

Overview of PFIC rules – U.S. tax implications on domestic real estate investors in offshore funds

For offshore funds that invests in equity of other operating companies, they can file a one-time U.S. tax classification election (Form 8832) and elect to be treated as a pass-through entity for U.S. tax purposes

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It is common to see capital flow across the borders in the search of higher return on investments in a free flow global economy and over the years, there has been an increasing trend of U.S. outbound investments to a whopping 5.96 trillion U.S. dollars in 2019 from 1.32 trillion U.S. dollars in the year 2000^[1]. This topic is of particular importance to real estate investment management companies.



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The Passive Foreign Investment Company rules were enacted in 1986 to discourage U.S. investors from investing in offshore funds that do not have a similar tax regime to the U.S. Why is the PFIC regime so daunting for U.S. investors? Let's take a deeper dive into the U.S. tax laws to better understand.

Brief overview of the PFIC rules

Under Internal Revenue Code Section ('IRC') Section 1297, a passive foreign investment company is any foreign corporation which meets either the **asset test** or the **income test**.

- The **asset test** is met when the average percentage of assets held by a foreign corporation during a taxable year which produce passive income, or which are held to produce passive income, is at least 50 percent. Cash and other assets readily convertible into cash are passive assets for purposes of testing.
- The **income test** is met when 75 percent or more of the gross income of a foreign corporation for a taxable year is passive income. Passive income generally includes portfolio dividends, interest, rents^[2] and royalties, gains from the disposition of stocks, securities and commodities, and currency exchange transactions.

The **subsidiary look-through rule** applies when a foreign corporation owns at least 25% of the stock of another foreign corporation. Consequently, for purposes of determining whether the foreign corporation is a PFIC, the foreign corporation looks-through to the assets and income of the other corporation.

Taxation of U.S. shareholders of a PFIC

- If a foreign corporation is categorized as a PFIC, the default tax treatment of U.S. shareholders of the PFIC is to treat its passive income as attributable to the U.S. shareholder. This would mean that no tax is imposed on the income until there is a distribution from the PFIC or a sale of the PFIC stock. However, interest is deemed to accrue on the taxable income from the date of ownership of the stock and is included in the taxable income of the U.S. shareholder on the date of a distribution or sale of the PFIC stock.
- Qualified Electing Fund (QEF) Election: When the U.S. shareholder makes a QEF election in respect to a PFIC, income of such PFIC is taxed on accrual basis to such shareholder irrespective of the fact of whether such amount has been distributed or not by the PFIC. This QEF election (Form 8621) is a four-page annual report that needs to be filed with the IRS and gets attached to the shareholder's U.S. income tax return.
- MTM Election: U.S. shareholders of PFICs may also elect to be taxed on a mark-to-market basis. Under the mark-to-market rules, a U.S. shareholder of a PFIC is taxed each year on the appreciation in value of the stock interest in the PFIC.

It is important to note that "ONCE A PFIC, ALWAYS A PFIC" unless the U.S. shareholder makes a purging election whereby, they must recognize all the income inherent in such investment along with the penalty taxation. The corporation must be purged of its PFIC taint to avoid having distributions in subsequent years and gain upon selling the shares being subject to the excess distribution regime.

Working around the PFIC rules – Planning tool

Is there a way around the PFIC regime? For offshore funds that invests in equity of other operating companies, they can file a one-time U.S. tax classification election (Form 8832) and elect to be treated as a pass-through entity for U.S. tax purposes. Consequently, for U.S. investors' tax reporting purposes, the offshore funds can issue K-1 equivalents.

This way the U.S. investors can retain the character of income that is earned by the offshore funds, for example, capital gains earned by them would be taxed as such in the hands of the U.S. investors rather than being taxed as ordinary income under the default PFIC tax regime. This would be beneficial in cases where the offshore funds own less than 25% and are not eligible to take the benefit of look-through rules.

Since the offshore funds hold the equity investments in the underlying portfolio companies, each such company would be subject to the PFIC tests and the PFIC disclosures included accordingly on the K-1 equivalents if any such companies are indeed PFICs. This may increase the tax compliance and reporting burden for the offshore funds but would offer tax benefits to the US investors investing in such funds, making it more lucrative.

This could be a good planning tool for any venture capital funds that will be investing in operating start-ups and hedge funds investing in equities of other operating companies. For offshore funds investing in derivative instruments and debt securities, these may not be subject to PFIC rules unless the securities invested have an option to be convertible into equity. However, the offshore funds investing any temporary surplus funds in any other liquid investments like mutual funds or other investment companies would be categorized as PFIC investments.

All cash and any other liquid investments are passive assets producing passive income, whether the cash is held for the reasonable needs of the business or has been raised to develop/expand a business. This is a huge setback for start-ups (beyond the start-up year exception) and other operating companies that may hold significant amounts of cash for their working capital or funds waiting to be deployed. For example, venture capital funds investing in technology startups will take a few years before

the business is fully operational. In such cases, it would be prudent to contribute funds in such portfolio companies closer to the deployment date as per the business plan so that the companies don't fail the asset test with too much cash on the balance sheet as of the testing dates.

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[1] Source: BEA, Direct Investment Position Data of U.S. abroad 2000-2019, published July 2020

[2] Certain rents are not considered passive income which include rents from leasing real property provided these are from active and substantial management and operational functions.



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