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## Global Investment Taxation Pitfalls for 2007

By Eric Roseman

Before delving into the offshore investment world, your number one priority should be taxes. How will your investments be taxed and what investments, if any, should be avoided due to possible onerous tax implications in the United States?

It's amazing, but since 1992, I've heard numerous disaster stories whereby investors actually made offshore investments upon opening a foreign bank account and later, discovering they were hit hard by punitive taxes because they failed to survey the consequences *before* investing.

Since 1997, the United States has changed the way certain offshore investments are taxed.

The most onerous tax implications facing American investors is the QEF rule, or Qualified Elected Fund rule. Basically, a U.S. investor who purchases offshore mutual funds must now pay annual capital gains from that investment even if there was no distribution; unlike the majority of U.S.-based mutual funds, which make year-end distributions, most offshore funds don't issue year-end per share capital gains, dividends or interest income distributions. Effectively, an investor holding an offshore fund must pay capital gains taxes every year, assuming he has gains, from a separate source of income. In my book, that's an onerous tax regime, making offshore mutual funds a bad investment for Americans.

However, Americans can defer offshore mutual fund taxes by investing in a offshore variable annuity or moving an IRA or Individual Retirement Account (IRA), offshore. This way, you get to defer taxes in the policy or account and hopefully, accrue some impressive long-term gains from some top-performing offshore funds. But outside of a tax-deferred solution, an investor should avoid offshore mutual funds because they are onerously taxed by the IRS.

International stocks are a different story altogether.

Another common mistake made by international investors is buying U.S.-listed ADRs or foreign stocks traded as American Depositary Receipts (ADRs) *inside* a retirement plan. Also, buying foreign-listed stocks from an offshore private bank will result in withholding of dividends. Both

strategies, unfortunately, will result in losing that dividend tax credit because an IRA cannot recover that lost income held at source since it can't file a tax return.

When a foreign company pays a dividend to a foreign investor, it withholds the tax you owe on that dividend in its home country. For example, let's say you own Britain's *Barclays Bank ADR*, partly because of its attractive dividend. Outside of a tax-deferred plan, an investor can claim a dividend tax credit or take a tax deduction, assuming the country withholding the income has a tax treaty with the United States. In this example, the United Kingdom does have a tax treaty with the United States. An investor will therefore recover that dividend as a credit or a tax deduction. But that's not the case with a tax-deferred plan, like an IRA; an investor in a tax-deferred plan should *avoid* dividend-paying stocks in an IRA (even in an offshore IRA) because there's no way to recoup the tax.

If you choose to buy foreign stocks, either domestically or from a private bank abroad, then make sure you buy these securities in a taxable account so you can indeed reclaim the dividend withholding at source.

One way to ensure you don't buy a dividend-paying ADR in a retirement account is to check-out a universe of ADRs online. *The Bank of New York*, the largest sponsor of ADRs in the United States, offers a mostly free source of per share information, including current dividend distributions.

Foreign bonds also pose a similar dilemma to retirement investors.

If you buy international bonds in an IRA or in any other tax deferred account, interest income will be withheld. And because you cannot reclaim a credit in a retirement plan, you'll lose a portion of the income, a horrible consequence because interest-income is a big part of a bond's total return. But you can claim that withholding outside of a retirement plan.

Going global with a portion, or even all of your investment portfolio, can yield some impressive long-term results. But make sure you fully understand the tax implications of investing in foreign securities before executing trades in the United States or overseas.

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