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a closer look

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GLOBAL TAX WEEKLY
a closer look

Global Tax Weekly – A Closer Look

Combining expert industry thought leadership and the unrivalled worldwide multi-lingual research capabilities of leading law and tax publisher Wolters Kluwer, CCH publishes Global Tax Weekly — A Closer Look (GTW) as an indispensable up-to-the minute guide to today's shifting tax landscape for all tax practitioners and international finance executives.

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Understanding The PFIC Rules And The Implications Of Owning Foreign Mutual Funds

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Proceed With Caution Before Investing In Foreign Mutual Funds

While many portions of the US tax code possess confusing and sometimes harsh rulings, the tax rules for Passive Foreign Investment Companies (PFICs) is almost unmatched in its complexity and almost draconian features. Countless times, Americans overseas uncover a startling revelation that the small foreign investment they had made in a non-US 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 US taxpayers can be advised of the consequences by their US tax professional.

What Is A PFIC?

There are two central elements that form the basis of PFIC taxation:

(1) "The definition of a PFIC";[1] and
(2) "The tax regime imposed on US owners of shares." [2]

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.*);[3] 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).[4]

PFICs often include foreign-based mutual funds, exchange-traded funds (ETFs), money market accounts and other pooled investment vehicles (such as many foreign REITs) that have at least one US shareholder. 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 US code definition of a foreign corporation).

PFICs are subject to complicated and strict tax guidelines, which cover treatment of these investments in Sections 1291 through 1297 of the income tax 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.

PFIC History

The PFIC tax regime was created *via* the Tax Reform Act of 1986 with the intent to level the playing field for US based investments (such as mutual funds). Prior to the legislation of 1986, US-based mutual funds were forced to pass-through all investment income earned by the fund to its investors (resulting in taxable income).[5]

US taxation of foreign corporations was strictly tied "to control of the corporation held by US persons." [6] This allowed not only foreign mutual funds to avoid US taxation, but also US persons who invested in the fund. For starters, the fund itself avoided US 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 (or "CFC") because it was owned by a large number of US and foreign investors, each of whom owned a relatively small percentage.

The enactment in 1986 of the passive foreign investment company (or "PFIC") changed all of that. For starters, it significantly expanded the reach of US taxing authorities with respect to passive investment income earned by US persons through foreign corporations. An important feature of PFIC taxation is that it applies without regard to the extent of US ownership.

The taxation of PFICs is built on the idea of "denying to United States persons – and hence capturing for the US Treasury – the value of deferral of US taxation on all passive investments channeled through foreign entities." [7] The rules achieve this end in one of two ways: first, by directly taxing US investors in PFICs,[8] and second, by indirectly "imposing an interest charge on the deferred distributions and gains of these investors." [9]

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,[10] such as an election to treat the PFIC as a QEF (qualified electing fund), "election to mark-to-market PFIC stock," or whether the "default" PFIC tax regime of Section 1291 applies.

Qualified Election Fund (QEF)

The QEF is designed to "[ease] the complexities of PFIC taxation for US investors in foreign mutual funds." [11] The QEF election puts US shareholders in a position almost equal to as if they had invested in a domestic mutual fund. It accomplishes this goal by allowing shareholders the opportunity to elect to be taxed currently on their *pro rata* share of the PFIC's earnings and profits.[12] 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." [13]

However, to make this election, shareholders must receive a PFIC Annual Information Statement every year the election is in effect (Regs. §1.1295-1(f)(2)(C)). It must be signed by an authorized

representative of the PFIC (Regs. §1.1295-1(g)(1)). 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.

Mark-To-Market (MTM)

To make an MTM election, the PFIC must be "marketable stock" that is regularly traded on a national exchange registered with the SEC or other exchange or market that meets IRS qualifications (§1.1296(e)). With this election at the end of each year, gains are calculated *versus* the beginning of year basis and taxed at ordinary tax rates under IRC Section 196. Most foreign mutual fund holdings will qualify for an MTM election if the election is timely made. However, the problem is that a timely election is often not made as the taxpayer is not even aware that they have a PFIC holding.

Default Rules?

A taxpayer who does not make an election is taxed under the "default" PFIC tax regime of Section 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 (*i.e.,* dividend) 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).

Section 1291 very roughly "negates the tax benefit of deferral." [14] Taking a "big picture" view makes it easier to understand how PFIC taxation undoes this advantage. First, the economic value of deferral of US 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." [15]

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." [16]

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." [17] But the worst is yet to come. And that is that the "sum of the deferred yearly tax amounts is calculated using the *highest tax rate* in effect in the years that the income was accumulated." [18]

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 with respect to any withholding taxes imposed on PFIC distributions." [19]

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 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.[20] 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.

An example will help illustrate how Section 1291 operates. This example is based on a similar hypothetical that comes from the creative genius of Professor Robert Misey in his book, *Practical Guide to US Taxation of International Transactions*:

> Fred is a US 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 USD2,400, 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 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 USD5,400.
>
> Because Fred never made any election, Fred must "throw-back" the entire USD3,000 gain received over the entire period that he owned the FORmut shares: USD1,000 to 2013, USD1,000 to 2014, and USD1,000 to 2015. "For each of these years, Fred will pay tax on the thrown-back gain at the highest tax rate in effect that year with interest." [21]

Form 8621 Filing Requirements

As far as filing requirements go, a US person must file, for each PFIC owned, the Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund* if the US 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 mark-to-market election;
- Is making an election such as a QEF or mark-to-market election; or
- The aggregate value of the US person's PFIC stock is more than USD25,000 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.[22]

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.

What Are The Consequences Of Failing To File Form 8621?

Section 1298(f) and the regulations do not impose a specific penalty for failing to file Form 8621. However, the regulations coordinate the Form 8621 filing requirements with the Form 8938, *Statement of Specified Foreign Financial Assets* filing requirements.

Professor Misey explains how this works:

> "Under Section 6038D, a US individual must disclose any directly held foreign financial assets on Form 8938 if the aggregate value of the individual's foreign financial assets exceeds a certain filing threshold. An exception to this requirement applies to any foreign financial asset the individual reports on another disclosure form, such as Form 8621.
>
> A US individual shareholder who fails to disclose a directly held PFIC investment on either Form 8621 or Form 8938 can be subject to a USD10,000 penalty under Section 6038D(d). In addition, 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." [23]

This means that the IRS could potentially have "an [unlimited] amount of time to audit a US shareholder's tax return and assess tax if the shareholder fails to file a required Form 8621." [24] 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 is suspended only with respect to unreported PFIC investments … [and not to any] unrelated portions of the shareholder's tax return." [25]

Foreign Mutual Fund Pitfalls

As one can imagine, many US taxpayers abroad invest in foreign mutual funds unbeknownst to the PFIC rules, so this ends up being a very common occurrence where they are unaware of the pitfalls of such investments. Taxpayers should be advised by their US 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.

Endnotes

1. Joseph Isenbergh, *International Taxation*, Second Edition, Foundation Press, 2005, at p. 211.
2. *Id.*
3. IRC Section 1297(a).
4. *Id.*
5. *Supra* note 1, at p. 215.
6. *Id.,* at p. 211.
7. *Id.,* at p. 211.
8. *Id.,* at p. 211.
9. *Id.,* at p. 211.
10. *Id.,* at p. 212.
11. *Id.,* at p. 213.
12. *Id.,* at p. 213.
13. Robert Misey, *Practical Guide to US Taxation of International Transactions* (9th Edition), Wolters Kluwer, 2013.
14. *Supra* note 1, at p. 212.
15. *See* IRC Section 1291(a)(1)(C)
16. *Supra* note 13.

[17] *Id*.
[18] *Id*.
[19] *Id*.
[20] *Id*.
[21] *Id*.
[22] *Id*.
[23] *Id*.
[24] *Id*.
[25] *Id*.