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PFIC rules: US passive foreign investment company rules

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Many taxpayers are surprised to learn that they are investors in a passive foreign investment company and that this can have negative tax consequences. The experts from Marcum LLP* can provide a detailed analysis of a taxpayer's PFIC exposure, US tax liability from PFIC investments, and planning opportunities to improve their effective global tax structure.

US PFIC rules are meant to curtail the deferral of current US taxation on passive investments. A PFIC is defined as a foreign corporation that is owned less than 50% by US person(s) and:

- generates primarily passive income (i.e. 75% or more of its annual gross income is passive income) or
- has primarily passive assets (i.e. 50% or more of the average percentage of assets generate passive income).

Disadvantages of owning a PFIC

- US taxation on certain distributions from a PFIC may be taxable at the maximum rate of 37% plus interest for US individuals regardless of their graduated income tax rate;
- 20% long term capital gains ("LTCG") rates are not available on the sale of PFIC shares; and
- Generally, tax-free transactions with PFICs are disallowed (e.g., mergers).

Contact us for an analysis of your global tax burden or other international matters.

Benny Taveras, CPA, Marcum LLP*, Miami, Florida, USA

Common PFIC Pitfalls

The following are the most common investment scenarios that trigger PFIC status:

- Foreign pensions or life insurance policies that hold underlying investments in foreign entities, such as foreign pensions that hold foreign ETFs or unit linked insurance plans ("ULIPs");
- Foreign real estate companies that rent properties, but do not have their own active employees to manage such properties; and
- Foreign corporations that offer a separate class of stock to fund the acquisition of passive income-generating investments.

Exceptions and elections that may apply to PFICs

Exceptions

- Start-up rule:
- Not a PFIC for the "start-up year" (i.e., first taxable year such corporation earns gross income) if it was not a PFIC in prior years or two years after the start-up year.
- Change of business rule:
- Not a PFIC if it was never a PFIC, and it sold its trade or businesses to start a new venture that will not be a PFIC.

Elections:

- QEF election:
- By having an annual inclusion of the PFIC’s ordinary and capital gains income by the US shareholder, regardless of distribution, the PFIC rules can be avoided. Note that the PFIC’s income must be calculated on a US basis and the books and records of the company must be available for IRS inspection.
- Future distributions of previously taxed amounts are not taxable again upon distribution.
- Mark-to-market election:
- By having the US taxpayer include the annual built-in stock gain of the PFIC, the taxpayer may also be able to avoid the PFIC rules. Note that this exception is only available if the PFIC’s value is easily obtainable on the open market.

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*Marcum LLP is the exclusive associated partner of ECOVIS International for accounting, tax and audit in the United States of America.