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International Tax Planning

The PFIC Storm

How Passive Foreign Investment Company Rules Cause Problems for U.S. Companies with Foreign Subsidiaries

by Joseph B. Darby III (Greenberg Traurig LLP)

In 1986, the U.S. Congress discovered that there was a glaring imperfection in that monument to human perfectibility otherwise known as the Internal Revenue Code (Code). The tragic flaw was this: Wealthy U.S. taxpayers could easily avoid current U.S. taxation on their investment income through the simple expedient of putting their investment assets into overseas investment funds.

To address this perceived flaw, Congress came up with what was then considered a perfect solution: the introduction of the passive foreign investment company (PFIC) rules. The new PFIC rules were grafted on top of two existing "anti-deferral" tax regimes then present in the Code—controlled foreign corporation (CFC) rules and foreign personal holding company (FPHC) rules—and operated such that "extra" U.S. tax was triggered (through the application of retroactive interest charges) that became due and payable either upon distributions from the PFIC to a U.S. taxpayer or on a sale of the PFIC stock by a U.S. taxpayer.

The problem is that the PFIC regime has never worked as well as Congress originally hoped. The overlap of the CFC, FPHC and PFIC regimes produced a true hodge-podge of compliance headaches for U.S. corporations and taxpayers merely out to earn an honest living and a decent buck.[1] More ominously, the PFIC rules in particular produced a raft of unintended consequences, because the rules tended to classify as PFICs a whole variety of foreign corporations engaged in what any sensible person would view as "active" rather than "passive" businesses.

In short, the PFIC concept that Congress thought would be a "perfect" solution has turned out, in retrospect, to be a PFIC mess.

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Congress' Original Concern

In the early 1980s it became widely known that a U.S. taxpayer could invest in an offshore investment fund and enjoy the same investment returns as from a U.S.-based mutual fund but without having to pay current U.S. tax. Whereas U.S.-based mutual funds (technically called regulated investment companies—RICs) must distribute virtually all income and gains to investors each year, a foreign investment corporation could earn and retain passive investment income (dividends, interest, and capital gains) without triggering current U.S. income tax obligations for U.S. investors. Instead, a U.S. investor generally paid tax only when the investor sold the foreign investment corporation stock. Best of all, the sale of foreign investment corporation stock would generally produce capital gain taxed at favorable U.S. tax rates.

The overlap of the CFC, FPHC and PFIC regimes produced a true hodge-podge of compliance headaches for U.S. corporations.

It was easy for a foreign investment corporation to dodge the then-existing U.S. anti-deferral tax rules by controlling the number, and aggregate investment, of its U.S. investors. In order for the CFC rules (also known as the "Subpart F" rules) to apply, "U.S. shareholders" (defined as U.S. persons each owning at least 10 percent or more of the total combined voting power of all classes of stock of the foreign corporation entitled to vote[2]) must have aggregate ownership of more than 50 percent by combined voting power or value.[3] Meanwhile, in order for the (now repealed)[4] FPHC rules to apply, five or fewer U.S. taxpayers had to own more than 50 percent of the corporation.[5] These

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ownership requirements were easily sidestepped, e.g., by making sure that U.S. investors did not acquire 50 percent or more of the foreign investment corporation.[6]

To be very clear from the outset, the "problem" addressed by the PFIC rules was never so much a large or wide-spread problem as it was a politically sensitive one. Establishing a foreign investment corporation for U.S. investors was not especially easy, and, among other things, the offshore fund could not solicit investments nor deliver shares into the U.S. It was strictly a tax dodge for a limited number of wealthy investors—a politically unacceptable situation that led to the "PFIC storm."

Congress' Response

Congress adopted the PFIC regime as part of the Tax Reform Act of 1986. The legislative history to that tax act (the so-called "Bluebook"[7]) states that "Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States."[8] However, in discussing the authority of the Secretary to provide regulations, the Bluebook notes that "A foreign corporation engaged in an active trade or business generally will not be a PFIC."[9]

Especially if the foreign corporation has strong prospects for appreciation, a QEF Election can be a wise strategy for managing PFIC tax costs.

A PFIC is defined as a foreign corporation if either *(i)* 75 percent or more of its gross income for the taxable year is passive income (Income Test), or *(ii)* 50 percent or more of the average value of its assets consists of assets that either produce, or are held for the production of, passive income (Asset Test).[10] There is also a special rule that provides for a "Look-Thru" rule if the foreign corporation owns 25 percent or more of another corporation.[11] The Bluebook explains that the purpose of this "Look-Thru" rule is that "Congress did not intend that foreign corporations that own subsidiaries primarily engaged in active business operations be treated as PFICs."[12]

For purposes of the PFIC test, the term "passive income" is generally defined by a cross-reference to the definition of "foreign personal holding company income" used in Subpart F and set forth in Code section 954(c).[13] However, except as provided in regulations, the term "passive income" does not include:[14]

- income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in regulations, by any other corporation);
- income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation;
- income that is interest, a dividend, or a rent or royalty, which is received or accrued from a related person (within the meaning of Code section 954(d)(3)) to the extent such amount is properly allocable (under regulations prescribed by the Secretary) to income of such related person that is not passive income; or
- income that is foreign trade income of a FSC or export trade income of an export trade corporation (as defined in Code section 971).

PFIC Not Perfect

The fundamental problem with the PFIC rules is that Congress chose to define a PFIC using two alternative percentage tests based on passive assets and passive income. Almost remarkably, the 1986 Bluebook, which is a notably detailed and even "chatty" source of legislative history on a wide variety of subjects, does not provide any explanation whatsoever of why Congress established the percentage thresholds at 75 percent and 50 percent, nor even any reason why Congress chose to employ percentage-based tests.

Although the supposedly abusive foreign investment corporations that Congress was trying to attack with the PFIC rules were invariably located in low-tax jurisdictions, Congress did not limit the PFIC rules just to corporations established in tax havens.[15] Such a "high tax jurisdiction" exception, which is integral to the CFC rules,[16] would likewise seem a logical component of the PFIC rules: After all, a foreign corporation operating in a high-tax jurisdiction is hardly the kind of tax-avoidance structure that the PFIC rules were intended to attack. Unfortunately, the PFIC rules rely solely on the percentage thresholds described above, and thus the PFIC rules can (and do!) apply in situations where a corporation is operating in a high-tax jurisdiction where there is absolutely no tax-avoidance motive or opportunity.[17]

The use of mechanical percentage tests, coupled with the fact that the PFIC rules did not attempt to identify and exempt clearly active businesses, means that a remarkable number of seemingly "active" foreign business corporations can turn out to be "surprise" PFICs.[18] Interestingly, although the difference between the 50 percent Asset Test and 75 percent Income Test does not at first appear to be huge, in practice it is

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almost always the Asset Test that produces a "surprise" under the PFIC rules.

To illustrate why this is the case, assume a foreign corporation has $1 million of "active" income. To be a PFIC under the Income Test, the foreign corporation must have $3 million or more of passive income.[19] Assuming that the foreign corporation can earn a relatively impressive 10 percent return on its investments (this may be on the high side based on historic averages, but it proves the point), this means that the corporation would have to have at least $30 million of passive investment assets in order to generate the $3 million of passive income needed to offset just $1 million of "active" income under the 75 percent Income Test. The point is that the Income Test is relatively hard to "flunk" if the foreign corporation has any significant source of active income.

> ***In practice, a remarkable number of seemly "active" foreign business corporations can turn out to be "surprise" PFICs.***

By contrast, it is far easier for a foreign corporation to "flunk" the Asset Test, i.e., be classified as a PFIC. To illustrate, assume a foreign corporation has $1 million of active business assets used in carrying on a trade of business and has accumulated over time, from business profits, a cash operating reserve in excess of $1 million, which is currently invested. This is actually a relatively common situation in the real world, particularly where the foreign corporation operates a profitable business using a relatively small capital investment, earns a reasonable return, and then retains profits offshore rather than distributing them to U.S. shareholders. Defining the difference between "active" assets and "passive" assets for purposes of the Asset Test is beyond the scope of this article, but the point is that if retained cash is viewed as a passive asset (very likely under current rules) this business would have more passive assets than active assets and would "flunk" the Asset Test.[20]

The point is that these two PFIC percentage tests have dramatically different prospects of being triggered by a typical foreign operating corporation in the real world and, as a practical matter, the Asset Test has become the dominant factor in determining whether the PFIC rules apply.

The "Surprise" PFIC

The oddly low percentage threshold employed under the Asset Test can cause the PFIC rules to apply in a wide variety of unexpected—and often hard-to-justify—circumstances. Early on, for example, it became clear that the PFIC rules could apply in the case of a CFC subsidiary of a U.S. corporation, even if the CFC was operated in a manner that did not produce Subpart F income! In particular, if a CFC qualified under the "same country" exception,[21] or operated in a high-tax jurisdiction and qualified under the high foreign taxes exception,[22] that CFC's income might not be characterized as "Subpart F income"—but, because of an accumulation of cash offshore, could be subject to the then-applicable PFIC rules. This situation made no sense and was eventually corrected by legislation that eliminated the overlap between Subpart F and the PFIC provisions,[23] but this rather astonishing disconnect between the anti-deferral regimes underscored the fundamental problems with the Asset Test.

In recent years, PFIC rules have continued to trip up U.S. investors in active foreign corporations, because of the perverse effects of applying rote percentage tests to determine if a foreign corporation is a PFIC. For example, U.S. investors in a foreign technology start-up company may provide a substantial cash infusion, e.g., acquiring a 40 percent stake for $40 million. This price implies that the value of the remaining assets of the company—principally its goodwill[24]—is $60 million. Assuming the technology company is engaged in an active business, the goodwill likely will be considered a "good" asset for purposes of the Asset Test, and the corporation will not be a PFIC.[25] But assume that, following such investment (as happened in 2000 at the time the "Internet bubble" collapsed), the value of the technology company drops abruptly, and the company is now valued at $75 million, while still holding $40 million in cash. Under these facts, the company would be classified as a PFIC under the Asset Test.

Another category of "surprise" PFICs is foreign services or sales corporations that are principally driven by "payroll" activities (i.e., sales or service personnel) and have relatively modest assets. For example, a foreign sales subsidiary may have almost entirely active sales income from sales activities in its country of incorporation, but because it has almost no assets other than working capital it may fail the Asset Test.

Another potential "trap" is if a foreign corporation owns a less-than-25 percent interest in one or more other companies. As noted above, the 25 percent "look-thru" rule is intended to treat a holding company with operating subsidiaries as not a PFIC. However, if the ownership level falls below the 25 percent threshold, the investment stock is treated as a passive asset. Moreover, if the investments are successful (i.e., the

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companies appreciate substantially in value) it can have the perverse effect of causing the foreign corporation to be classified as a PFIC under the Asset Test.

Although probably not as common, the Income Test can also trigger a "surprise" PFIC. For example, a foreign manufacturing corporation can be transformed into a PFIC if it has losses from manufacturing operations, and at the same time generates even a small amount of investment income. The PFIC Income Test is based on gross income rather than gross receipts, and therefore a manufacturing corporation operating at a loss may have zero gross income (gross receipts minus cost of goods sold) from manufacturing operations, which, coupled with even a small amount of investment income, can cause the entity to be classified as a PFIC under the Income Test.[26]

Similarly, the Income Test can sometimes cause a foreign corporation engaged in leasing or licensing of property to be classified unexpectedly as a PFIC. For example, royalty income from licensing activities will be treated as passive unless either the foreign corporation has created the IP through active research and development activities, or the foreign corporation has a substantial organization and engages in substantial marketing (or marketing and services) activities in the foreign country from which it licenses the IP.[27]

Determining whether the business activities carried on in the foreign jurisdiction are "substantial" is a facts-and-circumstances test, and there is a regulatory safe harbor that is deemed met if the "active licensing expenses" equal or exceed 25 percent of the adjusted licensing profit.[28] "Active licensing expenses" means deductions incurred by the licensor organization in the foreign country that are properly allocable to royalty income and that would be allowable to the licensor as ordinary and necessary business expenses under section 162 if the licensor were a domestic (U.S.) corporation.[29] In making the preceding calculation, the regulations exclude (1) deductions for compensation for personal services rendered by shareholders of, or related persons, with respect to, the licensor, (2) deductions for royalties paid or incurred, (3) deductions that, although generally allowable under Code § 162, would be specifically allowable to the licensor (if the licensor were a domestic U.S. corporation) under any provision other than Code § 162, and (4) deductions for payments made to agents or independent contractors with respect to the licensed property.[30] "Adjusted licensing profit" is equal to gross income from royalties less royalties paid or incurred with respect to such royalty income, deductions allowable under sections 167 and 197 if the licensor were a domestic U.S. corporation, and amounts paid to agents or independent contractors with respect to such royalty income.[31]

As a practical matter, meeting all the requirements to make a foreign licensing corporation an "active" business requires either a sizeable commitment of resources on the ground in the foreign jurisdiction, or real evidence that the foreign corporation is actively engaged in the creation and/or upgrading of the IP property being licensed.

Tax Consequences of PFIC Status

Assuming a foreign corporation is classified as a PFIC (and that no QEF [qualified electing fund] election has been made), a U.S. shareholder in the PFIC is taxed on PFIC income only when cash is actually realized from the investment, either through "excess" distributions from the PFIC or through dispositions of PFIC stock.[32] However, in addition to the payment at that time of U.S. taxes, the delayed payment also carries an interest charge based on the value of the tax deferral.

If a foreign corporation is a PFIC, the practical question becomes whether or not to make a QEF Election.

An "excess distribution" is defined as any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the three preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year).[33] A disposition of PFIC stock is treated such that any gain recognized is treated as if it were an excess distribution.[34]

An excess distribution is allocated ratably to each day in the taxpayer's holding period for the stock in the passive foreign investment company.[35] The taxpayer's gross income for the current year includes, as ordinary income, the portion of the excess distribution allocated to the current year plus, if applicable, amounts allocated to any tax period beginning in 1986 or before, if the foreign corporation was then a PFIC.[36] In turn, the U.S. shareholder must pay tax on the excess distribution plus an interest charge. The U.S. tax due in the year of receipt of an excess distribution (or in the year of disposition of PFIC stock) is the sum of (1) U.S. tax computed using the highest statutory rate of tax for the investor on the income attributable to the years of his holding period (other than the current year and other than years before the foreign corporation was a passive foreign investment company), plus (2) interest computed (using the rates and methods provided in Section 6621) from the due date of the returns (without regard to

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extensions) for the years to which income is attributed to the due date of the return (without regard to extensions) for the year of disposition (or year of receipt) imposed on the deferred tax, plus (3) U.S. tax on the income attributed to the year of disposition (or year of receipt) and to the years in which the foreign corporation was not a passive foreign investment company that precede the year of disposition (for which no interest is due).[37]

The portion of any distributions from a PFIC to a U.S. shareholder that is not characterized as "excess distributions" is subject to tax in the current year under the general rules in the Code, i.e., there is no time-value-of-money adjustment and the current year's tax rates apply.[38]

QEF Election

Any U.S. shareholder whose PFIC agrees to supply appropriate information to the IRS can avoid the complications (and potential extra tax costs) of PFIC status by making a "qualified electing fund" election (QEF Election). The best way to understand a QEF Election is that it makes the PFIC roughly comparable to a U.S.-based RIC or mutual fund, in that a U.S. investor is taxed currently on his or her pro rata share of PFIC income.

If a QEF Election is made, the U.S. shareholder is required to include currently in gross income his pro rata share of the PFIC's earnings and profits. Note that earnings and profits are computed based on U.S. principles, which may differ substantially from local tax accounting methods. The amount currently included in the taxpayer's income under a QEF election is divided between an investor's pro rata shares of the ordinary income and net long-term capital gain income of the PFIC.[39]

The U.S. tax is due currently even if no distribution has been made from the PFIC to the U.S. shareholder. To avoid cash-flow problems, there is also a shareholder-level election that allows the shareholder to defer payment of the tax, subject to the payment of interest.[40] Amounts currently included in income increase the U.S. shareholder's stock basis, and subsequent distributions of amounts previously included in income under the QEF Election decrease such stock basis.

To QEF or Not to QEF

If a foreign corporation is a PFIC, the practical question becomes whether or not to make a QEF Election. A shareholder in a PFIC (absent a QEF Election) is subject to tax under the PFIC rules only when income is actually realized, i.e., either upon a corporation distribution or disposition of the PFIC stock. At that time, the shareholder will generally have the money to pay the tax (and the accrued interest).

However, the drawback of not making a QEF Election is that *all* of the deferred income will be taxed as ordinary income[41] and the U.S. tax on any excess distribution (including all gain from disposition of PFIC stock) is calculated using the highest statutory tax rate for the U.S. investor on all income attributed to the years of his holding period (other than the current year and other than years before the foreign corporation was a PFIC).[42]

By comparison, a QEF Election makes the U.S. shareholder subject to current taxation on its pro rata share of the foreign corporation's income, whether or not such income is distributed. The good news is that any net capital gain recognized by the foreign corporation will receive capital gain treatment in the hands of the shareholder (similar to the distribution of capital gain items from a mutual fund). The shareholder in a QEF can individually elect to defer payment of tax until there is an actual distribution by the QEF or a disposition of the stock, subject to payment of an interest charge.[43] Another benefit is that a U.S. investor in a QEF can defer gain (without an interest charge) on the stock of the QEF itself, and, when the QEF stock is sold, can treat such gain as capital gain.[44] By contrast, gain on the disposition of PFIC stock is treated as an excess distribution, and taxed as ordinary income, at the maximum tax rate, with an interest charge.[45] Especially if the foreign corporation has strong prospects for appreciation, and if it can (and is willing) to provide the required information to the IRS, a QEF Election can be a wise strategy for managing PFIC tax costs.

As a practical matter, the Asset Test has become the dominant factor in determining whether PFIC rules apply.

The Imperfect Answer

As described above, the PFIC rules have a strange and anomalous history, and can have an impact on U.S. investors in foreign corporations that far exceeds the original intention of Congress to attack offshore investment funds. The Asset Test in particular has a remarkably broad reach and has the nasty habit of turning an "active" foreign corporation into a "surprise" PFIC.

More generally, Congress has been rethinking the nature and future direction of the U.S. tax system[46] and Congress eventually needs to figure out a coherent

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regime to replace the increasingly ad hoc rules that govern U.S. taxation of international transactions. In the meantime, the PFIC regime remains a far-from-perfect answer to the question of how the U.S. should tax outbound investments by U.S. taxpayers.

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[1]In 2004, Congress finally acknowledged that the overlap of these three anti-deferral regimes was excessive, and so the American Jobs Creation Act of 2004 repealed the FPHC rules for tax years beginning after Dec. 31 2004. Sec. 413(a)(1), PL 108-357, 10/22/2004. This left "just" the CFC and PFIC regimes to complicate the world of U.S. "outbound" tax planning.
[2]Code § 951(b).
[3]Code § 957(a) technically defines a CFC as a foreign corporation where more than 50 percent of either (1) the total combined voting power of all classes of stock of such corporation entitled to vote, or (2) the total value of the stock of such corporation, is owned (or considered owned) by U.S. shareholders.
[4]See footnote 1.
[5]See former Code § 552(a)(2), prior to repeal in 2004. See footnote 1.
[6]In addition, there were also at that time foreign investment company rules under Code § 1246 that generally converted gain on the sale of foreign investment company stock from capital gain to ordinary income. These rules also contained a more-than-50 percent ownership test that could be avoided by controlling the ownership levels of U.S. persons.
[7]Staff of the Joint Committee on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986 (it is known as the "Bluebook" because of the color of its cover).
[8]Bluebook, at 1023.
[9]Bluebook, at 1032.
[10]Code § 1297(a).
[11]Code § 1297(c). The "Look-Thru" (Congress' spelling) rule provides that if the 25 percent rule is met, for purposes of determining whether a foreign corporation is a PFIC, such corporation is treated as if it (1) held its proportionate share of the assets of the 25 percent subsidiary, and (2) received directly its proportionate share of the income of the 25 percent subsidiary.
[12]Bluebook, at 1026.
[13]Code § 1297(b)(1).
[14]Code § 1297(b)(2).
[15]By contrast, the CFC rules in Subpart F clearly recognize that the central thrust of those rules is to prevent a shifting of income to a low-tax jurisdiction. See Code § 954(b)(4), setting forth an exception to the normal Subpart F rules for income subject to high foreign taxes (greater than 90 percent of the maximum rate of tax specified in Code § 11).
[16]See footnote 15 above.
[17]The problem is further compounded by the fact that there is generally no "indirect" tax credit available under Code § 902 to a PFIC shareholder (normally either an individual or a corporation owning less than 10 percent of the foreign entity), and so high foreign taxes are followed by even higher PFIC taxes.
[18]Passive income is defined in the Code to exclude income derived from the active conduct of a banking business or an insurance business (see footnote 14, above) and the Regulations further exempt income from active rental or licensing activities (see footnote 25, below). However, as discussed below, even a truly "active" foreign corporation with little or no passive income can still be inadvertently trapped by the Asset Test.
[19]The math is as follows: \$3 million of passive income and \$1 million of active income means that \$3 million/\$4 million = 75 percent of the total income is from passive sources.
[20]In general, cash is considered "passive" even if it is held as operating capital. This can be especially problematic for early stage companies (e.g., technology companies) that have raised a lot of cash but have limited operations and thus not a lot of active assets. Ironically, one of the "logical" strategies in addressing the Asset Test is that it is better to hold accounts receivable (which are an "active" asset) rather than collect the receivables and hold cash (which is a passive asset). Business logic and tax logic diverge completely when it comes to the PFIC rules.
[21]Code § 954(d)(1).
[22]Code § 954(b)(4).
[23]Tax Reform Act of 1997, Act § 1121, amended then-Code § 1296(e)(1) (now Code § 1297(e)(1)) such that a PFIC that is also a CFC will not be treated as a PFIC with respect to any person who is a U.S. shareholder (as defined in Code § 951(b)).
[24]Goodwill can be characterized as an active asset or a passive asset, depending on the nature of the income derived from the activity. See Notice 82-22, 198-1 CB 489.
[25]Id.
[26]See PLR 9447016 (August 19, 1994).
[27]Treas. Reg. § 1.954-2(b)(6), (d)(1)(ii).
[28]Treas. Reg. § 1.954-2(d)(2)(ii).
[29]Treas. Reg. § 1.954-2(d)(2)(iii).
[30]Id.
[31]Treas. Reg. § 1.954-2(d)(2)(iv).
[32]Code § 1291(a)(1), (2).
[33]Code § 1291(b)(1).
[34]Code § 1291(b)(2).
[35]Code § 1291(a)(1)(a).
[36]Code § 1291(a)(1)(b)(i) and (ii).
[37]Code § 1291(c); see Bluebook at 1027.
[38]Id.
[39]Code § 1293(a)(1).
[40]Code § 1294(a)(1) provides that a taxpayer may elect to defer payment of U.S. tax attributable to the amounts currently included in income but for which no current PFIC distributions are received. An election to defer tax is not available if any amounts are required to be currently included in income under the Subpart F rules (Code § 951). Code § 1294(a)(2). An election to defer tax is treated as an extension of time to pay tax for which the taxpayer is liable for interest. Code § 1294(g).
[41]Code § 1291(a)(1)(b).
[42]Code § 1291(c).
[43]Code § 1294(g).
[44]Bluebook, at 1030.
[45]Code § 1291(a)(2) and 1291(c).
[46]See "Fixing the U.S. International Tax System," *Practical U.S./International Tax Strategies*, June, 2006. ❑