing in mutual funds in their country of residence (AKA foreign mutual funds).

The two Events that triggered the metastasis of PFIC from a dormant academic concept to a life altering hell for U.S. citizens abroad:

First Event: The Great IRS OVDP PFIC Discovery of 2009

Why did normal Americans abroad who were tax compliant in their country of residence enter the OVDP? The answer to that question could (and should) be the basis of a book.

Once people were enticed and locked into the OVDP program the questions became:

1. **What was the OVDP penalty base?**

   In order to determine their penalty base, participants were required to disclose their financial accounts. The disclosure of financial accounts revealed the existence of a specific kind of financial investment:

The mutual fund in their country of residence (AKA "foreign" mutual fund)

2. **How were mutual funds to be taxed in the OVDP penalty base?**

In the beginning the IRS was not sure how to tax these non-U.S. mutual funds. Ultimately the IRS allowed the mutual funds to be given the possible benefit of the "Mark to Market" election (see below).

In any event, the "cat was out of the bag". The IRS had discovered PFICs (after 23 years) and the tax professionals (ever so happy to find a way to complicate the lives of clients) enthusiastically embraced them.

This great PFIC discovery is described by U.S. tax lawyer Michael Miler as follows:

"For many early participants in the 2009 VDP, their PFIC problems never materialized because the IRS agents processing their amended (or original) returns had never heard of PFICs. Moreover, if their tax preparers or other tax advisors had ever heard of PFICs, they kept that to themselves. These taxpayers executed closing agreements that treated PFIC gains as regular capital gains, and were blissfully unaware of the fate they escaped.

Eventually, the IRS woke up to the issue, gave its agents a mini-course in PFICs, and instructed them to look out for foreign mutual funds. For taxpayers with such investments, this slowed the process down considerably. First, neither the IRS agents nor most return preparers had a particularly firm grasp on how to apply the PFIC rules. Second, to the extent that taxpayers' return preparers and other advisors did know about the PFIC rules, they were reluctant to apply them. Third, even where both the expertise and the will to apply the PFIC rules were present, calculating the tax imposed on a sale of PFIC stock requires not only the historic cost basis but also the precise acquisition date."

http://www.robertsandholland.com/siteFiles/News/598article.pdf

Second Event: The IRS Chief Counsel "Non-PFIC" Memorandum-Number: 201003313 - January 22, 2010

This memorandum had nothing do with PFICs. The memorandum was in the context of a Canadian estate and Gift tax issue. It was NOT for the purpose of seeking advice on whether a Canadian mutual fund was a PFIC. Nevertheless, as part of the memorandum, the IRS counsel wrote that:

"You indicated that the RRSP held shares in several mutual funds that are organized as trusts. However, a mutual fund may have been formed as a "trust" under Canadian law, but be properly classified as a corporation under U.S. law. Based on the information provided, it appears that all the Canadian mutual funds held by Decedent's RRSP would be classified as corporations for U.S. tax purposes."

http://www.irs.gov/pub/irs-wd/1003013.pdf

What might this mean? A **Canadian mutual fund** (even though it was a trust under Canadian law) was deemed a **Corporation** under U.S. law. This was significant because this would mean that a Canadian mutual fund was (1) a "corporation" that was also (2) "passive", (3) "foreign" and for (4) "investment".

QED: This means that Canadian mutual funds must be:

Passive Foreign Investment Corporations or "PFICs" – AKA "Sacred Instruments of Confiscation" from a Congressional perspective.

(One more example of the "law of unintended consequences".)

The Memorandum of an IRS counsel has no legal status. We also remind the Committee that there are NO PFIC regulations defining what a PFIC is (only proposed PFIC regulations).

Nevertheless, the tax community interpreted the Memorandum to mean that:

Canadian mutual funds were NOW PFICs and NOW potentially subject to a different kind of taxation/confiscation.

This explains why the word "PFIC" is relatively new in the lexicon of the "cross border professional". Furthermore, the assumption that mutual funds are PFICs is not only a prospective (meaning mutual funds are NOW PFICs) assumption. It is also a retrospective assumption that non-U.S. mutual funds have been PFICs since 1986. Like the FBAR rules, PFICs lay dormant until the discovery of 2009/2010.

This is of enormous significance because of the way that PFICs are taxed under the default regime. To put it simply:

Americans abroad who invested in non-U.S. mutual funds are required to pay penalties for investing in mutual funds <u>before</u> there was any suggestion that mutual funds were PFICs!

How PFICs are taxed – Three Different Options

In theory there are three ways that PFICs can be taxed. In practice (since nobody ever imagined that a non-U.S. mutual fund could be a PFIC), those who sell their mutual funds will be taxed according to the **default S. 1291 "Excess Distribution Method".**

Before describing the S. 1291 Excess Distribution method, let me describe the first two methods by which (theoretically) PFICs can be taxed. They both require that an "election" be made. To make the election one must know that one has a PFIC. (No foreign mutual fund holder knew that the mutual fund was a PFIC. The proof is that nobody would knowingly buy a PFIC.)

That said, here we go:

Theoretical Method Number 1 – QEF ("Qualified Electing Fund") – IRC S. 1293 - 1295

General Principle: The fund owner pays tax on the ACTUAL INCOME of the fund

The income of the fund flows through to the owner whether the income is actually distributed or not. This involves the following steps:

1. How much income did the fund earn?
2. Allocate the income into dividends and capital gains.
3. Include those dividends and capital gains on your tax return as dividends and capital gains (which is good) and NOT as ordinary income.
4. Pay tax.

Two important points:

1. The income **retains its character** as dividend or capital gain affording beneficial tax treatment.
2. This results in a (step up in) basis (meaning that at the time the fund is sold you will not be double taxed).

In order to benefit from the QEF rules a specific election is required (which may or may not be available).

Theoretical Method Number 2 – Mark to Market Election – IRC S. 1296

General Principle: The fund owner pays tax on the INCREASE IN VALUE of the fund.

One is taxed on the difference in the value in the fund from one year to the next. The increase in value is taxed as ORDINARY INCOME and NOT as capital gains or dividends. This method also requires that a specific election be made. Note that the taxpayer **is paying tax on income that has NOT been distributed.**

There are additional wrinkles (including a step up in basis), but you get the idea.

In order to benefit from the "Mark to Market" rules a specific election is required.

Now, let's move to the reality for Americans abroad <u>who didn't make elections</u> and are therefore subjected to the default treatment.

Practical Method 3 – The Excess Distribution Method AKA "Confiscation" – S. 1291 IRC – The Reality for Americans Abroad

Understanding EXCESS DISTRIBUTIONS

In order to understand this method, let's imagine that your mutual fund was actually a stock. If you owned a share of a stock, you would receive the following two payments:

First Dividend Distributions – Your share of the company's profits

Second Capital Gain on the sale – The difference between what you paid for the stock and what you sold it for. This would be your profit on the sale.

Dividends and capital gains are taxed at lower rates than ordinary income. (That's why Warren Buffet pays tax at a lower rate than his secretary.)

It is common for small investors to purchase mutual funds instead of stocks. But, if an American abroad buys shares in a mutual fund of his country of residence (non-U.S.) he has just bought a PFIC. Because he has a PFIC, he will (since he made neither the QEF nor "Mark to Market" election) be taxed according to the "Excess Distribution" method.

The "Excess Distribution" method is described in S. 1291 of the IRC. The title of S. 1291 is: **"Interest on tax deferral".** You know where this is going. Deferral, how can this be? Isn't this a fiction? Of course it's a fiction. <u>The principle is that Americans abroad are to be punished for having bought a foreign mutual fund</u>. That's it. The theory behind "Excess distributions" is that you should pay tax on money you did NOT receive but is attributed to you.

Let me repeat: you are required to pay the U.S. interest on the dividends and capital gains that <u>you did **NOT** receive</u>!

That's the law of "Excess Distributions" – How Americans abroad are taxed.

But, what is an EXCESS DISTRIBUTION?

S. 1291 defines two kinds of excess distributions.

First, the **capital gain on any sale** of a PFIC is an excess distribution.

Second, to the extent that a **distribution/dividend exceeds 125% of the average of the preceding three years of distributions**, that excess, will be treated as an excess distribution. Interestingly, the currency of the fund (not U.S. dollars) is used to determine whether an excess distribution exists. (The amount of the excess distribution is then converted to U.S. dollars.)

The "Taxation" of "excess distributions" – Four Stages of Punishment

Punishment Stage 1 – "Excess distributions" are taxed as ordinary income!

Remember that capital gains and dividends are taxed at lower rates. So, as further punishment, "Excess distributions" are (NOT taxed at the lower rates of the capital gains and dividends which they obviously are) taxed as ORDINARY income. Remember this is the way Warren's secretary is taxed (ordinary income) and NOT the way Warren is taxed (dividends and capital gains).

Punishment Stage 2 – "Excess distributions" are ordinary income taxed at the **<u>highest</u> marginal tax rate!**

ORDINARY income is taxed at different rates. As further punishment, because no American abroad should EVER invest in a non-U.S. mutual fund, that American abroad must pay tax on this ORDINARY income at the highest marginal tax rate in effect for that year. (This is so clearly about punishment.) And now for the next level of punishment!

Punishment Stage 3 – "Excess distributions" (the capital gains of American abroad) are then prorated over all the days of the holding period. Interest is then charged, at prescribed rates, **compounded daily**!

Think of it! The magic of compound interest!

But, we are not finished yet! Just when you thought it couldn't get any worse:

Punishment Stage 4 – All of this generates (who could have known?) the filing of Form 8621

Form 8621 is so difficult, so complicated, and so expensive that most small investors (almost all Americans abroad):

A. Can't afford the costs of Form 8621 preparation;
B. Will have trouble finding tax preparers who are competent to complete this form; and
C. Will find that many tax preparers will NOT accept American clients who have PFIC issues requiring form 8621.

Putting it all together - An example demonstrating the horrors of the S. 1291 excess distribution rules:

Let's assume a PFIC with a ten year holding period and a $10,000 profit. Note that the profit will NOT be treated as a capital gain and that, in order to calculate interest, the gain will be pro-rated over the ten year period. The gain attributed to the year of sale will NOT be subject to an interest penalty.)

Assumptions:

Tax rates: Years 1 - 5 - 39% maximum income tax and Years 6 - 10 (where 10 is the current year) - 35% maximum tax. (Maximum tax rates can fluctuate from year to year.)

Prescribed Interest rates on tax payable: 5 % for years 1 - 5 and 10% for years 6 – 9

Hypothetical: Mutual fund sold in year 10 with a $10,000 gain.

How to determine the Excess Distribution tax:

1. **Determine Total Gain**: After ten years we sell the PFIC at a profit of $10,000.
2. **Allocate the gain over the 10 year holding period**: We do a "pretend gain" of $1000 each year and calculate tax at the highest marginal rate for ordinary income
3. **Calculate the tax "on the annual gain" at highest marginal rate**
4. **Calculate the interest charge on the tax "on the annual gain" for each year**: The issue is to charge interest on the tax that you would have paid if you had received the "pretend gain" each year. Note that the interest is charged over all years except the year of sale AND is compounded daily. The longer you hold the fund the more interest you will pay.

Examples of how these steps are applied based on the following assumptions:

1. The tax payable for years 1 – 5 is $390 per year – 39%
2. The tax payable for years 6 – 10 is $350 per year – 35%
3. The interest rate used to calculate the interest on the tax payable for years 1 – 5 is 5%
4. The interest rate used to calculate the interest on the tax payable for years 6 – 9 is 10% [Note that interest rates prescribed by IRS can change from year to year]
5. In the year of sale tax but NO interest is paid on the $1000 allocated to that year.

Example 1: Demonstration using simple interest on $10,000 gain:

Year	Max.Income Tax Rate	Annual Gain	Interest on tax	Years	Pay to IRS
1	39% X	$1,000 X	238	10 =	$628
2	39% X	$1,000 X	218	9 =	$608
3	39% X	$1,000 X	199	8 =	$589
4	39% X	$1,000 X	179	7 =	$569
5	39% X	$1,000 X	160	6 =	$550

Now we switch our assumptions to a top marginal tax rate of 35% for each year and a prescribed interest rate of 10%.

6	35% X	$1,000 X	140	5 =	$490
7	35% X	$1,000 X	105	4 =	$455
8	35% X	$1,000 X	70	3 =	$420
9	35% X	$1,000 X	35	2 =	$385
10	35% X	$1,000 X	0	1 =	$350
No interest charges for the year 10				Total:	**$5044**

Example 2: Demonstration using interest compounded daily

Year	Max. Income Tax Rate	Annual Gain	Interest on tax	Years	Pay to IRS
1	39% X	$1,000 X	357	10 =	$747
2	39% X	$1,000 X	321	9 =	$711
3	39% X	$1,000 X	286	8 =	$676
4	39% X	$1,000 X	253	7 =	$643
5	39% X	$1,000 X	222	6 =	$612

Now we switch our assumptions to a top marginal tax rate of 35% for each year and a prescribed interest rate of 10%.

6	35% X	$1,000 X	172	5 =	$522
7	35% X	$1,000 X	122	4 =	$472
8	35% X	$1,000 X	77	3 =	$427
9	35% X	$1,000 X	37	2 =	$387
10	35% X	$1,000 X	0	1 =	$350
No interest charges for the year 10				Total:	**$5547**

The preceding example describes the general theory that applies to all excess distributions (whether generated by distributions or sales). Remember that the interest is compounded daily.

The results were done by hand and are approximate. If the calculations are correct, kudos to the math expert with the master's degree who helped us out.

Should the numbers be incorrect, this shows how impossible it is for a normal person to comply with this PFIC tax rule.

How severe is the punishment?
If the gain had been treated as a capital gain (which it would be if the investment had not been a U.S.-based mutual fund):

$10,000 gain at 15% capital gains tax = **$1500 in tax.**
But, since the gain is based on a sale of a mutual fund outside the U.S. it is taxed according to the Excess Distribution rules we start with:

$10,000 gain taxed at 37% (the average of 39 and 35) which is $3700. We then need to add the interest charged each year. If my researcher is correct, the interest charges will be $1847. **Total tax** plus interest is: $3700 + $1847 = **$5547. This is 55.47%.**

But, this example assumes a 10 year holding period.

What if the holding period had been 20 years?

Here is the answer I received from our researcher:

*"Similar to a mortgage (when doubling the amortization period increases the interest payable dramatically), here **the total payable goes from $5547 to $9236**."*

In other words, if the holding period is 20 years, the rate of tax on the gain is 92.36%

Compare again the PFIC tax on this 10 ($5547) or 20 ($9236) year investment vs. the typical capital gains tax of $1500:

The longer you own a PFIC, the greater the rate of punishment.

For example, what if you had owned the mutual fund since 1986?

Imagine that you were a "buy and hold" investor and you bought a foreign mutual fund in 1986 and sold it in 2014. It seems clear that (using the same tax rates and interest rate assumptions) that the "tax" would EXCEED 100% of the gain!

But, do not forget the FURTHER compliance costs necessitated by Form 8621 (likely to be $500 to $1000) for each (!) year for the mutual fund. Let's assume $1000 per year. For ten years the compliance cost to own the mutual fund **would equal the total gain ($10,000) over the holding period**.

That's what happens if a U.S. citizen abroad buys a mutual find in his country of residence and fails to "Buy American"!

When it comes to PFICs:

It’s not about tax. It’s about confiscation.

Some further observations (none of these is pleasant) …

1. **Each PFIC is to be treated as a separate investment …**

Which means that any losses from one PFIC cannot be used to offset the gains from another! Yes, you read right.

2. **Notice also that the longer you own the mutual fund the more punitive it becomes.**

When it comes to PFICs, the lower the gain the better the investment. The stock market crash of 2008 would have been an excellent time to have sold them. Put it another way: In the world of PFICs, the best investments are actually the worst investments (a kind of “Alice in Wonderland” quality).

3. **The method of calculating the interest penalty assumes that the average gain each year of the holding period is equal to the actual gain. This improperly distorts the reality of what is happening.**

A. Imagine (in our example) that the complete $10,000 gain was attributable to growth in year 10 (the final year of the holding period). The methodology of averaging the gain over the 10 years means that the taxpayer is charged interest on tax that he would have owed, had the gain been attributable to those earlier 9 years, and if he had actually received that gain. In this example, the unfairness of the "deemed charge" is magnified and the taxpayer is "in effect" required to leave the IRS a tip. The taxpayer is paying interest on a holding period that is far too long.

B. Or imagine (in our example) that the complete $10,000 gain was attributable to growth in year 1 of the 10 year holding period. In this case the methodology of averaging the gain over the 10 year holding period works to the benefit of the taxpayer. The complete gain is averaged over a larger number of more recent years. In this case the taxpayer pays less interest than would have been owed, had the complete gain been taxed in year 1. This is because the taxpayer is deemed to have been the recipient of gains for a shorter period of time.

The point is that the ONLY way to accurately calculate the interest charge, is to treat every additional contribution to the fund as though it is a separate PFIC.

4. It's really too bad (and this is the most unconscionable) …

It's really too bad that U.S. citizens abroad were never told about this. It's really too bad that these rules are applied to the years before 2009 and 2010 when no one had any awareness of this.

It's really too bad that Canadian (and other non-U.S.) mutual fund companies never issued warnings to U.S. persons. It's really too bad that for Americans abroad so much of their retirement funds may well be in non-U.S. mutual funds.

It's all really just too bad.

Just when you thought it couldn't get any worse let's consider …

PFIC Reporting and FATCA ...

The FATCA rules have made owning PFICs even more risky. On December 31, 2013 (See Section B) the IRS passed temporary regulations regarding PFIC reporting.

Practical advice …

Don't buy any non-U.S. mutual funds. Should you sell the ones you have? **It's worth getting outside advice and counsel on what to do with existing ones. Don't forget that selling mutual funds held for a long time (see the above examples) will guarantee very significant erosion of capital!**

As one lawyer put it:

"Bye, bye investment!"

In conclusion: What the FBAR rules and PFIC rules have in common …

In both cases, an OLD law has been resurrected to punish unsuspecting Americans abroad.

It is clear that there was virtually NO knowledge of the application of PFIC rules to non-U.S. mutual funds prior to 2010. This is blatantly obvious. Yet, the IRS with the help of the tax professionals is punishing investments made years and years before "Mutual fund awareness". This follows the same narrative as the punitive application of the FBAR rules.

For Americans abroad:

The PFIC rules are the Title 26 equivalent of the Title 31 FBAR rules.

Think of it like this:

Confiscation coming soon to a mutual fund near you ...

The law of PFICs is found here:

http://www.law.cornell.edu/uscode/text/26/subtitle-A/chapter-1/subchapter-P/part-VI

- Subpart A—Interest on Tax Deferral (§ 1291)
- Subpart B—Treatment of Qualified Electing Funds (§§ 1293 –1295)
- Subpart C—Election of Mark to Market for Marketable Stock (§ 1296)
- Subpart D—General Provisions (§§ 1297 –1298)

Note that the new FATCA PFIC reporting rules are found in S. 1298 (f).

Section D – The HIRE Act, FATCA and the new PFIC S. 1298 (f) Reporting Requirement

In 2010 the HIRE Act ("Hiring Incentives To Restore Employment") was signed into law. The Act contained a "hitchhiking" (not part of the legislation) provision called FATCA.

FATCA is an acronym that stands for "Foreign Account Tax Compliance Act". At the risk of oversimplification, FATCA has two broad provisions:

First, a controversial provision that is an extraterritorial application of U.S. law which imposes "reporting requirements" on non-U.S. banks; and

Second, a (lesser discussed) provision that imposes additional reporting requirements on U.S. citizens abroad. The new reporting provisions incorporate the existing FBAR provisions but add many more reporting provisions (subject to the usual draconian penalties). This is reflected in the new Form 8938 requirement for Americans abroad.

Of specific interest is **a new provision requiring that U.S. citizens abroad report their PFICs to the IRS**. This is found in Section 1298 (f) of the Internal Revenue Code. The authorization to make regulations is found in S. 1298 (g).

They read as follows:

(f) ***Reporting requirement***
Except as otherwise provided by the Secretary, each United States person who is a shareholder of a passive foreign investment company shall file an annual report containing such information as the Secretary may require.

(g) ***Regulations***
The Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part.

This reporting requirement is triggered NOT by the receipt of income from a PFIC.

This reporting requirement is triggered simply by owning a PFIC.

FATCA authorized the IRS to make regulations. On December 31, 2013 the first IRS PFIC regulation came into force. It is significant because (subject to a $25,000 threshold):

U.S. citizens abroad are required to report their PFICs annually on Form 8621.

Form 8621 is an expensive form to complete. It is another burdensome reporting requirement for Americans abroad.

We ask that the Committee consider that the obvious **solution** is to either exempt U.S. citizens abroad from the FATCA requirements or to deem investment products bought in the taxpayers country of residence to NOT be foreign and NOT be a PFIC.

The new FATCA/PFIC regulations were discussed by U.S. tax lawyer Virginia La Torre Jeker as follows:

http://blogs.angloinfo.com/us-tax/2014/01/06/irs-gives-good-news-on-pfic/#.UsorHKj3dYk.twitter

"The previously deferred annual reporting requirement will begin for 2013 tax returns (assuming a calendar year taxpayer). So, for most taxpayers with PFIC interests, the annual report must be filed with the tax return due for the calendar year 2013. For Americans overseas this is generally due by June 15, 2014. Don't be lulled into a false complacency. US tax return preparers are always working under tight deadlines and as more and more taxpayers fear penalties for making errors, they are turning to professionals to get the job done. Start gathering your tax information early.

Newly Introduced – De Minimis Dollar Value Threshold Required for Annual PFIC Reporting and Piggy-Back Filings

The Temporary Treasury Regulations also establish a brand new de minimis threshold amount. Only if it is met, is the annual PFIC reporting requirement triggered (this assumes the shareholder is not otherwise required to file the Form 8621, for example, because the investor received an "excess distribution" or has made a so-called QEF election). If the threshold is not met on the last day of the shareholder's taxable year, then reporting is not required for that particular tax year. Generally, reporting is not required if on that last day, the value of all PFIC stock owned directly or indirectly by the shareholder is $25,000 or less; or, if the shareholder holds his PFIC stock only indirectly and the value of the stock indirectly owned is $5,000 or less.

In addition, the Temporary Regulations attempt to eliminate duplicative reporting in certain cases. The annual report is not required when a US person owns PFIC stock through another US person which timely files the annual report and the US investor is required to include an amount in income only under the QEF or Mark-to-Market rules with respect to PFIC stock held through the other US person. An example would be that of an individual member of a US hedge fund or private equity fund, when the US entity owns interests in foreign funds that are PFICs. In such a case, the individual member of the hedge fund or equity fund will not be required to file the annual Form 8621 provided the US entity itself has filed the annual report and the individual has a QEF or Mark-to-Market election in place.

Make Sure Filings Are Done Correctly

A US investor in a PFIC should make sure all required information and tax forms are completed and submitted with regard to his PFIC investment. In addition to the Form

*8621, the taxpayer may need to file Form 8938 and the so-called FBAR (Form 114a). Record-keeping and preparation time for the Form 8621, alone, **is extremely complicated** and a separate Form must be filed for each PFIC owned. The IRS estimates that the time required with regard to Form 8621 for each PFIC investment is at 22 hours per year! **The tax preparation costs may be prohibitive and in fact, many return preparers will not take on clients who need PFIC filings.***

Don't forget that starting this year, under certain provisions of the "Foreign Account Tax Compliance Act" (FATCA), "foreign financial institutions" will be required to report either directly (or indirectly through their local government authority) to the IRS about assets held by US persons with that institution. The FATCA rules will make it very easy for the IRS to cross-reference the information provided by the foreign financial institution with the taxpayer's Form 8621 to determine whether taxes and reporting on the PFIC have been properly undertaken"

Section E – Conclusion and Recommendation:

It is clear that the PFIC rules "in and of themselves" make retirement planning for Americans abroad somewhere between difficult and impossible.

It is obvious that this is an area that deserves attention and reform. This must be considered both in the context of U.S. domestic legislation and tax treaties.

We note that the U.S. Senate Finance Committee has identified PFICs as an area ripe for reform.

To reiterate our specific request: We ask that all investment and retirement vehicles or analogous entities which are in the country of residence where the American abroad lives must NOT be treated as PFIC.

We trust that this submission will help explain and reinforce the necessity for PFIC reform.

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