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Taxation of Passive Foreign Investment Companies (PFIC)

Executive summary

Congress added the passive foreign investments company (PFIC) rules in 1986. The PFIC rules were designed to prevent taxpayers from avoiding both current taxation and converting ordinary income into capital gains.

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The rules were designed to catch passive investments placed into foreign corporations, but has caught unsuspecting taxpayers in recent years, such as start-up that earns interest on invested cash or an individual invested in a mutual fund.

The PFIC regime is a penalty provision that taxes gains and distributions at the highest tax rate plus an interest charge on the deferral period. Once a corporation is a PFIC at any point during the holding period of the taxpayer, the stock is treated as PFIC for as long as the taxpayer holds the stock (or purges the PFIC taint). Understanding the PFIC rules is crucial because there are elections available to help minimize or mitigate the tax treatment under the PFIC regime.

Even if taxpayers do not have direct ownership in a foreign corporation, they can still be subject to the PFIC regime. An example would be if the taxpayer is invested in a fund and the fund owns a PFIC, the taxpayer would be subject to the PFIC rules. Following will be a summary of the PFIC rules and the choices available if taxpayer owns a PFIC.

Introduction

Following is a description of what a PFIC is, and what you can do if you have one. We will go over the tax consequences if you nothing and the alternatives.

What is a PFIC?

- A Passive Foreign Investment Company (PFIC) is any foreign corporation that meets either an income test or an asset test (there is no stock ownership test)
- Corporation meets income test if 75% or more of its gross income is passive income, or
- Asset test if 50% or more of its assets are passive income producing assets
- Foreign mutual funds are usually PFICs
- If no elections are made, the gain on the sale of a PFIC is subject to tax under IRC §1291

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What can I do if I have a PFIC?

Qualifying Electing Fund (QEF) (§1295)

- Make a QEF election by filing Form 8621
- The election must be made in the first year the interest is a PFIC
- The election is made by the first U.S. Person
- Taxpayer must include pro-rata share of the earnings of the PFIC in income each year (treats PFIC like a partnership – no deferral)
- The downside of this election is there is income recognition with no corresponding cash and often the information required to make the election is not available
- Option to elect to defer tax payment until cash received (made on Form 8621)

Mark-to-Market Election (§1296)

- If making a QEF election is not possible, a Mark-to-Market election is possible
- If Mark-to-Market election made, taxpayer includes unrealized appreciation (and depreciation to the extent of prior year recognized appreciation) into ordinary income each year
- Because no U.S. tax is being deferred the PFIC taxation rules will not apply on the disposition of the stock
- There may be an interest-charge on a limited basis

Do Nothing (§1291) - Default

- Excess distributions taxed by prorating distribution across the holding period (by day), compute tax (at highest ordinary income rate, and add interest charge on the portion of income deemed to be deferred
- Distributions that are not "excess distributions" taxed like regular dividend distributed on Schedule B
- Gains are taxed like excess distributions

Election to Purge PFIC Taint

- If no QEF election was made and no mark-to-market election is made, there will be a PFIC taint (meaning there is deferred income that will be subject to the 1291 rules) even if a QEF election is made in a later year.
- Taxpayer can make an election to purge the PFIC Taint
- Treated as deemed sale for 1291 and the gain is subject to tax at the highest rates and interest is charged on the deferral
- Basis is increased by the gain recognized and there is a new holding period
- Removes the taint so that interest does not continue to increase
- This election may make sense if the corporation is no longer a PFIC or if the interest is expected to increase in value

Other Considerations

- If there are PFIC related disclosures shown on a K-1 they need to be addressed
- Failure to address PFIC filing requirements will result in maximum taxation under §1291 rules
- PFIC Amnesty Program is available to all voluntary disclosure program participants
- There are special foreign tax credit rules for "excess distributions":
  - » foreign tax credit for an excess distribution for one PFIC cannot be credited to offset the U.S. income tax liability for an excess distribution received from another PFIC
  - » no carryback or carryforward is allowed for unused foreign tax credits attributable to excess distributions
  - » distributions that are not "excess distribution" are treated the same for foreign tax credit purposes as any other dividend.
- If the interest is both a controlled foreign corporation (CFC) and PFIC then the CFC rules (i.e. subpart F income) prevail

Conclusion

Many foreign mutual are PFICs. As practitioners we need to be sure that we make the appropriate elections related to client PFIC investments, and we need to ensure that clients are advised of the ramifications of holding or transferring PFIC stock. This is a general summary of the PFIC regime. The underlying rules are complicated and there are other issues to consider.

If you have a client who owns PFIC stock and need assistance, please contact one of your MGI network international tax specialty firms.

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