How PFIC Tax Rules affect most Americans Abroad

This guide examines the complex tax regulations surrounding Passive Foreign Investment Corporations (PFICs) and how they affect U.S. taxpayers.

"As a result of the Tax Reform Act of 1986 and subsequent legislation, PFICs make investing offshore for U.S. citizens/Permanent-residents punitively taxed with burdensome reporting requirements."

EXECUTIVE SUMMARY

PFIC regulations make offshore investing a headache for U.S. persons

Our paper outlines major takeaways for U.S. taxpayers who have invested in a Passive Foreign Investment Corporation (PFIC), namely:

- Tax treatment of PFICs is highly punitive compared to U.S.-domiciled funds. It explains the filing requirements for shareholders and details three tax elections for reporting PFIC information, including:

    1. The Qualified Electing Fund (QEF) Election
    2. The Mark-to-Market Election
    3. The Default, or "Do Nothing," Approach

- Beyond high tax rates, the stringent tax reporting requirements surrounding PFICs make it time-consuming and expensive to properly comply.
- One of the most effective ways to mitigate the negative financial consequences of PFIC ownership is to invest using individual securities.

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In international and cross-border financial planning, the financial services landscape gets complicated, fast, and missed opportunities can be costly. Expat investors in either country making decisions without specific advice on tax, fees and regulation, may be risking reduced returns and/or lack of compliance.

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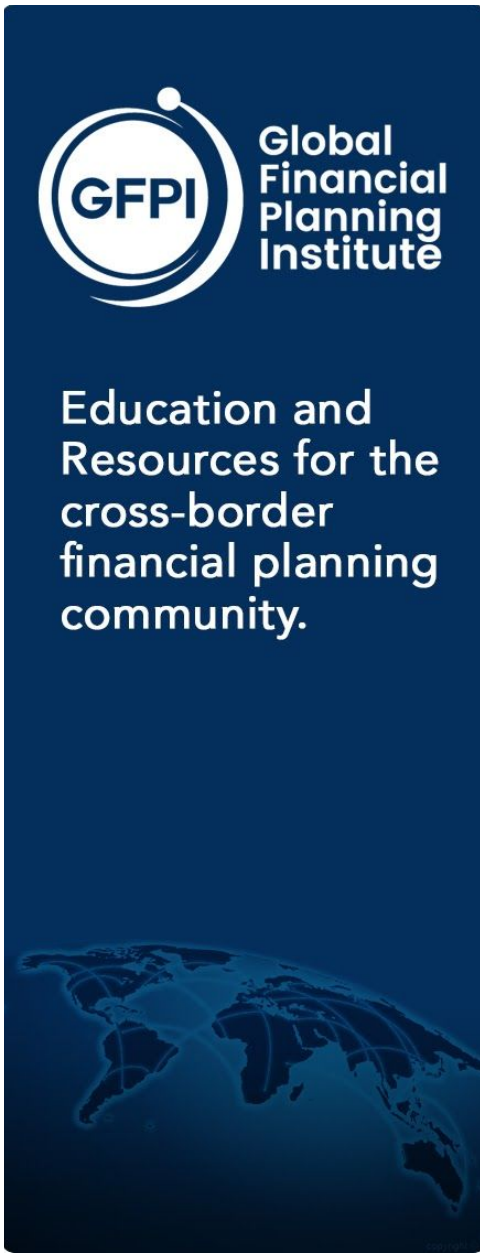

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INTRODUCTION

PFICs and The Cost of Foreign Domiciled Investments to the American US Tax Resident Abroad

This guide examines the complex tax regulations surrounding Passive Foreign Investment Companies (PFICs) and how they affect U.S. taxpayers holding foreign domiciled investments.

The Tax Reform Act of 1986 introduced new reporting requirements for shareholders of certain offshore investment funds. The intention was to encourage investment in domestic investment vehicles and level the playing field between countries where distributed income and gains within a fund are not taxed on an annual basis.

A Passive Foreign Investment Corporation (PFIC) is any foreign corporation that meets either an *income* test or an *asset* test. All non-U.S. domiciled mutual funds, ETFs, money market funds, listed investment companies and real estate funds held outside of retirement accounts are PFICs.

Knowledge of PFICs is pertinent to the investment strategy of Americans abroad and expatriates in the United States for two main reasons:

a) PFICs make investing offshore for U.S. citizens/Permanent residents highly tax-inefficient, and

b) They impose burdensome tax reporting requirements.

Since filing a U.S. tax return as a PFIC shareholder can come with multiple challenges, it is imperative to consider these regulations when reviewing a client's offshore investments.

"Understanding the tax treatment of PFICs can help you make the most of your international investments"

1. Background

While many parts of the U.S. tax code are both convoluted and punitive, the IRS regulations involving the treatment of Passive Foreign Investment Companies (PFICs) are almost unmatched in their complexity and harsh tax treatment.

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.

These regulations came about as part of the Tax Reform Act of 1986. The purpose of the regulation was to eliminate the beneficial tax treatment for certain foreign investments. Under prior law, U.S. taxpayers could accumulate tax-deferred income from foreign investments and then, upon sale of the investment, recognize the gain (and associated accrual of ordinary income) at the preferential long-term capital gains tax rate. The prior law put U.S. managed funds at a disadvantage as they are required to pass-through all income to the shareholder in the year earned. The new IRS PFIC regulations were designed to create a more level playing field for U.S. funds.

Then in 2010, after a policy review, the IRS determined that all foreign (non-U.S.) domiciled funds and Exchange Traded Funds (ETFs) are to be classified as corporations (rather than trusts) for U.S. tax purposes. This made them subject to the extremely complex and onerous tax consequences of the PFIC tax regime. Consequently, all U.S. citizens, green card holders or others required to file a U.S. 1040 tax return anywhere else in the world are subject to the ridiculously complex set of PFIC rules if they invested in any foreign domiciled managed funds or ETFs.

"Knowledge of, and avoidance of PFIC taxation, is key to improving shareholder returns from foreign domiciled investments."

2. What is a PFIC?

Under § 1297, a Passive Foreign Investment Corporation (PFIC) is any foreign corporation that meets either an *income* test or an *asset* test:

- Income Test: A foreign corporation meets the income test if 75% or more of its gross income is passive income[1]. or
- Asset Test: If 50% or more of its assets are passive income--producing assets

As a result, practically all foreign mutual funds, ETFs, money market funds, listed investment companies and real estate funds held outside of retirement accounts are PFICs. Notably, individual stocks of foreign corporations that do not fail the asset test are not considered PFICs (i.e. operating companies).

There is some uncertainty as to whether the investments held within certain foreign retirement accounts are to be taxed as PFICs.

[1] IRC § 1297(b)(2) excepts from the definition of passive income any income that is from the active conduct of a banking or insurance business, as well as certain interest, dividends, rents, or royalties.

"... there are elections available to help minimize or mitigate the tax treatment under the PFIC regime."

3. PFIC Shareholder Filing Requirements

Beginning in 2013, U.S. citizens, green card holders or any U.S. 1040 tax filer who holds more than U$25,000 in PFIC shares (U$50,000 if married filing jointly) are required to disclose certain information to the IRS on Form 8621 on an annual basis. In previous years, there was a reporting obligation with respect to PFICs only if there was a transaction related to that investment. Now, reporting must be made even if there is no activity.

Disclosure of a PFIC is clearly required for a regular taxable brokerage account. While some uncertainty remains, the final regulations provided by the IRS in early 2017, make exempt all applicable foreign pension funds (or equivalents) under any type of arrangement regardless of their classification for US federal tax purposes[2].

In the meantime, if you are subject to the IRS PFIC requirements, you must file Form 8621 for each PFIC you own with your tax return and you have the option of taking one of two tax treatment elections for each one, or doing nothing.

The first election is to treat the PFIC as a qualified electing fund (QEF), probably the most advantageous of the three options. The second method is the mark-to-market method, which requires the shareholder to report annual increase in market value of the PFIC as ordinary income. If neither of these options is selected, the "default" method is employed, in which the investment is treated like a Section 1291 Fund (Excess Distributions).

[2] "There are several tax treaties that include such a provision, though many apply only if the IRS has specifically agreed that the foreign plan generally corresponds to a US plan which may require a specific competent authority request submission (some provide for 'automatic' treatment for plans). Certain treaties provide relief only for contributions to foreign pensions, but not earnings, and thus this exception would not apply.
Note that general employee trusts – as opposed to foreign pension funds – are not PFICs. The former is a much more common occurrence with respect to mobile employees." "United States: Passive foreign investment company (PFIC) guidance provides new reporting exceptions and clarifications," Insights from Global Mobility, Price Waterhouse Coopers, Feb 20, 2017

4. Tax Treatment of a PFIC

The Qualified Electing Fund (QEF) Election under § 1295.

- Make a QEF election by filing Form 8621
- The election must be made in the first year the interest is a PFIC

If the QEF election is taken, a U.S. taxpayer's investment in a PFIC is generally subject to the same tax rules and rates as a domestic investment, except dividends are not considered qualified dividends and subject to ordinary income. The taxpayer includes a pro rata share of the PFIC's ordinary earnings and net capital gains on their U.S. tax return each year.

Let's look at an example:

An investor owns five shares of ABC Managed Fund, an Australian managed fund that qualifies as a PFIC. At the end of the year, the managed fund as a whole earns $50,000 in investment income and $75,000 in capital appreciation. To figure out the tax due according to the QEF method, the investor needs to know their proportionate ownership of the managed fund so they can calculate the income and gains attributed to them. If there are 500 shares outstanding, we can calculate the investor of five shares owns 1% of the fund. Therefore, the investor is taxed on $500 of investment income and $750 of capital gains on their U.S. return.

This method seems quite straightforward; however, there is one major obstacle. In order to take the QEF election, the managed fund (PFIC) must comply with substantial IRS reporting requirements. The PFIC itself must provide an Annual Information Statement to the shareholder, which must include the shareholder's pro rata share of the PFIC's ordinary earnings and net capital gains for that tax year. Because most foreign managed funds are unaware of these requirements, or may not be willing to comply because of the cost[3], the QEF election is not frequently available to U.S. 1040 tax filers invested in foreign managed funds.

[3]That is changing as Americans pull their money from these managed funds

The Mark-to-Market Election (§ 1296)

The shareholder can elect to treat the PFIC using the "mark-to-market" method if the PFIC is considered a "marketable" stock or fund. To be considered a "marketable" stock or fund, the PFIC must be regularly traded on either a national securities exchange that is registered with the SEC, the national market system established by the Securities Exchange Act of 1934, or a foreign exchange regulated by a governmental authority of the country in which the market is located (like the Australian Stock Exchange).

If the mark-to-market election is taken, the PFIC holder recognizes the gain or loss on the shares of the fund as if they had sold all shares at fair market value at the end of the taxable year. The gain or loss is treated as ordinary income on the U.S. return, an unfavorable tax treatment for most individuals. Unrealized losses are only reportable to the extent that they offset previously reported gains. Upon the sale of the PFIC shares, all gains are reported as ordinary income whereas losses are reported as capital losses on Schedule D.

Let's look at some examples to illustrate the potential adverse tax consequences of the mark-to-market method.

First, let's look at the issue of taxation on unrealized capital gains from managed funds. Let's assume you purchase $50,000 of XYZ Fund, a British managed fund that qualifies as a PFIC, but does not provide the necessary information to select the QEF option. Therefore, you elect the mark-to-market tax treatment. At the end of the year, your position in the fund is worth $60,000, a 20% gain. Let's also assume that the fund is managed in a tax-efficient manner so no capital gain distributions occurred during the year. On your U.K. tax return, no tax is due from this investment since no distributions were made from the fund.

However, for U.S. tax purposes, you would be taxed on the $10,000 gain in value according to the mark-to-market tax method. Furthermore, this gain would be characterized as ordinary income for U.S. tax purposes. . . an unfavorable tax outcome. The same tax disadvantages hold true for all other managed funds and Exchange Traded Funds that qualify as PFICs.

Let's turn to an example involving the sale or disposition of an asset using the mark-to-market method for an Australian and U.S. tax resident (i.e. dual citizens and green card holders). To begin, let's assume you buy $50,000 of QRS Fund that is NOT a PFIC (i.e. a portfolio of individual shares). The investment does very well and you sell it one year and one day later for $75,000. As an Australian tax

resident in this example, with long term capital gains treatment, one-half of the gain is taxable at your ordinary income rate. The highest marginal bracket for the 2018-19 tax year was 45% (+ 2% for the medicare levy). Therefore, the tax rate on the capital gain would be 23.5%. For U.S. purposes, the gain would be taxed at 20%, the top long-term capital gains tax rate (we assume the 3.8% surtax of investments does not apply). Since the Australian tax exceeds the U.S. tax, no U.S. federal tax is due because of the foreign tax credits permitted by the Australia/U.S. Tax treaty. U.S. state income tax may also be due on this sale.

Let's look at the scenario again, but this time the investment qualifies as a PFIC. For U.S. tax purposes, you pay your highest marginal income tax rate on the gain, which is currently 37% (once again, we will assume the surtax of 3.8% does not apply). The tax rate in Australia remains at 23.5%. Since the U.S. tax exceeds the Australian tax, you could owe the IRS 14.6% of the $25,000 gain, or an additional $3,650 in tax if no other foreign tax credits were available, and possibly State income tax.

Interest on Tax Deferral / Excess Distributions (§ 1291)

If neither election is made (i.e. the "do nothing approach"), the PFIC will be considered a Section 1291 and the shareholder is subject to even more complex and generally less favorable treatment.

The general penalty for investing in a PFIC is that "excess distributions," including gains from the sale of the PFIC, are thrown back over the shareholder's holding period and subject to tax at the shareholder's highest ordinary income tax rate in each throwback year.

The definition of an "excess distribution" is:

1. The part of the distribution received from a Section 1291 fund in the current tax year that is greater than 125% of the average distributions received in respect to such stock by the shareholder during the 3 preceding tax years (or, if shorter, the portion of the shareholder's holding period before the current tax year).

2. Any capital gains that result from the sale of PFIC shares.

- 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.

Let's look at an illustration of the "excess distribution" rules at work:

An Australian resident buys 100 shares of REM fund (a PFIC) on January 1, 2010, valued at $1,000 per share for a total investment of $100,000. The fund distributes $80 per share in dividends every year. On December 31, 2012, the shares were sold for $250,000. Since the dividends each year never exceeded the prior year's amount, there are no excess distributions relating to dividends (point 1 from above). However, since the sale resulted in a capital gain of $150,000, the gain is an excess distribution and will be allocated over the life of the investment. In particular, the excess distribution

would be allocated $50,000 for 2010, $50,000 for 2011, and $50,000 for 2012. The taxable amounts in 2010 and 2011 are taxed at the highest marginal tax rate for those tax years (35%). Furthermore, the resulting additional tax for 2010 and 2011 draws an interest charge as if it were an underpayment of taxes for the year in question. Fortunately, amended returns don't need to be filed, the underpayment of taxes is simply included on line 16c of Form 8621. The allocation of the final $50,000 of gains is added to ordinary income on line 21 on the 2012 1040 and subject to the taxpayer's marginal tax bracket for that year.

Moreover, the taxable amounts allocated to the prior year PFIC period are not included in the investor's income. Rather, the tax and interest are added to the investor's tax liability without regard to other tax characteristics. This means that tax and interest is payable even if the investor otherwise had a current loss or net operating carryovers.

Investment Alternatives to PFICs

The stringent tax treatment of PFICs makes U.S. domiciled investments a more practical choice for Americans tax residents. Nevertheless, there will be circumstances when investing offshore is simply more appropriate for a given client. Given the paucity of Qualified Electing Funds (QEFs), the best investment approach will be an investment in individual securities like stocks, bonds or direct real estate.

Separately Managed Accounts (SMAs) are a convenient way for a retail investor to hold beneficial ownership in the underlying stock or bond while avoiding PFIC taxation; however, these require substantial knowledge and expertise to properly manage. An SMA avoids much of the complications associated with PFIC tax filing requirements.

Conclusion

As you can see, the complexity and punitive nature of the PFIC rules render most individual taxpayers incapable of filing their own returns without qualified, professional assistance. The American Institute of CPAs (AICPA) wrote a letter to the IRS in May of 2013 asking the IRS to provide an exemption for certain shareholders in PFICs that include: shareholders with ownership of less than 2% in a PFIC, shareholders that don't know they own a PFIC or PFICs that did not notify its shareholders of its status as a PFIC. This would eliminate many innocent taxpayers from having to comply with these complex, draconian tax rules. Hopefully, the IRS will heed some of what the AICPA is saying.

Updates:

- In December 2018, the IRS and the U.S. Treasury Department proposed changes to the guidelines of taxing PFICs. If approved, the new regulation will reduce some of the existing rules from the Foreign Account Tax Compliance Act (FATCA) and will more precisely define an investment entity[4].
- Dual resident tax payers: The new regulations provide a welcome change for certain foreign nationals who maintain tax residency in treaty countries. There is now an exception to filing Form 8621 for dual resident taxpayers that determine any US income tax liability as a nonresident alien for the taxable year pursuant to treaty tie-breaker provisions. Under this exception, the taxpayer must file either Form 1040NR (US Nonresident Alien Income Tax Return) or Form 1040NR-EZ (US Income Tax Return for Certain Nonresident Aliens With No Dependents), including a treaty-based return position disclosure in accordance with regulations.

  A similar exception is provided for a dual resident taxpayer that determines any US income tax liability as a nonresident alien for only a portion of the tax year pursuant to treaty tie-breaker provisions and files a so-called 'dual-status' income tax return. This exception requires Form 8621 to be filed (and PFIC tax consequences to apply) only for the portion of such taxable year that Form 1040NR does not apply.

[4] "FATCA Proposed Regulations," Maynor, J., Raghuvanshi, P., National Law Review, Dec 19, 2018

This exception generally mirrors an exception for the filing of Form 8938 (Statement of Specified Foreign Financial Assets) that was adopted in response to public comments. This welcome change hopefully signals the start of a trend for other foreign information reporting requirements for those individuals filing Form 1040NR under the tie-breaker provisions of an income tax treaty. These types of exceptions can generate significant time savings.

- PFIC stock held by certain foreign pension funds: The temporary PFIC regulations provided an exception for certain foreign pension funds. Specifically, no Form 8621 must be filed for PFIC interests that are owned through a foreign trust that is a foreign pension fund operated principally to provide pension or retirement benefits where an income tax treaty essentially provides that the earnings from the pension fund are not taxable until distribution. Effectively, this exception only applied to those foreign pension funds treated as foreign trusts under entity classification rules for US tax purposes. The final regulations expand this exception to include all applicable foreign pension funds (or equivalents) under any type of arrangement regardless of their classification for US federal tax purposes. This exception applies for any beneficiary of, participant in, a plan, trust, scheme, or other arrangement that is treated as a foreign pension fund if an income tax treaty states that any income from the fund is only taxed when it is paid to the shareholder. There are several treaties that include such a provision, though many apply only if the IRS has specifically agreed that the foreign plan generally corresponds to a US plan which may require a specific competent authority request submission (some provide for 'automatic' treatment for plans). Certain treaties provide relief only for contributions to foreign pensions, but not earnings, and thus this exception would not apply. Note that general employee trusts – as opposed to foreign pension funds – are not PFICs. The former is a much more common occurrence with respect to mobile employees[5].

[5] "United States: Passive foreign investment company (PFIC) guidance provides new reporting exceptions and clarifications," Insights from Global Mobility, Price Waterhouse Coopers, Feb 20, 2017

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