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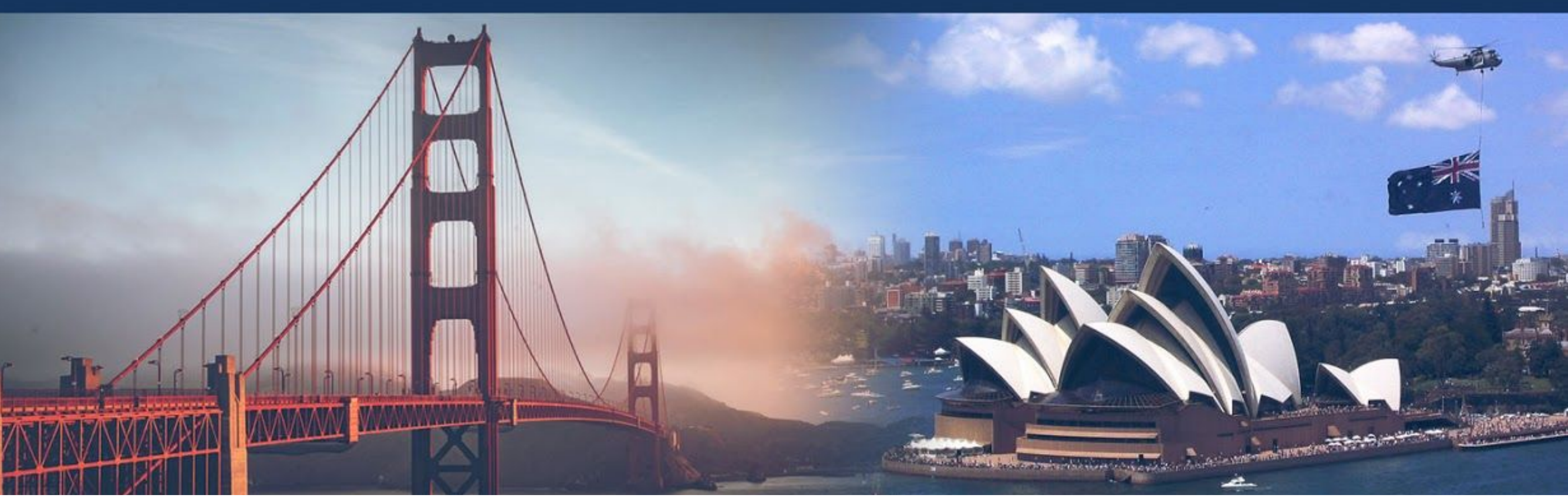
How Passive Foreign Investment Corporation (PFIC) Tax Rules Affect Almost All Americans Abroad



"As a result of the 1986 tax law and subsequent legislation, PFICs may not be an ideal investment strategy for everyone."

CONTENT

INTRODUCTION

Then and Now: The Changing Complexity of Foreign Investments

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

As a U.S. taxpayer, your investments are not solely limited to domestic funds. In fact, foreign investments were historically quite common. But to encourage taxpayers to invest in more U.S.-based mutual funds, the Tax Reform Act of 1986 introduced new reporting requirements for shareholders of certain foreign investment accounts.

One such investment affected by this legislation was the Passive Foreign Investment Corporation (PFIC). As a result of the 1986 law and subsequent tax legislation, PFICs may not be an ideal investment strategy for everyone.

Since filing a U.S. tax return as a PFIC shareholder comes with several challenges, it is imperative to consider these regulations before including this option in your investment strategy.

Independent research with expert insights

The Arete Wealth Strategists team has 7 years of expertise in cross-border finances. We've analyzed years of independent data from Morningstar for insights into a comparison of managed fund investments across the two countries.

Morningstar is an independent Chicago-based investment research firm. Since 2009, the Morningstar Global Fund Investor Experience Study compares investor experience in 25 nations every two years. Nations are ranked based on four elements and assigned an overall score. This analysis uses the 2017 Morningstar Global Fund Investor Experience

Study and the 2019 Morningstar Global Investor Experience Study 2019 (Fees and Expenses).

Partnering For Financial Success

In both Australia and the US, the financial services landscape gets complicated quickly, 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.

About Arete

If your financial life reaches across borders, look for a partner who understands the financial systems in both countries to create an investment plan that works.

Arete Wealth Strategists Australia works with Americans in Australia, Australians living long-term in the US, and Australians leaving the US. We bring strategy, structure, clarity, confidence and compliance to our clients' financial lives.

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Financial Planning and Investment Management

“Understanding the tax treatment of PFICs can help you maximize returns from your international investments”

EXECUTIVE SUMMARY

Stringent PFIC regulations complicate U.S. tax returns

Because of complex U.S. tax regulations, the decision to invest in PFICs requires a discerning eye and good judgment. Make the wrong election, and you may risk facing major penalties in fees and interest. For this reason, incorporating PFICs into your investment portfolio requires additional planning and consideration.

Simply put, as a PFIC shareholder, it's crucial to work with an adviser familiar with international tax law so that you can identify the best tax regime for your circumstances. Understanding the tax treatment of PFICs can help you maximize returns from your international investments.

Key Insights

Our paper outlines major takeaways for U.S. taxpayers considering PFICs as an investment vehicle, namely:

- Tax treatment of PFICs is extremely punitive compared to U.S.-based funds.
- Beyond high tax rates, the stringent guidelines surrounding PFICs make it difficult to comply with the IRS's reporting requirements.
- To mitigate the negative financial consequences of PFIC ownership, even the savviest investors should work with an adviser well versed in international tax law.

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

At A Glance

Some taxpayers may be subject to PFIC tax regulations without being aware of it. Qualified tax professionals can provide guidance in helping PFIC shareholders understand the financial ramifications of each election option should they choose to make one.

WHITE PAPER REPORT

U.S. Tax Challenges for PFIC Shareholders

This paper focuses on the tax challenges posed to U.S. taxpayers that hold a substantial amount of Australian PFIC shares. It explains the filing requirements for shareholders and details three tax elections for reporting PFIC information, including:

- The Qualifying Electing Fund (QEF) Election
- The Mark-to-Market Election
- The Default, or “Do Nothing,” Approach

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 1986 Tax Reform Act. 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.) managed funds and Exchange Traded Funds (ETF's) 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 (including those residing in Australia or anywhere else in the world) are subject to the ridiculously complex set of PFIC rules if they invested in any Australian managed funds or ETFs.

2. What is a PFIC?

A Passive Foreign Investment Company (PFIC) is any foreign corporation that meets either an income test or an asset test (there is no stock ownership test):

- Corporation meets income test if 75% or more of its gross income is passive income, or
- Asset test if 50% or more of its assets are passive income producing assets

As a result of this definition, all Australian (foreign) managed funds, ETFs, money market funds, listed investment companies, real estate funds, and possibly even Superannuation funds (excluding individual stocks) fall squarely into this definition.

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 required in a "non-registered" account (regular taxable brokerage account); however, there is much debate about PFICs held in a "registered" account (like an Superannuation account), as the IRS has not issued guidance on whether they must be disclosed. One may form the opinion that the Australia/US Treaty election taken on Form 8891 or 8833 provides protection from the taxation of PFICs in a registered account. However, to further complicate things, the IRS revised Form 8621 in December of 2012 and included a new "Part I – Summary of Annual Information" that may apply to all PFICs no matter where they are held but . . . Part I is currently "reserved for future use" until the underlying regulations under Section 1298(f) are published which are undetermined at this time.

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. The first election is to treat the PFIC as a qualified electing fund (QEF), probably the most advantageous of the three methods. 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).

4. Tax Treatment of a PFIC

The Qualifying Electing Fund (QEF) Election

- 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 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 Australian managed funds are unaware of these requirements, or may not be willing to comply because of the cost (that is changing quickly as people pull their money from these managed funds), the QEF election is not frequently available to U.S. 1040 tax filers invested in Australian 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 Australian 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 Australian 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 Australian listed Exchange Traded Funds and all other 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. The investment does very well and you sell it later on in the same year for $75,000. As an Australian tax resident in this example, one-half of the gain is taxable at your ordinary income rate. The highest marginal bracket for the 2018-19 tax year is 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 the top ordinary 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.

Do Nothing / Default - 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.

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.

"A financial adviser experienced with international tax and PFICs can help you get more from your investment portfolio."

"Knowledge of international investment accounts is key to maximizing PFIC gains."

Please visit [arete-wa] to schedule a consultation.

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