

Tax Trap for the Unwary: The Passive Foreign Investment Company



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In an effort to curtail perceived abuses of U.S. investors in foreign mutual funds, Congress enacted the Passive Foreign Investment Company (PFIC) regime in *The Tax Reform Act of 1986*. Prior to this legislation, U.S. investors were able to place investments in foreign corporations while avoiding U.S. taxation. Domestic mutual funds, i.e., regulated investment companies, are required to pay at least 90 percent of income to shareholders as dividends or be subject to tax at the corporate level. In contrast, a foreign corporation serving in a similar capacity was beyond the jurisdiction of U.S. tax authorities unless receiving U.S. source income. Further, the wide dispersion of shareholders typically seen in these types of investment vehicles

would not trigger anti-deferral provisions of Controlled Foreign Corporations (CFCs). Thus, by investing in foreign mutual funds, U.S. taxpayers were able to avoid U.S. tax unless and until the foreign corporation paid dividends.

As with many well-intended tax provisions, PFICs fall into the ever-growing category of “tax traps for the unwary.” U.S. taxpayers may find themselves unwitting shareholders in a PFIC as a result of how legislation initially intended to curb abuses surrounding foreign mutual funds was drafted to cast a wider net. The tax practitioner may find himself/herself in the position of delivering the bad news to a new client or even worse, informing the client of his/her failure to advise the client properly on certain foreign investments or subsidiaries. To illustrate how this may occur, let’s look first at the rules that define a PFIC.

A PFIC is a foreign corporation that meets one of two tests. The income test is met when the foreign corporation has passive income comprising at least 75 percent of gross income. The asset test is met when the corporation has passive assets comprising at least 50 percent of total assets by average market value. Passive assets are assets that produce passive income. Passive income generally includes dividends, interest, royalties, rents, annuities, gain on the sale of passive assets, and certain gains on commodity and foreign currency transactions.

If a U.S. taxpayer is a shareholder of a foreign corporation for any tax year it is determined to be a PFIC, the corporation remains a PFIC with respect to that shareholder even if in subsequent periods it does not meet the income or asset tests. Among international tax practitioners is the saying, “Once a PFIC, always a PFIC.” The saying is not entirely true, however, as PFIC taint may be purged in certain circumstances. Nonetheless, it is often too easy for a foreign corporation to become a PFIC unbeknownst to its U.S. shareholders. A formerly operational foreign subsidiary left idle for a year may fall into the PFIC trap, just as a U.S. expatriate investing savings in non-U.S. financial institutions may find himself/herself the (not so proud) owner of a PFIC. So why is owning a PFIC so bad?

First, if no action is taken with respect to the PFIC, the U.S. shareholder is permitted to defer U.S. tax on the PFIC until an “excess distribution” is made. An excess distribution is the total actual distributions made during the tax year to the extent they are in excess of 125 percent of the average actual distributions made in the previous three tax years. In addition, any gain realized on the disposition of PFIC stock is treated as an excess distribution. Excess distributions are allocated pro-rata to the shareholder’s holding period in the stock from the tax year it was first a PFIC and are taxed at the highest tax rate in effect for the applicable tax year(s), a particularly costly result for individual taxpayers who otherwise may be subject to preferential rates. Moreover, interest

on underpayment is due as if the excess distributions were actually received by the shareholder ratably over his/her holding period in the stock while it was a PFIC. There is no excess distribution for the first year a stock is a PFIC and for a PFIC distribution in any year, the "in lieu of" foreign tax credit may be claimed on withholding by a foreign government.

Fortunately, there are alternatives to the draconian PFIC regime, although they may initially seem no less draconian. By making an election to be taxed as a qualified electing fund (QEF), the U.S. shareholder of a PFIC is taxed on his/her pro-rata share of PFIC income every year. The PFIC becomes a conduit entity. The character of such income, capital or ordinary, passes through to the shareholder and increases his/her stock basis. For individuals, dividends passed through are not eligible for preferential rates. Any distributions from the PFIC of previously taxed income are a tax-free recovery of basis to the extent thereof. Such distributions decrease basis in the PFIC stock, but not below zero. If the taxpayer lacks the liquidity to pay tax on PFIC income for the year of pass through, he/she may elect to pay at a later date of actual distribution, plus any applicable interest. For corporate shareholders owning 10 percent or more of the PFIC, a deemed foreign tax credit is available on earnings passed through from the PFIC.

If a QEF election is made during the first tax year a foreign corporation meets the definition of a PFIC, the QEF will move forward without any PFIC taint. If the election is made in a year subsequent to its first PFIC year, as is often the case, the QEF carries with it PFIC taint. In other words, the U.S. Treasury does not forget there remains a tax deferral on earnings of the foreign corporation while it was a PFIC prior to the QEF election.

The taint may be purged in one of two ways. First, the QEF electing shareholder may agree to be taxed on a deemed sale of his/her PFIC shares for fair market value on the first day of the tax year. As a result, the foreign corporation with respect to the electing shareholder gets a fresh start, including a new holding period and basis, and is no longer a PFIC, but at a cost. The deemed sale is an excess distribution under the PFIC regime described above and carries the same consequences as any other sale of PFIC stock. Thus, making the QEF election by or before the stock becomes a PFIC may be crucial to a client's tax savings (and overall satisfaction with his/her tax advisor). A taxpayer who neglects to make a QEF election in the first year may make a late election having retroactive effect in certain circumstances or seek special consent from the IRS to do so.

Second, if a QEF carries PFIC taint, the shareholder may make a deemed dividend election where he/she includes as a dividend his/her pro-rata share of PFIC earnings attributable to the stock on the first day of the tax year the QEF election was in effect. While the deemed dividend is taxed as an excess distribution described above, the PFIC taint is purged and the shareholder may move forward with his/her investment free of any lingering PFIC concerns.

When information with respect to PFIC earnings is difficult or too burdensome to obtain, a QEF election may not be a possibility. If the stock has a readily ascertainable market price, a PFIC

shareholder may make a mark-to-market election on his/her PFIC stock. Under this election, the shareholder includes as ordinary income the amount the fair market value of the stock exceeds his/her basis on the last day of the tax year. The shareholder's basis is increased by the amount of inclusion. A shareholder may similarly recognize loss when fair market value is below his/her adjusted basis in the stock, but only to the extent of previously recognized gains. If the mark-to-market election is made in a year after the foreign corporation first becomes a PFIC, the inclusion in the year of election will be an excess distribution as defined above.

A U.S. shareholder of a foreign corporation that was once a PFIC, but no longer meets the income or asset tests, and who did not make a QEF or mark-to-market election, may wish to purge the PFIC taint. In the absence of one of these elections, the shareholder runs the risk of having his/her investment meet the income or asset test in later years and again becoming a PFIC. Nonetheless, the PFIC taint may be purged by electing to recognize gain on the last day of the last tax year the corporation was a PFIC as if the stock were sold on that day. Such a deemed sale in a prior period will result in interest due in addition to the tax on the excess distribution.

Information on PFIC, QEF and mark-to-market election stock activities is reported on Form 8621 *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*. Taxpayers attach Form 8621 to their annual federal income tax return. Generally, tax-exempt organizations owning PFIC stock are not subject to the PFIC regime unless income from the PFIC is unrelated business taxable income (UBTI). As such, temporary regulations provide an exception for tax-exempt organizations from filing Form 8621, unless there is UBTI.

Previous mention is made of the CFC. It's worth noting that if a foreign corporation qualifies as a PFIC and a CFC, the CFC rules will apply. A CFC is a foreign corporation with U.S. shareholder(s) owning, directly or indirectly, more than 50 percent of its stock by vote or value. For CFC purposes, a U.S. shareholder is a U.S. person who owns 10 percent or more of the foreign corporation's stock. A U.S. person is a U.S. citizen or resident alien, or a business entity organized under the laws of the U.S. U.S. taxpayers owning stock in a CFC are subject to a wide array of anti-deferral provisions that are not explored here.

Discovering that one is a shareholder in a PFIC is never a pleasant experience. Knowing the PFIC rules and tax consequences as a practitioner provides an opportunity to add significant value to client services, as does knowing the options available to purge PFIC taint. As global economies seemingly become more local, PFIC issues no longer touch only those clients served by Big 4 accounting firms. There is an increasing likelihood the boutique firm practitioner will start to see PFIC issues, as well. ■

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