MASECO

Do you own PFIC investments?

Passive Foreign Investment Companies (PFICs) form part of the 1986 IRS tax reforms that closed loopholes being used to protect offshore investments from taxation. The 1986 tax reforms not only sought to close the loophole, but also to bring such offshore investments under US taxation and deter US taxpayers' interest in such investments through punitive tax rates.

What determines PFIC Status

The PFIC regime applies when a US person owns an interest in a foreign corporation that is treated as a PFIC, i.e., if either the 50 percent asset test or 75 percent income test is satisfied.

- **Income Test** - at least 75% of the corporation's gross income is "passive". Income from investments would be passive, but not that from the company's regular business operations.
- **Asset Test** - at least 50% of the company's assets are investments which produce income in the form of earned interest, dividends or capital gains.

PFICs are fairly easy to identify as they encompass almost all pooled investments registered outside of the US, including mutual funds, exchange-traded funds (ETFs), closed-end funds, hedge funds and insurance products. Furthermore, unsuspecting US persons can be caught out as investments such as a money market fund held within bank accounts can also be considered a PFIC.

However, the PFIC regulations have provided an exception for investments held inside foreign pension funds. Some plans can be exempt from PFIC rules where the plan is deemed "qualified" under the terms of a double-taxation treaty between the U.S. and the respective country. A qualified pension fund operates principally to provide pension or retirement benefits, the treaty provides that the earnings from the pension fund are not taxable until distribution.

Taxation of PFICs

For US taxpayers the determent of investing into PFICs is not only through high taxation rates, but additionally through the lengthy and onerous 4-page 8621 form which is used to report income from foreign mutual funds. Completion of this form is estimated by the IRS to take up to 22 hours a year. Adding to the complexity and volume of the necessary administrative work, a separate Form 8621 is required for each PFIC owned.

Additionally, as American expatriates most commonly own PFICs, this creates a requirement to appoint an expatriate tax specialist to manage your affairs creating further additional cost and administrative burden for holders of PFICs.

Under the PFIC regulation, income and gains from PFICs no longer benefit from the lower capital gains tax rate of other investments. Instead, revenue from PFICs is now taxed at the highest rate of income tax, regardless of your personal income tax rate.

PFIC Reporting and Tax strategies

Under the IRS PFIC rules, a few elections and reporting methods can be employed to reduce the taxes paid on PFICs. Using these strategies involves further in-depth and complicated reporting, which is likely to require a tax specialist. In most cases, if the filer does not make the relevant election in the initial year, they will generally lose the opportunity.

Mark to Market – Section 1296

A US person who is a holder of a PFIC can make a mark-to-market (M-T-M) election if the stock is considered "marketable stock". A stock is considered marketable if it is regularly traded. The M-T-M election must be made in the first tax year of the taxpayer's holding period for the PFIC stock.

The M-T-M election allows the unrealised gain allocated to the current tax year to be included as ordinary income. When a M-T-M election is made the taxpayer is obligated to "purge" any prior gain in the PFIC by doing a deemed disposition under section 1291 rules and paying any tax and interest prior to the election. This means that the entire investment is treated as if it were sold for fair market value on December 31st.

Qualifying Electing Fund (QEF)

Investing into a QEF PFIC would allow taxpayers to pay tax under the same rules and rates as tax efficient domestic US investments. This would mean ordinary and capital gain income from the PFIC would flow separately through to the shareholder according to percentage of ownership.

This option is not often available since the PFIC would need to agree to comply with IRS reporting requirements. For a PFIC to be considered to allow for Qualified Electing Fund treatment by the shareholders, the PFIC must provide the US taxpayer with an annual information statement detailing the U.S. taxpayer's proportionate share of ordinary income, capital gains, and distributions made within the relevant tax year. If no annual statement is provided to the taxpayer- no QEF election can be made. Additionally, the PFIC must maintain books under IRS acceptable accounting procedures and compute gain, loss and income each year using those same principles.

PFIC Compliance and Regulation

The requirement to file an individual 8621 form per PFIC is a result of the 2010 FATCA law. FATCA affects individual US persons and foreign financial institutions (FFIs) are now required to report on the assets held by U.S. citizens and U.S. permanent residents directly to the IRS. Although it may seem like a large demand from the IRS, it has been observed that most FIIs globally have complied with the reporting requirements due to the heavy sanctions on non-compliant financial institutions. Therefore, it can be safely assumed that the IRS has a direct and accessible view of US person's holdings held in FIIs. Therefore, the regulation on correct PFIC reporting (forms 8938 and 3621) can be monitored, correctly taxed and implemented efficiently by the IRS.

Summary

The issue of PFICs increases the complications of compliance with the international tax regimes to which American expat investors may be bound. For many years after the original 1986 PFIC regulation, US persons could safely ignore the rules due to lack of cross-border financial transparency which made it difficult for the IRS to enforce. However, the 2010 FATCA legislation created a new era of information sharing. This has meant that the opportunity cost on incorrect reporting on PFIC investments for US persons and expats has dramatically increased with the IRS much more likely to uncover any mishaps.

PFICs are generally best avoided by US expats. At MASECO, we recommend adopting a tax efficient investment strategy in one's portfolio, it will likely save time, reduce cost and preserve after-tax investment returns.

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• Information about potential tax benefits is based on our understanding of current tax law and practice and may be subject to change. The levels and bases of, and reliefs from, taxation is subject to change. The tax treatment depends on the individual circumstances of each person and may be subject to change in the future.
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