Why investing in most US Mutual Funds can damage your wealth

About collective investments

In this MASECO Private Wealth whitepaper, we provide what we believe is an easy-to-follow guide for High Net Worth US investors, wealth advisers, lawyers and accountants on how to create US tax-efficient portfolios for Americans living in London who seek to invest for international diversification and transparency without potentially onerous tax liabilities.

MASECO Private Wealth has been at the forefront of its field since its inception in 2008 – not only in striving to provide an exceptional and innovative service to its clients but also working hard to ensure that the wider community of Americans living in the UK are not inadvertently treated unfairly by the tax regimes to which they are liable.

US citizens who are long-term UK residents face challenges when making investment decisions as they are taxed on their portfolios by two tax regimes (UK & US). This can result in negative tax consequences if portfolios are not structured carefully.

US citizens living in the UK and investing globally may be able to considerably reduce their tax bills with sensible planning and expert guidance through the regulatory maze that is interaction between the US and the UK tax code.

The paper is designed to provide information on the different kinds of collective investments (e.g. mutual funds) - and how their structure can affect a tax bill. More importantly, it assists with the technical questions that may help protect returns: How often should a portfolio reinvest gains and in what currencies? What is the difference between reporting and non-reporting funds? What about Passive Foreign Investment Companies (PFICs)? What about the Foreign Bank and Financial Accounts form (FBAR)? If the forms aren't completed on an annual basis, US citizens and green card holders living in the UK for more than seven years could find their tax bills double – and not because their investment gains have doubled but because of poor tax planning.

US mutual funds are no bargain in the UK due to tax treatment of offshore income gains

Historically US investors have pretty much engaged in a love affair with mutual funds, closed-end funds, money market funds, and, more recently, exchange-traded funds (ETFs). All of these investment vehicles may provide an efficient way to gain access to a broad array of asset classes and often at a low cost. But if the US investor living in the UK doesn't take preventative measures, the low overhead on some of those funds won't be adequate to offset the high tax bill long-term they could incur particularly as a result of the UK non-domicile rule changes implemented in 2008.

"The UK tax rules changed dramatically in 2008 and 2009 for US investors," says James Sellon, Managing Partner at MASECO Private Wealth. "I alerted clients that change was afoot back in 2007 and, where appropriate, recommended that clients sell the majority of their US collective investments. More recently we are finding a new cohort of investors potentially facing large tax bills on US capital gains and they don't understand why. Some haven't had significant profits to report until now given the upset in the markets in recent years; some are just now 'aging' into the new rules and discovering that they weren't adequately prepared for their change in tax status."

In addition to paying US taxes, long-term US citizens in the UK are now subject to their marginal income tax rate on dividends and capital gains deemed to be Offshore Income Gains (OIG). The rate can be as high as 45% for wealthy individuals, nearly twice the capital gains rate. Prior to being long-term UK residents for more than 15 out of 20 years, US investors can choose to continue with the status quo and pay tax on the remittance basis and incur a hefty annual levy (of up to £60,000), which can then be offset against US tax liabilities. However, given a low interest rate environment and the difficulty of remitting funds to the UK, the relative attractiveness of electing to pay taxes on the remittance basis diminishes.

Finding a solution that is easy to implement, transparent, and tax-efficient: US Mutual Funds with UK Reporting Status

MASECO was, we believe, the first of our kind to consider and develop a simple solution to the tax challenges for US investors who prefer investing in mutual fund-like vehicles. The first step was to establish a relationship with a number of US-based mutual fund providers that were willing to obtain "UK Reporting Status" – formerly known as UK Distributing Status – which immediately put the investment in a different, more favourable tax category. Investors now would be able to benefit from the maximum capital gains tax rate in the UK of 20% and also take advantage of the £12,300 UK capital gains annual tax allowance (2020/21); losses could also potentially be used to offset capital gains if appropriate UK elections are made..

The challenge facing US citizens living in the UK of finding tax-efficient non-US investments US citizens in the UK could invest in non-US collective investments efficiently, but the US Internal Revenue Service (IRS) doesn't make it simple.

Some clients have suggested side-stepping the offshore income gains (OIG) issue simply by using UK investments. "That would at first glance appear to be an elegant solution. But the IRS rules are no less complex than UK HM Revenues and Customs (HMRC).

US citizens buying non-US collective funds could end up paying tax on income they don't even receive," says MASECO's Managing Partner Josh Matthews. "Investors can diversify assets effectively by using UK investments, but they need to be aware of the tax consequences."

There are several danger zones from a tax perspective. First, the IRS taxes gains and income derived from non-US collective investments such as UK and offshore ETFs, at the individual's highest marginal tax rate, currently 37% on an annual basis.

Second, US citizens must file taxes on the gains annually whether they are realised or not. If they fail to do so, the IRS will penalise them and charge interest – up to 100% of the gain when eventually sold!

The attractiveness of US Mutual Funds with UK reporting status, explained:

Suppose a US person living in the UK had $1mm invested in a US mutual fund/ETF strategy. They had been living in the UK for longer than seven years and were filing their UK taxes on the arising basis and were in the highest UK marginal tax bracket. Over the course of a year the portfolio increased by 10% to $1.1mm. The US person then sold the assets after one year and crystalised the gain. The gain on the investment would amount to $100,000 (£80,000 assuming the exchange rate remained the same on the date of purchase and sale).

The US person would have to pay US tax on the gain at their long-term capital gains tax rate. They would also have to pay income taxes to the UK if the fund did not have reporting status, therefore the individual would have to pay tax at 45% on the $100,000 gain equating to $45,000 (£36,000) in tax.

If however the US person had made investments in a reporting status US mutual fund then they would pay tax at 20% instead ($20,000 or £16,000) and they would also be eligible to use the £12,300 ($15,375) UK capital gains tax allowance for 2020/21. The gain would therefore be $84,625 ($100,000 – $15,375) and this gain would be taxed at 20% resulting in a tax liability of $16,925 rather than $45,000.

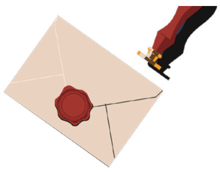
It is plain to see that by not investing tax-efficiently and not using reporting status funds the tax due would be nearly double! Of course every situation is different and individuals have currency gains, foreign tax credits and other issues to consider so it is imperative that Americans in the UK seek professional guidance before embarking on cross border investment management strategies.

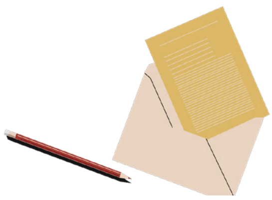
Passive Foreign Investment Companies (PFICs) can give US investors an entree to global investing strategies

PFICs come in three basic forms, each with their own pluses and minuses. They require careful administration to meet rigorous compliance rules and this raises the cost of investing. Specialist help is needed in the investment, tax and accounting arena to ensure the right tax forms are timely filed and that the right kind of PFIC is selected to provide for individual investment needs. (See the box on the following page)

For qualified purchasers, (those worth $5 million in liquid assets or more), MASECO has developed a turn-key solution for offshore funds denominated in sterling and euros, that are tax-efficient for a US citizen.

The funds give US citizens the ability to diversify into asset classes previously unavailable or impractical to invest in. These positions work well in portfolios seeking to match assets with foreign liabilities.





Assessing Advisers in a complex investing and regulatory world

Skilled wealth managers keep an eye on currency fluctuations and average costs to minimise tax bills. The High Net Worth investor with far-flung investments requires singular guidance through tax and compliance issues to avoid finding him/herself paying hefty taxes for whatever reason. An Adviser should be registered with the local financial authorities. Some items an Adviser needs to be monitoring are:

- Exchange rate fluctuations. If GBP depreciates versus a dollar investment, the tax consequences can be hefty – 45%. That is what happened in 2008 to anyone who bought US (non-reporting) money market funds, a singularly inefficient vehicle for UK-based US investors.
- Timing of dividend payments versus exchange rate. The Adviser must keep track of the exchange rate on the date dividends are received from stocks, distributions from funds, and interest from bonds. This can be particularly tricky for funds that are automatically re-invested.
- Average cost on all collective investments. The rules changed in 2008 to "share pooling" and are based on the average cost of an investment.
- Thus, managers need to constantly re-calculate the cost of shares if they are owned in multiple accounts or averaged into a single account. If the same security is purchased on multiple occasions over a period of time, at different prices, accounting becomes complicated when a portion of the position is sold. One must now take the average cost basis and sell the correct portions from each purchase date. And all purchases and reinvestments must be calculated in GBP.
- Watching how the US custodian reports gains and losses. If possible, convince the custodian to report changes using the average cost basis method. Some may resist changing from the path of least resistance – first in, first out.

PFICs hold promise for US investors investing in non-US funds, if properly managed

Until now, investors could choose three different ways to handle PFICs for US tax purposes, each with their own drawbacks:

1. **Fund Excess Distribution, accruing taxes at the ordinary rate**
   Taxes are deferred on PFIC gains but the compounding of interest charges on deferred taxes can be surprisingly large. Plus, taxes are accrued at the highest US ordinary rate of 37%. Investors cannot offset gains with losses.

2. **Mark-to-Market, a limited menu for investors**
   As a result of FATCA many investment managers are being stringent and prohibitive with regards to accepting US persons into their funds.

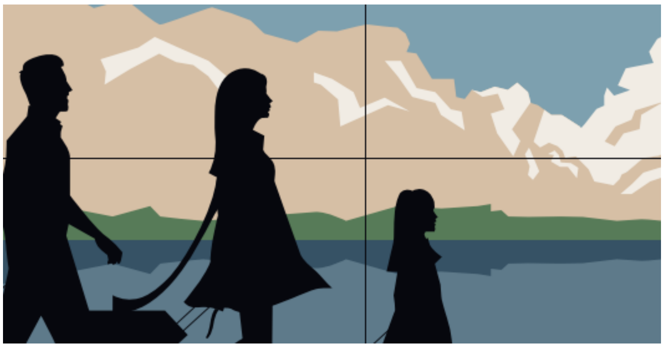
3. **Qualified Electing Fund (QEF), a record keeping challenge**
   The tax rules are virtually identical to US funds. The problem: very few offshore funds are able to keep books and tax records to satisfy the QEF election.

MASECO Private Wealth has taken a close look at each option and developed a turnkey solution for investors who are seeking a way to diversify their assets, that copes with the reporting and tax issues for US investors.

MASECO and the services we provide to High Net Worth investors

We believe that US registered funds with UK reporting status are efficient investing vehicles for many Americans living in the UK, or trustees with UK and US tax issues. MASECO is not however a tax specialist and strongly advises investors, to seek independent tax advice prior to engaging in any investment that has tax implications.

These investments might not be suitable for all investors and so a careful assessment of a personal situation is of paramount importance. MASECO is not a tax adviser but a wealth management firm that considers taxes when working with clients.



Important Information

US Mutual Funds come under the heading of Non Mainstream Pooled Investments (NMPIs). Some US registered mutual funds are not regulated in the UK by the Financial Conduct Authority (FCA) and are Unregulated Collective Investment Schemes (UCIS). Many of the protections provided by the UK regulatory system may not apply to investments in particular NMPIs. This may include access to the Financial Services Compensation Scheme and the Financial Ombudsman Service. Prior to investing in US mutual funds, US citizens should seek advice from an FCA regulated Financial Adviser to ensure that these types of funds are appropriate. NMPIs may not be freely marketed to the general public in the UK.

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Risk Warnings

- All investments involve risk and may lose value. The value of your investments can go down as well as up depending on market conditions and you may not get back the original amount invested.
- Your capital is always at risk.
- Currency exchange rates may cause the value of an investment and/or a portfolio to go up or down.
- Alternative strategies involve higher risks than traditional investments, such as speculative investment techniques, which can magnify the potential for investment loss or gain.
- Certain products, such as US Mutual Funds, used within a portfolio are not regulated in the UK and therefore clients will not have the benefit of the protections afforded by the UK regulatory regime.

Performance

- Past performance is not a reliable indicator of future results.

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MASECO LLP is authorised and regulated by the Financial Conduct Authority for the conduct of investment business in the UK and is registered with the US Securities and Exchange Commission as a Registered Investment Adviser.

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