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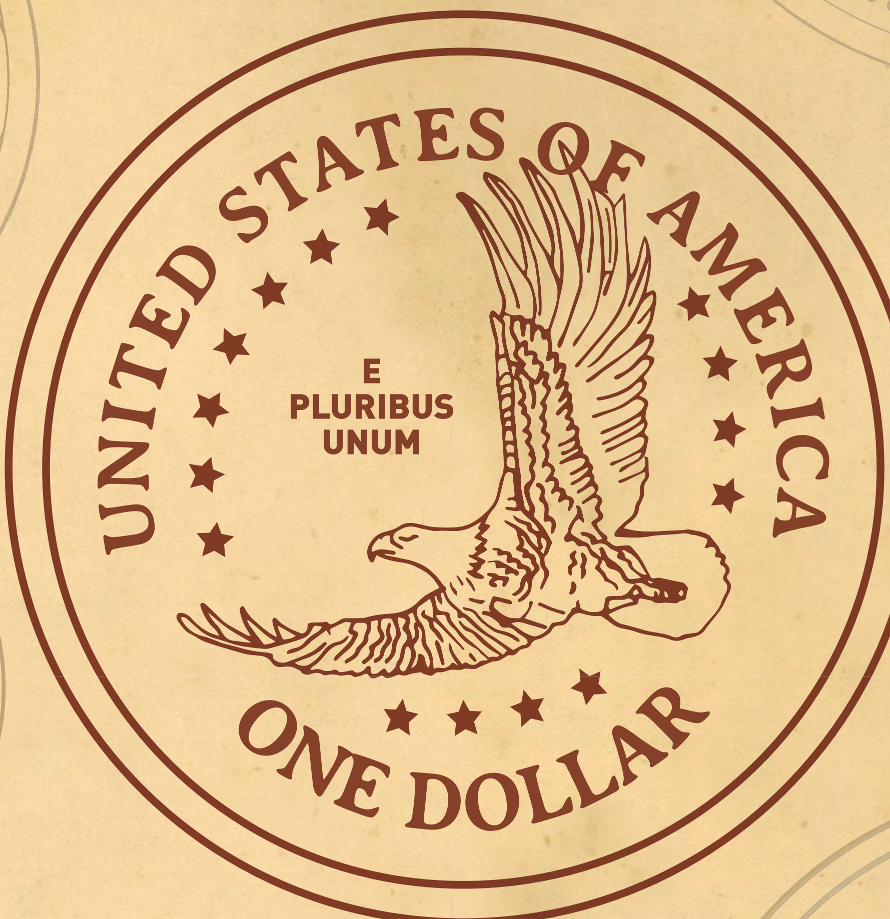

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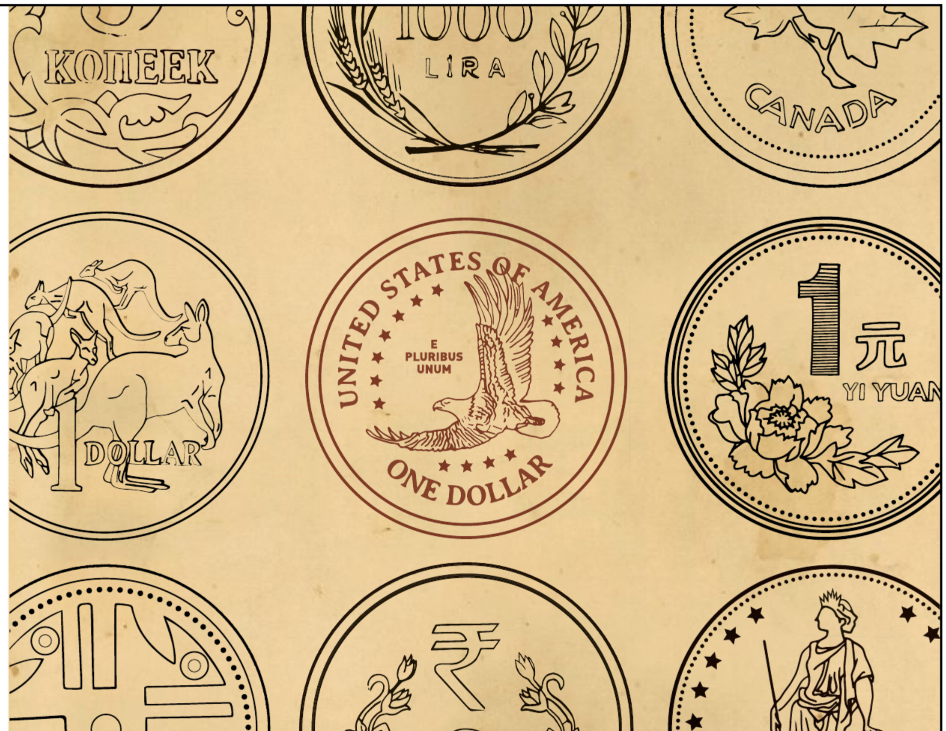

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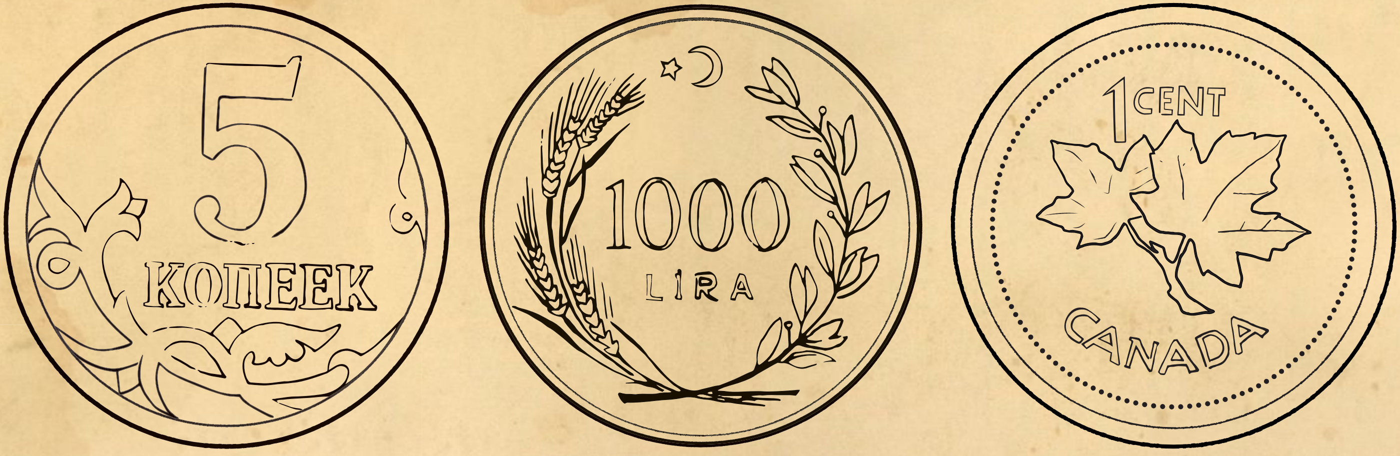
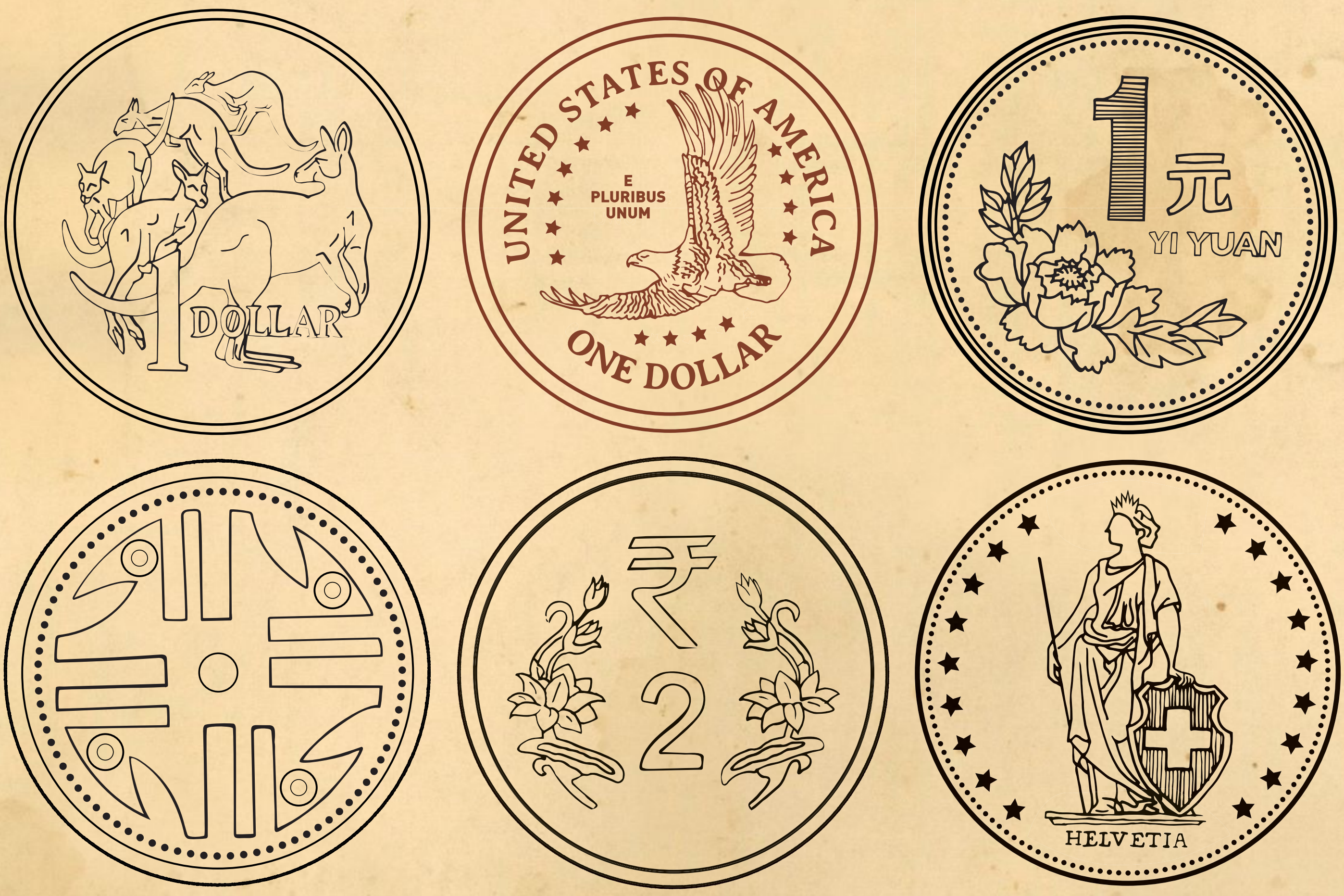
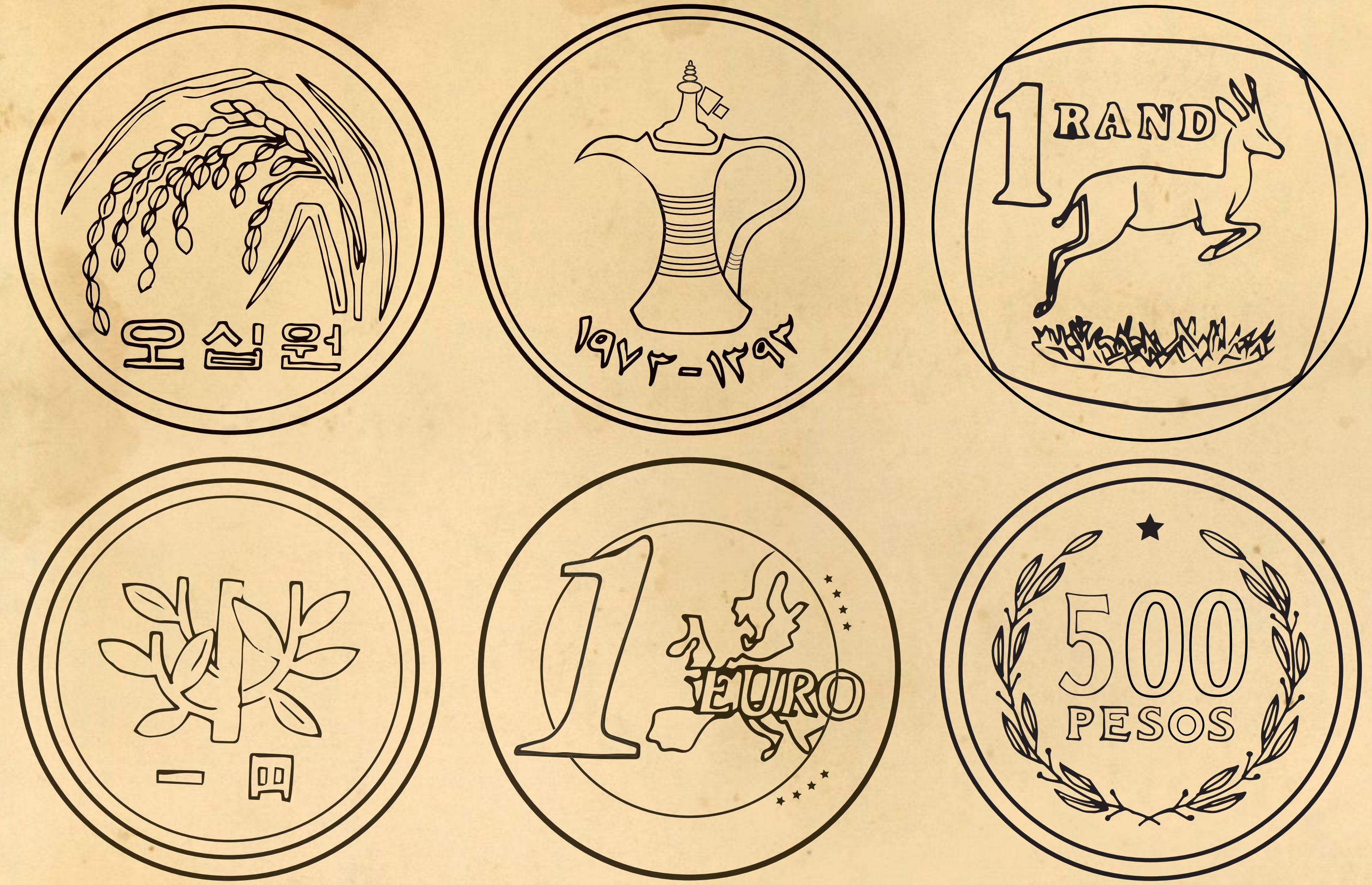


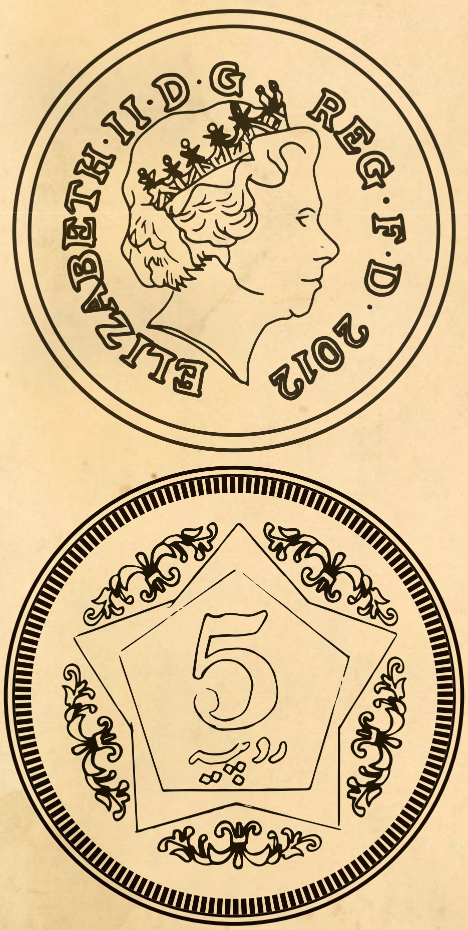
UNDERSTANDING THE PFIC RULES

and the Implications of Owning Foreign Mutual Funds

Michael J. DeBlis III, Esq. and Randall Brody, EA







While many portions of the U.S. tax code possess confusing and sometimes harsh rulings, the tax rules for passive foreign investment companies (PFICs) are almost unmatched in their complexity and draconian features. Countless times, Americans overseas uncover a startling revelation that the small foreign investment they had made in a non-U.S. mutual fund is now subjecting them to all the significant filing requirements and tax obligations that apply to a PFIC.

The tax laws involving PFICs are extremely complex and not very well known by the majority of investors and tax professionals. While it is beyond the scope of this article to cover all the numerous details related to PFIC reporting requirements, our hope is to provide guidance and awareness into the world of PFICs so that U.S. taxpayers can be advised of the consequences by their U.S. tax professional.

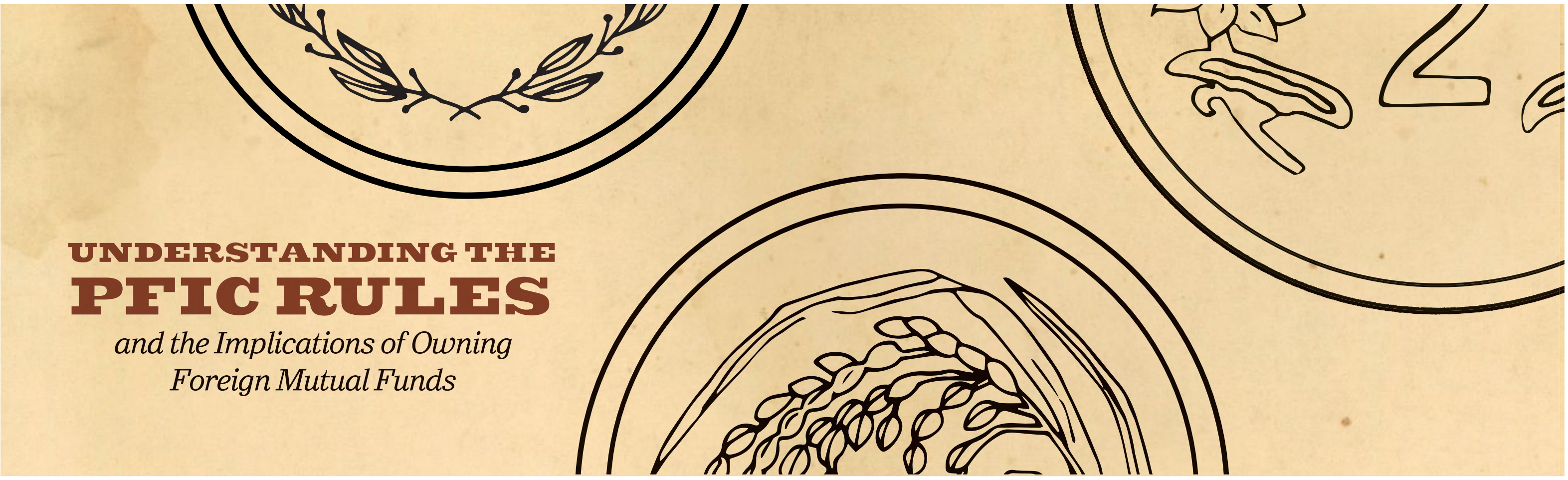
What Is a PFIC?

There are two central elements that form the basis of PFIC taxation: the definition of a PFIC and the tax treatment imposed on U.S. shareholders.

A PFIC is generally defined as an entity that receives mainly passive investment income or holds mainly passive investment assets. Specifically, a foreign corporation is defined as a PFIC if it meets either of the following tests that apply to passive income:

- Income Test: 75 percent or more of the corporation's gross income is passive income (interest, dividends, capital gains, rents, etc.),[1] or
- Asset Test: 50 percent or more of the corporation's total assets are passive assets. Passive assets include cash and any investments that produce passive income (such as interest, dividends, rents and/or capital gains).[2]

PFICs often include foreign-based mutual funds, exchange-traded funds (ETFs), money market accounts, and other pooled investment vehicles such as many foreign real estate investment trusts that have at least one U.S. shareholder.



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Finally, a foreign holding company that possesses passive investments, like rental real estate or government bonds, would be subject to PFIC regulations if the company is set up as a foreign corporation (based on the U.S. code definition of a foreign corporation).

PFICs are subject to complicated and strict tax guidelines, which cover treatment of these investments in Sections 1291–1297 of the Internal Revenue Code. Both the PFIC and the shareholder must keep accurate records of all transactions, including share basis, dividends and any undistributed income earned by the company in order to complete all required reporting.

The taxation of PFICs is built on the idea of removing the benefit of U.S. tax deferral on all passive investments by foreign entities.

PFIC History

The PFIC tax regime was created via the Tax Reform Act of 1986 with the intent to level the playing field for U.S.-based investments such as mutual funds. Prior to the legislation of 1986, U.S.-based mutual funds were forced to pass through all investment income earned by the fund to its investors, resulting in taxable income.

U.S. taxation of foreign corporations was strictly tied to control of the corporation held by U.S. persons. This allowed not only foreign mutual funds to avoid U.S. taxation but also U.S. persons who invested in them. For starters, the fund itself avoided U.S. taxation, because it was a foreign corporation that derived only foreign-source income. The fund was able to avoid the taint of being classified as a controlled foreign corporation because it was owned by a large number of U.S. and foreign investors, each of whom owned a relatively small percentage.

The enactment in 1986 of the Tax Reform Act changed all that. For starters, it significantly expanded the reach of U.S. taxing authorities with respect to passive investment income earned by U.S. persons through foreign corporations. An important feature of PFIC taxation is that it applies without regard to the extent of U.S. ownership.

The taxation of PFICs is built on the idea of removing the benefit of U.S. tax deferral on all passive investments by foreign entities. The rules achieve this end in one of two ways: first, by directly taxing U.S. investors in PFICs, and second, by imposing an interest charge on these investments on deferred distributions and dispositions (gains).

After the passage of the Tax Reform Act of 1986, the main advantage of foreign mutual funds was effectively nullified by a tax regime that made the practice of delaying the distribution of income prohibitively expensive for most investors.

To employ this punitive regime, the IRS requires shareholders of PFICs to effectively report undistributed earnings via choosing to be taxed through one of three possible methods. Each method is designed to eliminate the benefits of deferral. However, each differs in the way it accomplishes this objective.

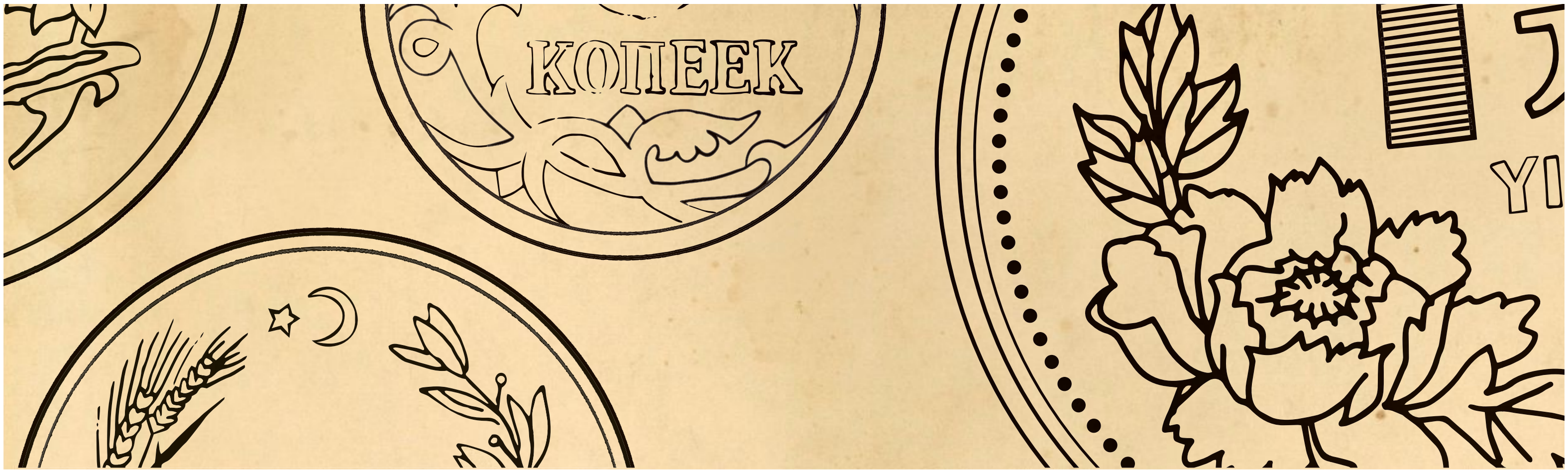
The specifics depend on whether the shareholders of the PFIC have made an election such as an “election to mark-to-market (MTM) PFIC stock,” “election to treat the PFIC as a qualified electing fund (QEF),” or whether the “default” PFIC tax regime of Sec. 1291 applies.

Qualified Election Fund

The QEF is designed to reduce the complex default treatment of PFIC taxation. The QEF election puts U.S. shareholders in a position almost the same as if they had invested in a domestic mutual fund. It accomplishes this by allowing shareholders the opportunity to elect to be taxed currently on their pro rata share of the PFIC’s earnings and profits. The included income is treated as ordinary income to the extent of the taxpayer’s pro rata share of the QEF’s ordinary income, and capital gains to the extent of the taxpayer’s *pro rata* share of the QEF’s net capital gain.

However, to make this election, shareholders must receive a PFIC Annual Information Statement every year the election is in effect.[3] An authorized representative of the PFIC must sign it.[4] For foreign mutual funds that are PFICs, this is not a very common election to qualify for, as very few foreign mutual fund companies are willing to issue the Annual Information Statement to shareholders as required.

A QEF election must generally be made during the first year of ownership no later than the due date (including extensions) of the tax return. While you cannot make a late or retroactive QEF election, it is possible to make a QEF election for the current year and future years. Making what is known as a



purging election, which is in essence making a pretend sale of the PFIC under the excess distribution regime, a QEF election can be made prospectively.

Mark to Market

To make an MTM election, the PFIC must be marketable stock that is regularly traded on a national exchange registered with the U.S. Securities and Exchange Commission or other exchange or market that meets IRS qualifications.[5]

With this election at the end of each year, MTM gains are calculated as if there was a disposition of the PFIC stock on the last day of the tax year. The MTM gain is taxed at the ordinary income tax rate and the basis of the PFIC stock is increased by the MTM gain included in income.

Most foreign mutual fund holdings will qualify for an MTM election if the election is timely made. To be timely made, an MTM election must be made during the first year of ownership no later than the due date (including extensions) of the tax return.

However, the problem is that a timely election is often not made, as the taxpayer is not even aware that he or she has a PFIC holding. While there is no option to make a late or retroactive election, you can make an MTM election prospectively by having a "pretend" sale of the PFIC holding under the excess distribution rules as of the last day of the tax year. Then, in the following year, the MTM rules will apply.

Default Rules

A taxpayer who does not make an election is taxed under the default PFIC tax regime of Sec. 1291. Under this regime, taxpayers are permitted to defer taxation of a PFIC's undistributed income until the PFIC makes an excess distribution. An excess distribution includes the following:

- a disposition (*i.e.* sale) gain realized on the sale of PFIC stock
- any actual distribution made by the PFIC, but only to the extent that the total actual distributions received for the year exceed 125 percent of the average actual distribution received in the preceding three taxable years (or, if shorter, the taxpayer's holding period before the current taxable year)

Sec. 1291 is designed to eliminate and penalize the tax benefit of deferral on PFIC investments. Taking a big-picture view makes it easier to understand how PFIC taxation undoes this advantage. First, the economic value of deferral of U.S. taxation is the *time value* of the deferral itself. And second, PFIC taxation takes back the time value of deferral through the deferred tax amount.

Critical to understanding how PFIC taxation takes back the time value of deferral through the deferred tax amount is the treatment of excess distributions. An excess distribution is treated as if it has been realized *pro rata* over the holding period for the PFIC's stock.

With that in mind, the effect of a *pro rata* realization of an excess distribution becomes painfully obvious: The tax due on such a distribution is the sum of deferred yearly tax amounts plus interest. But the worst is yet to come. And that is that the deferred yearly tax amounts are calculated using the *highest tax rate* in effect in the years that the income was accumulated.

Very simply, this method unilaterally eviscerates the benefits of deferral by assessing an interest charge on the deferred yearly tax amounts. While there is no silver lining, taxpayers can take some comfort in the fact that they can claim a direct foreign tax credit for any withholding taxes imposed on PFIC distributions and dispositions.

To calculate the "excess distribution" for a sale (called a disposition), first the gain must be calculated and then the excess distribution (gain) is allocated to each day in the holding period and separated between the current tax year and prior years. The portion allocated to the current tax year is taxed as ordinary income at the ordinary income tax rate applicable to the taxpayer during the current tax year.

Tax is then calculated on the allocated excess distribution applicable to the prior years based on the highest ordinary income tax rate in effect for the tax year to which it was allocated. Current-year tax is then increased by this deferred tax with interest as if the deferred tax were an underpayment for the prior years in which this excess distribution is attributed.

The purpose is to in effect change the recognition of income and impose an interest charge based on deemed tax underpayments for prior years.

The taxpayer does not recognize a loss realized on a Sec. 1291 disposition. However, there are proposed regulations that may change this current treatment at some point in the future, but such proposals have been circulating for years.

An example will help illustrate how Sec. 1291 operates.

Fred is a U.S. citizen who invests in mutual funds. On the advice of his broker in the United Kingdom, on January 1, 2013, he buys 1,200 shares of FORmut for USD $2,400, a mutual fund incorporated in the United Kingdom. Because FORmut only earns passive income on passive assets, it is a PFIC.

Not having any knowledge of international tax or the PFIC rules, Fred and his

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tax preparer fail to make any election. On December 31, 2015, Fred sells (disposes of) all 1,200 of his FORmut shares upon learning of the punitive tax treatment of PFICs for total proceeds of USD $5,400.

Because Fred never made any election, Fred must "throw back" the entire USD $3,000 gain received over the entire period that he owned the FORmut shares: $1,000 to 2013, $1,000 to 2014, and $1,000 to 2015. For each of these years, Fred will pay tax on the thrown-back gain at the highest ordinary income tax rate in effect that year with interest.

Form 8621 Filing Requirements

As far as filing requirements go, a U.S. person must file for each PFIC owned on Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) if the U.S. taxpayer:

- received direct or indirect distributions (i.e. dividends) from a PFIC
- recognizes gain on a direct or indirect disposition (i.e. a sale) of PFIC stock
- is reporting information with respect to a QEF or MTM election
- is making an election such as a QEF or MTM election
- the aggregate value of the U.S. person's PFIC stock is more than $25,000 and is required to file an annual report

Adding to the complexity and volume of paperwork is that a separate Form 8621 must be filed for each PFIC (*i.e.* each separate mutual fund) owned.

Form 8621 is attached to the shareholder's tax return and both must be filed by the due date, including extensions, of the return at the Internal Revenue Service Center where the tax return is required to be filed.

Consequences for Failing to File Form 8621

Sec. 1298(f) and the regulations do not impose a specific penalty for failing to file Form 8621. However, failure to file a required Form 8621 can result in suspension of the statute of limitations with respect to the shareholder's entire tax return until the Form 8621 is filed. This means that the IRS could potentially have an unlimited amount of time to audit a U.S. shareholder's tax return and assess tax if the shareholder fails to file a required Form 8621. However, this comes with an important caveat. To the extent that the shareholder has reasonable cause for failing to file Form 8621 (*i.e.*, a defense), the statute of limitations can be suspended only with respect to unreported PFIC investments and not to any unrelated portions of the individual tax return.

It is also important to note that under Sec. 6038D, a U.S. individual must disclose any directly held specified foreign financial assets on Form 8938 (Statement of Specified Foreign Financial Assets) if the aggregate value of the individual's specified foreign financial assets exceeds the filing requirement threshold. A U.S. taxpayer who fails to disclose a directly held PFIC investment on either Form 8621 or Form 8938 can be subject to a $10,000 penalty under Sec. 6038D(d).

Foreign Mutual Fund Pitfalls

As one can imagine, many U.S. taxpayers abroad invest in foreign mutual funds not knowing the PFIC rules, unaware of the pitfalls of such investments. Taxpayers should be advised by their U.S. tax professional to pay particular attention to investments in foreign mutual funds and other investments that could be deemed to be a PFIC, particularly when investing through foreign banks and brokerages.

Before making a foreign investment, taxpayers should proceed with caution and be aware of the punitive tax consequences and significant costs of compliance of investing in foreign mutual funds. **EA**

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ENDNOTES

1. IRC Sec. 1297(a)
2. IRC Sec. 1297(a)
3. Sec. 1.1295-1(f)(2)(C)
4. Sec. 1.1295-1(g)(1)
5. Sec. 1.1296(e))