InvestmentNews
The Leading News Source for Financial Advisers

What lurks in some foreign ETFs

Passive foreign investment companies can generate big tax bills if proper reporting isn't filed

By Robert N. Gordon

May 22, 2011

The latest wrinkle in the world of exchange-traded funds is a fund that is a foreign company. The rush to silver, for example, spawned the creation of the Sprott Physical Silver Trust (PSLV), which is a Canadian corporation. Because the trust is not engaged in an active business, it is considered a passive foreign investment company.

By contrast, suppose an investor buys stock of a company such as Royal Dutch Shell PLC, the Anglo-Dutch oil company that conducts an active business. Any gains or losses in the shares will be taxed as if they came from a U.S. company.

However, years ago, canny investors had the ability to start a corporation in a country with no taxation that would exist only to hold investments. Because the investments were held within a corporation in a tax haven, there was no tax on the portfolio's turnover or income. Eventually, when the shares were sold, the gain was treated as a long-term capital gain. The U.S. thought that result was too sweet a deal, so it closed the loophole by creating a new type of vehicle, the PFIC, which induces current taxation in the U.S.

Under PFIC rules, a U.S. investor can make a qualifying electing fund election so that income received by the PFIC flows through to him or her. The offshore corporation would need to make yearly reports to the U.S. investor so that he or she could file a tax return properly.

Since the U.S. also wanted to halt the conversion of ordinary income into long-term gains, investors in a PFIC that does not provide proper QEF reporting can defer the PFIC's income only at a steep cost: all income is converted to ordinary income and the U.S. charges a nondeductible interest charge on the taxes not previously paid.

The Sprott ETF is a passive foreign investment corporation whose prospectus advises U.S. holders to make the QEF election. The “fund” will make the QEF information available so that any income will flow through to U.S. investors, just as income would from a U.S.-based fund. If the trust sells any silver, the

gain or loss on that trade will flow through to investors. Short-term gains would be taxed at 35% and long-term gains would be taxed at 28% (the tax rate on collectible long-term gains).

Sprott does not expect redemptions that might cause selling of the portfolio, and thus predicts little or no income flowing through each year to the shareholders. If an investor held the PFIC for more than a year and sold at a profit, he or she would be taxed at only 15% since the gain would be considered a long-term gain on a stock.

If the investor does not make the QEF election, all profits will be turned into ordinary income and taxed at the highest rate — with an interest charge.

I'm not sure why the fund could not face net redemptions. Presently, it is selling at a premium to its net asset value, which is baffling; why would anyone pay 15% extra to buy silver through an ETF when they can buy the same metal cheaper elsewhere? I would assume that this investor enthusiasm (or irrationality) could reverse itself as the bloom comes off the silver rose. As investors flock to sell, the trust's premium should evaporate.

After that, as investors sell PSLV, market makers will purchase the fund in order to prevent it from going to a discount. Those market makers then redeem from the sponsor; the ETF then will have to sell silver and a taxable event will occur.

The first precious-metal PFIC I'm aware of is the Central Fund of Canada (CEF), which was founded in 1961. CEF also advises U.S. holders to make the QEF election, but it is a closed-end fund with a fixed number of shares, so there should be no net redemptions to the fund — which would mean no taxable income.

With CEF trading at a smaller premium and possessing a more solid prognosis for favorable tax attributes, one wonders why the Sprott trust trades at a premium at all. Because there are no shares of PSLV to short, sanity will prevail only when investors turn negative on silver.

Robert N. Gordon is chief executive of Twenty-First Securities Corp. and an adjunct professor at New York University's Leonard N. Stern School of Business. He can be reached at bob@twenty-first.com.