Investing in US Mutual Funds can damage your wealth

US mutual funds are no bargain in the UK

US investors have pretty much engaged in a love affair with mutual funds, closed-end funds, money market funds, and exchange-traded funds (ETFs). All these investment vehicles provide access to a broad array of asset classes, often at a low cost. However, if the US investor living in the UK does not take preventative measures, the relatively low cost of such funds will not be sufficient to offset the high UK tax bill they could incur on realising gains.

"The UK tax rules changed dramatically in 2008 and 2009 for US investors," says James Sellon, Managing Partner at MASECO. *"I alerted clients that change was afoot back in 2007 and, where appropriate, recommended that clients sell most of their US collective investments as they would be treated punitively by the UK tax authorities."*

Why are UK taxes so high for most US mutual funds?

In addition to paying US taxes, long-term US citizens in the UK who hold mutual funds not recognised in the UK are subject to their marginal UK income tax rate on dividends and capital gains deemed to be Offshore Income Gains (OIG). The rate can be as high as 45% for high income individuals, more than twice the capital gains rate of 20%.

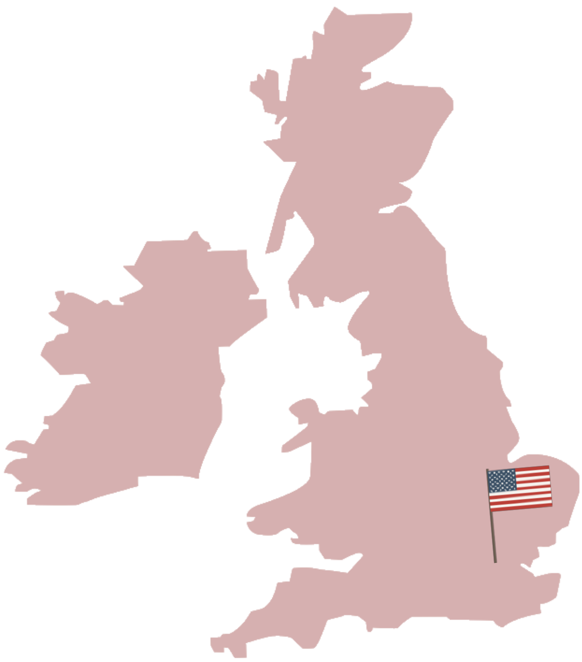
Some suggest side-stepping the offshore income gains (OIG) issue by using UK investments. *"That would at first glance appear to be an elegant solution. But the IRS rules are no less complex or punitive than UK HM Revenue and Customs (HMRC). US citizens buying non-US collective funds could end up paying tax on income they don't even receive as well as an elevated tax rate on realised gains"* says MASECO's Managing Partner Josh Matthews. *"Investors can diversify assets by using UK investment funds, but they need to be well aware of the negative tax consequences."*

There are several danger zones from a tax perspective. First, the US Internal Revenue Service (IRS) taxes gains and income derived from non-US collective investments (such as UK and offshore funds & ETFs) at the highest marginal tax rate, currently 37%.

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 tax-efficient solution: US Mutual Funds with UK Reporting Status

We believe MASECO was the first US / UK wealth manager to consider and develop a simple solution to solve the tax challenges for US investors who prefer investing in funds. The first step was to establish a relationship with a number of US-based mutual fund providers who shared our investment philosophy and were willing to obtain "UK Reporting Status" to ensure favourable UK tax treatment. Investors would now be able to benefit from capital gains tax treatment in the UK at 20% and utilise the £12,300 UK capital gains annual tax allowance (2022/23). Additionally, if appropriate UK elections are made losses can also be used to offset capital gains



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, were filing their UK taxes on the arising basis and they were in the highest UK marginal tax bracket (45%).

Over the course of a year the portfolio increased by 10% to $1.1mm. The US person then sold the assets and crystalised the gain. The gain on the investment would amount to $100,000 (£80,000 assuming an exchange rate of £1:$1.25).

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 offshore income gain (OIG) taxes to the UK if the fund did not have reporting status, meaning tax at 45% on the $100,000 gain equating to $45,000 (£36,000) in tax.

If 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 2022/23. 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 via reporting status funds the tax due would be nearly double!

Of course, every situation is different; 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.

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 themselves paying hefty taxes for whatever reason. An Adviser should be registered with the local regulatory 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 regularly 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. In addition, 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.

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 the Foreign Account Tax Compliance Act (FATCA) many investment managers are being restrictive 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 we strongly advise 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 the implication of taxes from an investment perspective when working with clients.

Important Information

US Mutual Funds come within the definition 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 do not apply to investments in NMPIs. This includes 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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• 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.
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• Currency exchange rates may cause the value of an investment to go up or down.
• Information about potential tax benefits is based on our understanding of current tax law and practice and may be subject to change. The levels and bases of, and reliefs from, taxation is subject to change. The tax treatment depends on the individual circumstances of each person and may be subject to change in the future.

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