Chapter 6 Passive Foreign Investment Companies

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a. Introduction

For federal purposes, United States (US) shareholders were able to avoid reporting a deemed dividend from a foreign personal holding company pursuant to the subpart F rules by investing in foreign investment companies with less than 50 percent US ownership. Current income was deferred because either the total US ownership of the foreign corporation was less than 50 percent or no one US person would own 10 percent or more of the total combined voting power of all classes of stock entitled to vote in the foreign corporation. Thus, the foreign corporation did not meet the definition of a controlled foreign corporation (CFC).

Without meeting the definition of a CFC, any gain would be recognized by the US shareholders only when their interest in the foreign corporation was sold or liquidated. Further, the US shareholders were able to convert ordinary income derived from a passive foreign investment into capital gain income.

To combat this perceived abuse, Congress introduced the concept of a passive foreign investment company (PFIC) by enacting Internal Revenue Code (IRC) §1291, §1293 through §1298. The PFIC rules apply to any taxable year beginning after December 31, 1986. These rules:

1. Establish the definition of a PFIC
2. Impose an interest charge on deferred passive income earned by PFIC
3. Tax PFIC distributions, actual or deemed, and dispositions of PFIC stock as ordinary income

The Tax Reform Act of 1986 introduced the concept of a PFIC as an anti-abuse regime to subject to current tax US shareholders investing in foreign corporations generating primarily passive income. Although intended to target a select type of investment, the PFIC rules can apply to any US shareholder (person, corporation, partnership, trust) who owns any amount of stock, directly or indirectly, in any foreign corporation, regardless of the extent of its passive earnings.

California has not conformed to this legislation. The effects of this legislation causes federal/state differences in both a worldwide and water's-edge combined report. Further, the PFIC rules overlap with the subpart F provisions and other code sections.

b. Passive Foreign Investment Company Defined

A foreign corporation is a PFIC if it satisfies either a passive income test or a passive asset test for the taxable year. If a foreign corporation satisfies either of these tests for any taxable year, then the foreign corporation is considered to be a PFIC from that day forward and the PFIC rules apply to that foreign corporation. Once the foreign corporation qualifies as a PFIC, it will be treated as a PFIC (with respect to that shareholder) until it is dissolved unless a qualified electing fund (QEF) election was in place for the entire period owned by the taxpayer or unless an election under IRC §1298(b)(1) is made. (Proposed Treas. Reg. §1.1291-1(b)(1)(ii).)

1. PFIC Passive Income Test

A. IN GENERAL

If 75 percent or more of the foreign corporation's gross income for the taxable year is passive income, then the foreign corporation is a PFIC. Passive income is defined as any income to be considered foreign personal holding company income (FPHCI) within the subpart F provisions, defined by IRC §954(c). (IRC §1297(b)(1).) Refer to WEM 2.3 for the discussion of FPHCI.

Example 1

Tiko Corporation, a foreign corporation, has total revenue of $435,000, of which $238,000 is from the production of ties and $197,000 is dividend and rental income. Does Tiko meet the passive income test?

No. Tiko's passive income is 45 percent of total revenue. The passive income does not exceed the required 75 percent ($197,000/$435,000 = 45%). Tiko is not a PFIC pursuant to the passive income test.

For purposes of the passive income test, gross income is gross sales less cost of goods sold, plus any income from investments or any other source. (Private Letter Ruling 9447016, 94-TNI 229-10.) Thus, the gross income of a foreign corporation for any taxable year is determined by treating the foreign corporation as a domestic corporation and by applying the provisions and regulations of IRC §11 and §61. The gross income test does not apply where a foreign corporation has negative gross income.

Example 2

SIKO Company, a foreign corporation, has gross sales from manufacturing kites of $300,000, cost of goods sold of $400,000, rental income of $35,000 and interest income of $5,000. Does SIKO meet the passive income test?

No. SIKO has a total loss of ($60,000). SIKO's nonpassive loss ($300,000 - $400,000 = ($100,000)) exceeds the passive income ($35,000 + $5,000 = $40,000). Even though there is passive income, total revenues result in a loss. Thus, the passive income test is not met. SIKO is not a PFIC pursuant to the passive income test.

B. EXCLUSIONS

For purposes of this passive income test, passive income does not include any income:

- Derived in the active conduct of a banking business by an institution licensed to do business as a bank in the US
- Derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax pursuant to Subchapter L of Chapter 1 of Subtitle A of the IRC if it were a domestic corporation
- Interest, dividends, rents or royalties received or accrued from a related person (defined by IRC §954(d)(3))) to the extent such income is properly allocable to income of the related person as not passive income
- Export trade income of an export trade corporation (as defined in IRC § 971) (IRC §1297(b)(2))

Revenue Notice 89-81 discusses the application of the passive income test to foreign banks, including a banking activity test and examples of a bona fide banking activity. It also discusses the identification of assets held by dealers. (Revenue Notice (RN) 89-81, 1989-2 CB, page 399.)

C. APPLICATION OF SUBPART F EXCLUSIONS

Within the subpart F provisions, the high foreign tax rule or the de minimis rule can be applied to the CFC's foreign base company income. If the income satisfies either of these two rules, then the income can be excluded from the subpart F deemed dividend. Any FPHCI that is excluded from subpart F because of the high foreign tax rule or the de minimis rule is still considered for purposes of the PFIC passive income test.

2. PFIC Passive Asset Test

If, during the taxable year, the average percentage of the foreign corporation's assets, which produce passive income or which are held for the production of passive income, is at least 50 percent of total average assets, then the foreign corporation is a PFIC. (IRC §1297(a)(2).)

The value of the assets, for purposes of computing this percentage, is determined as follows:

- For CFCs, the adjusted basis
- For publicly traded corporations (which are not CFCs) the FMV of the assets is used (Liabilities are excluded from the computation.)
- For all other corporations, the shareholder can elect to use FMV or the adjusted basis of the assets (IRC §1297(e))

The passive income test is fairly straightforward since a taxpayer will generally know whether or not the foreign corporation has primarily passive income. The passive asset test, however, can produce unexpected results in situations where the foreign corporation does not possess substantial fixed assets or does possess large amounts of liquid assets.

Example 3

Solo Corporation is a foreign corporation operating in Country X where income tax rates are very low. Solo manufactures laptop computers and services any repairs in relation to laptop computers. Solo's manufacturing process generates 70 percent of total revenue while its service income represents 25 percent of total revenue. Solo has passive income of 5 percent. Because of changing technology and the risk of obsolescence, Solo must maintain a low level of inventory. Also, because of low costs, Solo is quite profitable. As a result, Solo generally has high cash balances and high short-term investments. Solo is a PFIC.

The average value of Solo's assets from December 31, 1993, to December 31, 1994, is as follows:

Cash	$345,000	20%
Short-Term Investments	875,000	50%
Inventory	125,000	7%
Equipment	225,000	13%
Building	175,000	10%
Total	$ 1,745,000	100%

Based on the passive income test, Solo's passive income is only 5 percent and does not exceed the required 75 percent to be treated as a PFIC. However, based on the passive asset test, Solo's average asset value producing passive income is 70 percent (cash and short-term investments), exceeding the required 50 percent. Accordingly, Solo satisfies the passive asset test and must be treated as a PFIC.

Example 3 illustrates a case where a foreign corporation is not typically considered to be a passive business activity, yet the nature of its business and country of incorporation create an environment where the foreign corporation may exceed the passive asset test and be considered a PFIC.

3. Look-Through Rules

If a foreign corporation owns, directly or indirectly, at least 25 percent (by value) of the stock of another corporation, for purposes of either the passive income or passive asset test, then the pro rata share of the assets and income of that subsidiary is included in the assets and income of the foreign corporation being tested for PFIC status. (IRC §1297(c).)

If the foreign corporation is subject to IRC §531 (accumulated earnings tax) and owns at least 25 percent (by value) of the stock of a domestic corporation, then for purposes of both the passive income and passive asset tests, any stock held by the domestic corporation is not treated as an asset producing passive income and any income associated with any stock held by the domestic corporation is not treated as passive income. (IRC §1298(b)(7).)

Example 4

Assume FC1 manufactures butterfly nets. FC1's passive income is 10 percent of its total revenue of $456,000. FC1's average asset value is $2,475,050, which is 100 percent used in the active business of butterfly net manufacturing. In addition, FC1 owns 100 percent of FC2, which holds $2,854,103 in assets that produce passive income. FC2's passive income of $275,044 is 100 percent of its total revenue. FC1 is a PFIC.

Without the look through rule, FC1 would not satisfy the passive income test nor the passive asset test to be considered a PFIC. However, because FC1 owns at least 25 percent of FC2, it must include 100 percent (its pro rata share) of FC2's income and average asset values in FC1's calculations to determine whether or not FC1 is a PFIC.

FC1 does not satisfy the passive income test. Its passive income is 44 percent of total revenue (($45,600 + $275,044) / $731,044 = 44%) and does not exceed the required 75 percent of total revenue. FC1 does, however, satisfy the passive asset test. Its average asset value generating passive income is 54 percent of total average asset value ($2,854,103/$5,329,153 = 54%). This does exceed the required 50 percent. FC1 meets the passive asset test. Therefore, FC1 is a PFIC.

c. Exceptions

Exceptions exist for foreign corporations that are either starting up a business or changing their business activity and for situations where the PFIC rules would overlap with the CFC rules. If the foreign corporation satisfies any of these exceptions, the foreign corporation will not be treated as a PFIC.

1. Start-Up Corporations

A foreign corporation will not be treated as a PFIC for the first taxable year the foreign corporation generates positive gross income, as long as the foreign corporation:

- Had no predecessor that was a PFIC;
- Establishes to the satisfaction of the Secretary that the foreign corporation will not be a PFIC for either of the first two taxable years following the start-up year; and
- Is not a PFIC for either of the first two taxable years following the start-up year. (IRC §1298(b)(2).)

The start-up year is the taxable year in which the foreign corporation generates positive gross income. Thus, the foreign corporation is allowed a "start-up period" where operating results would typically result in the foreign corporation satisfying either the passive income test or the passive asset test.

2. Corporations with Transitional Business Activities

There is also an exception for certain corporations changing businesses. A foreign corporation will not be treated as a PFIC for the taxable year as long as the foreign corporation:

- Was not a PFIC in any prior taxable year.
- Establishes to the satisfaction of the Secretary that substantially all of the passive income of the foreign corporation is attributable to proceeds from the disposition of one or more active trades or businesses.
- Establishes to the satisfaction of the Secretary that the foreign corporation will not be a PFIC for either of the first two taxable years following such taxable year.
- Is not a PFIC for either of the first two taxable years following such taxable year. (IRC §1298(b)(3).)

3. Overlap of PFIC and CFC Rules

A US shareholder of a CFC (as defined in IRC §951(b)) will generally not treat the CFC as a PFIC for periods subsequent to December 31, 1997. (IRC §1297(d).) Pursuant to IRC §1298(b)(1), if the CFC was a PFIC that was not a pedigreed QEF in any period prior to December 31, 1997 in which the shareholder owned the stock, it will remain a PFIC unless the shareholder makes a timely election to purge the PFIC taint in accordance with IRC §1291(d)(2).

If the CFC meets either the asset test or income test, it will still be treated as a PFIC even after December 31, 1997 by any shareholders that do not meet the IRC §951(b) definitions of a US shareholder. (IRC §1297(d)(4).)

d. Passive Foreign Investment Company Types

Pursuant to Treas. Reg. §1.1291-9(j)(2), there are three types of PFICs: a qualified electing fund (QEF), a pedigreed QEF, and an unpedigreed QEF.

1. Qualified Electing Fund

A PFIC is a QEF with respect to a shareholder that has elected, under IRC §1295, to be taxed currently on its share of the PFIC's earnings and profits pursuant to IRC §1293. (Treas. Reg. §1.1291-9(j)(2)(i).) If a QEF election is not made, the PFIC is considered to be a nonqualified fund. A nonqualified fund is required to use the excess distribution (ED) method to recognize income. (IRC §1291.)

2. Pedigreed QEF

A PFIC is a pedigreed QEF with respect to a shareholder if the PFIC has been a QEF with respect to the shareholder for all taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock (Treas. Reg. §1.1291-9(j)(2)(ii).)

The first year the foreign corporation qualifies as a PFIC is not necessarily the first year the shareholder owns the stock. The ED method does not apply to pedigreed QEFs. Instead, the QEF method applies and the stockholder is required to currently recognize its share of the PFIC's income. (IRC §1291.)

3. Unpedigreed QEF

Pursuant to Treas. Reg. §1.1291-9(j)(2)(iii), a PFIC is an unpedigreed QEF for a taxable year if:

- An election under IRC §1295 is in effect for that year
- The PFIC has been a QEF for at least one, but not all of the taxable years during which the corporation was a PFIC included in the shareholder's holding period of the PFIC stock
- The shareholder has not made an election under IRC §1291(d)(2) or Treas. Reg. §1.1291-10 with respect to the PFIC to purge the non QEF years from shareholder's holding period

If a QEF election is made in a taxable year that is subsequent to the first taxable year the foreign corporation qualifies as a PFIC, the PFIC is considered to be an unpedigreed QEF. The QEF rules will apply to the election year and subsequent years.

The PFIC excess distribution rules will still apply, however, to the pre-unpedigreed QEF years. Therefore, if an excess distribution (ED) of stock occurs, the portion of the ED income that is allocable to pre-unpedigreed QEF years is subject to the deferred tax computation. If the US shareholder wants to remove "ED method" taint from these pre-unpedigreed years, it can either make a deemed dividend election (Treas. Reg. §1.1291-9) or a deemed sale election (Treas. Reg. §1.1291-10). The effect of the election is to accelerate and to report realized gains. If one of these elections is made, the unpedigreed QEF becomes a pedigreed QEF.

e. Passive Foreign Investment Company Taxing Methods

1. In General

Once a foreign corporation meets the definition of a PFIC, there are two alternative taxing methods available to the US shareholders of the PFIC: the "Qualified Electing Fund" (QEF) method or the "Excess Distribution" (ED) method. There are significant differences between these methods of reporting the income of the PFIC.

2. Treatment of a Qualifying Electing Fund

In general, if a QEF election is made pursuant to IRC §1293, the US shareholder's pro rata share of the PFIC net income and net capital gain is currently taxed, whether or not the income is actually distributed by the PFIC. (IRC §1293(a).) To make a QEF election, shareholders must follow the procedures set forth in Treas. Reg. §1.1295-1(c) to (g). The election is made by the shareholder, not the PFIC. The shareholder election only affects the individual shareholder. (Proposed Treas. Reg. §1.1295-1(b)(1).) On an annual basis, a shareholder may also elect, pursuant to IRC §1294, to extend the payment of tax (but not the interest) on its share of undistributed earnings of the QEF.

3. Excess Distribution Method

If a QEF election is not made, then the US shareholder must apply the ED method. This type of PFIC is referred to as a "§1291 fund". Under the ED method, the US shareholder's pro rata share of the PFIC income is not currently reported. No income is reported in the current years unless an actual distribution is made by the PFIC or the stock is sold. For actual distributions, the ED rules apply only if there is an excess distribution. The ED rules apply to any gain on sale of the stock.

An excess distribution is the amount by which current year distributions exceed 125 percent of the average distributions for the prior three years. The excess distribution amount or any gain on sale of the stock is assumed to have been earned ratably over the US shareholder's holding period. (IRC §1291.)

The portion of the accumulated gain allocated to the current taxable year and any taxable year in which the foreign corporation was not a PFIC is taxed as ordinary income in the current taxable year. The remaining gain, allocated to PFIC taxable years, except for the current taxable year, is subject to a deferred tax. (IRC §1291.) The US shareholder calculates the deferred tax due by multiplying the highest tax rate of each respective taxable year during the entire holding period by an equal portion of the PFIC gain. The highest tax rate of the respective taxable year applies in this calculation, not the effective rate of tax.

4. Election of Mark to Market Method

For years beginning after December 31, 1997, if the PFIC stock is marketable, the shareholder can elect to recognize gain or loss based on the difference between FMV of the stock and its basis at yearend. Any gain or loss recognized will affect the stock's basis. (IRC §1296.)

f. Coordination with Other Code Sections

1. In General

Prior to the enactment of the PFIC rules, there were five different tax schemes established in the IRC which attempted to limit the benefits of investing in foreign corporations that earn passive income. These include the following provisions:

- Accumulated Earnings Tax provisions, defined by IRC §531 through §537
- Personal Holding Company provisions, defined by IRC §541 through §547
- Foreign Personal Holding Company provisions, defined by IRC §551 through§558; these sections were repealed effective for tax years beginning after December 31, 2004
- Subpart F provisions, defined by IRC §951 through §964
- Foreign Investment Company provisions, defined by IRC §1246 through §1247

Theoretically, a US shareholder should only be taxed under one set of provisions. However, the scope of the PFIC provisions is so broad that the PFIC rules do overlap with all of the above provisions. Attempts have been made to resolve this problem and to coordinate the PFIC rules with the other code sections. (PL 100-647, Technical and Miscellaneous Revenue Act of 1988 (TAMRA), dated November 10, 1988, 1988-3 CB, page 1. PL 101-239, Omnibus Budget Reconciliation Act of 1989, dated December 19, 1989, 1990-1 CB, page 210. PL 103-66, Omnibus Budget Reconciliation Act of 1993, dated August 10, 1993, 107 Stat. 311.)

IRC §1293(g)(2) allows the Secretary to prescribe adjustments to the PFIC provisions that are necessary to prevent the same item of income of a QEF from being included in a US person's income more than once.

2. Accumulated Earnings Tax

The accumulated earnings tax imposed by IRC §531 does not apply to a PFIC. Thus, the PFIC rules will apply if the corporation is subject to both the PFIC rules and IRC §531. (IRC §532(b)(3).)

3. Personal Holding Company

Effective for tax years begin before December 31, 2004, IRC §542(c)(10) specified that the definition of a personal holding company did not include a corporation satisfying the definition of a PFIC. Thus, the PFIC provisions took precedence if the corporation was subject to both the PFIC rules and IRC §541. However, in 2004 P.L. 108-357, Sec 413(b)(1)(A) deleted paragraph (c)(10) effective for tax years beginning after December 31, 2004.

4. Foreign Personal Holding Company

A PFIC may also qualify as a foreign personal holding company (FPHC) pursuant to IRC §552. In this case, US shareholders will be subject to current tax on the undistributed income of the corporation pursuant to the FPHC rules rather than the PFIC rules. (IRC §551(g).)

5. Subpart F Provisions

IRC §951(c) states that where income is includible pursuant to the subpart F provisions and IRC §1293, which relates to the current inclusion of income for a QEF, the subpart F provisions take precedence over the PFIC provisions.

6. Miscellaneous

The amount of income treated as a dividend (under IRC §1248) on a sale or exchange of stock in a CFC that is also a PFIC does not include any income previously included under the QEF rules to the extent that such amount of income has not been distributed by the PFIC prior to the sale or exchange of the stock. (IRC §1248(d)(6).)

If stock in a PFIC is owned, directly or indirectly, by a pooled income fund (as defined in IRC §642(c)(5)), and no portion of any gain from a disposition of such stock may be allocated to income under the terms of the governing instrument of such fund, a US investor that is treated as owning stock in such PFIC cannot elect to have the income of such PFIC taxed under the QEF rules. (IRC §1298(c).)

g. Annual Reporting Requirements

The US shareholder must obtain from the PFIC the PFIC Annual Information Statement, which must contain information such as the taxable income, the shareholder's pro rata shares of ordinary earnings, the net capital gain, and the amount of cash or the fair market value of property distributed or deemed distributed to the shareholders. This statement (or a substitute), comparable to a Form K-1 from a partnership, must be attached to the federal Form 1120. (Treas. Reg. §1.1295-1(g).)

In addition, the US shareholder that directly or indirectly holds stock in a PFIC or has an interest holding in a foreign pass-through entity that is a direct or indirect shareholder of a PFIC must file a federal Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund. It must be filed annually for each PFIC interest a US shareholder owns. If a US person is not required to file a tax return, the shareholder files Form 8621. (Proposed Treas. Reg. §1.1291-1(i).)

In Announcement 90-35, the IRS announced that investors in PFICs who were required to file the federal Form 5471, solely because the corporation was a PFIC, are no longer required to file federal Form 5471, as Federal form 8621 provides adequate information. US shareholders otherwise required to file federal Form 5471, e.g., because they acquire or accumulate 5 percent or an additional 5 percent interest in a foreign corporation, are still required to file federal Form 5471, in addition to the federal Form 8621. (Revenue Announcement 90-35, 1990-11 Internal Revenue Bulletin, page 95.)

h. California Audit Considerations

1. In General

There is no California counterpart to the federal PFIC provisions. California has not conformed to the PFIC rules. Therefore, income properly reported for federal purposes as PFIC income or as QEF income does not enter into the California return except as a state adjustment. Not only is this a water's-edge issue, this is also an issue for a worldwide combined report.

The amounts reported pursuant to the PFIC provisions may appear as a Schedule M-1 or Schedule M-3 adjustment, in the detail to the "other income" line on the federal return, or as a state adjustment on the California return. Review the federal Form 1120 to determine whether income was reported under the PFIC provisions. You should also obtain a copy of the federal Form 8621 related to each PFIC and a copy of the federal Form 5471, if filed by the taxpayer.

If the income in question or foreign corporation could be subject either to PFIC rules or another code section, apply the information discussed in section f of this chapter to determine which provisions take precedence. If the foreign corporation can be treated as either a PFIC or as a CFC, then the subpart F provisions will take precedence. This is the case whether the PFIC is a QEF or an unqualified fund.

2. QEF Election is Made

Determine whether the income reported under the PFIC provisions should have been reported as subpart F income. If this is the case, a state adjustment should be made to subtract QEF income reported for federal purposes, and another corresponding adjustment should be made to include the appropriate amount of the CFC's earnings and factors in the water's-edge combined report.

For both worldwide and water's-edge, if a PFIC makes a QEF election and recognizes income currently, a state adjustment would be required to eliminate this income unless it was an actual distribution. Further, should an actual distribution occur, a state adjustment may be necessary to include this income since it was not previously taxed income for California purposes. (For federal purposes such actual distributions may not be subject to tax.)

For federal purposes, the basis of the PFIC stock is increased by any amount that is included in income and decreased by any amount distributed with respect to such stock, which is not includible because it was previously taxed. (IRC §1293(d).) California does not conform to the federal stock basis adjustments. For California purposes, PFIC stock basis will be the original cost, increased by any capital contribution and decreased by any return of capital. (CCR §25106.5-1(d)(3).) As a result, upon a disposition of the PFIC stock, the reported federal gain may be different than the California gain because of the basis difference. An adjustment may be required in the year of disposition to account for such difference.

3. QEF Election Is Not Made

The ED method discussion in this chapter has been simplified for purposes of the Water's-Edge Manual. Ultimately, your concern should be what is actually reported for federal purposes as opposed to how the deferred tax was computed.

If the ED method was used for federal, then the federal and California treatment would be the same until a disposition of the stock occurs. At that time, the gain would be treated as any other gain on the sale of stock for California purposes. Since this gain is subjected to a special tax computation for federal purposes, it may not be included on line 28 of the federal Form 1120. If not, a state adjustment may be necessary to include the gain in state net income.

i. Summary

The PFIC provisions may create a timing difference between the federal and state recognition of income derived by a PFIC, potentially necessitating a state adjustment to properly reflect the California taxable income. This issue can arise in both a water's-edge and worldwide combined report. Accordingly, investigate the issue and ensure the corporation reports the correct taxable income to California.