
United States: Passive foreign investment company (PFIC) guidance provides new reporting exceptions and clarifications

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In brief

Certain US persons may become subject to the passive foreign investment company (PFIC) regime if they own an interest in a foreign corporation that invests primarily in passive investments (or become US persons while owning such interests). The PFIC regime imposes obligations for US persons to report taxable income and comply with certain reporting requirements. The Treasury and IRS recently released final regulations that provide guidance on determining the ownership of a PFIC and on certain reporting obligations of PFIC shareholders. The final regulations finalize, with some modifications, proposed regulations and withdraw temporary regulations issued in 2013.

In brief, the final regulations provide clarification on various issues and provide new exceptions that eliminate the need to file reporting forms to the IRS – one such exception is for dual resident taxpayers that utilize income tax treaty residency tie-breaker provisions. Other exceptions are provided for bona fide residents of certain US territories and PFIC stock held for 30 days or less.

Employers or other entities with internationally mobile individuals should review annually whether their employees' or partners' (for example) direct and indirect investments in foreign corporations could trigger these PFIC rules. New exceptions and clarifications under the final regulations should be considered for determining the proper filing obligations.

In detail

Background

What is the US PFIC regime?

The passive foreign investment company (PFIC) regime aims to discourage US persons from forming a foreign corporation and using that company to invest in primarily passive investments, thereby

attempting to shift income out of the US federal tax net. Potentially harsh tax results will ensue for such US persons that may increase that investor's total US federal income tax liability, not simply affecting the overall timing of when US federal income tax is due.

Specifically, if a US person is treated as owning an interest in a PFIC, that person may be subject to special tax and interest charges upon receipt of an 'excess distribution,' which consists of certain distributions from, and all gain from the disposition of stock in, the PFIC. This special tax and interest

charge approximates the US federal income tax that would have been payable if the foreign corporation had distributed all of its income every year. The calculation of excess distributions is performed annually and can be quite complex.

Alternatively, that person may be able to avoid the application of the excess distribution rules by making a special election to include amounts in income each year, regardless of whether or not the PFIC makes a distribution in that year.

When is a foreign corporation treated as a PFIC?

The PFIC regime applies when a US person owns an interest in a foreign corporation that is treated as a PFIC, i.e., if either the 50 percent asset test or 75 percent income test is satisfied. Under the income test, a foreign corporation is treated as a PFIC if 75 percent or more of its gross income fits within the definition of 'passive income', which generally includes dividends, interest, royalties, rents, and annuities; there are many other special rules for determining what income is included.

Under the alternative asset test, a foreign corporation is treated as a PFIC if the average percentage of assets held by such corporation during the taxable year which produces passive income, or which are held for the production of passive income, is at least 50 percent. Various special rules apply to perform this calculation.

From a practical perspective, it may not be clear on its face that a US person holds an interest in a PFIC. For example, a foreign national that qualifies as a US person due to his/her status as a US resident may hold an investment in a foreign mutual fund. Although it depends upon the facts and analysis, the US resident owning an interest in such a fund may be subject to the PFIC rules if the fund

satisfies the passive income or asset tests.

How does an individual report to the IRS under the PFIC regime?

In general, a shareholder of a PFIC must file a four-page annual report with the IRS unless an exception applies. That annual report is Form 8621 (*Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*). Such form should be attached to the shareholder's US income tax return, and may need to be filed even if the shareholder is not required to file a US income tax return or other return for the tax year.

New PFIC reporting exceptions under the final regulations

The final regulations provide various new exceptions, but the following three may be particularly relevant to employers of mobile individuals:

Dual resident taxpayers

The new regulations provide a welcome change for certain foreign nationals who maintain tax residency in treaty countries. There is now an exception to filing Form 8621 for dual resident taxpayers that determine any US income tax liability as a nonresident alien for the taxable year pursuant to treaty tie-breaker provisions. Under this exception, the taxpayer must file either Form 1040NR (*US Nonresident Alien Income Tax Return*) or Form 1040NR-EZ (*US Income Tax Return for Certain Nonresident Aliens With No Dependents*), including a treaty-based return position disclosure in accordance with regulations.

A similar exception is provided for a dual resident taxpayer that determines any US income tax liability as a nonresident alien for only a portion of the tax year pursuant to treaty tie-breaker provisions and files a so-called 'dual-status' income tax

return. This exception requires Form 8621 to be filed (and PFIC tax consequences to apply) only for the portion of such taxable year that Form 1040NR does not apply.

This exception generally mirrors an exception for the filing of Form 8938 (*Statement of Specified Foreign Financial Assets*) that was adopted in response to public comments (PwC made a specific request for this exception.) This welcome change hopefully signals the start of a trend for other foreign information reporting requirements for those individuals filing Form 1040NR under the tie-breaker provisions of an income tax treaty. These types of exceptions can generate significant time savings.

Certain PFIC stock held for 30 days or less

The regulations provide a new exception to filing Form 8621 if the taxpayer acquires a PFIC fund in the taxable year or the immediately preceding taxable year, and only holds that fund for 30 days or less. Specifically, this test focuses on the period beginning 29 days before the first day of the shareholder's taxable year and ending 29 days after the close of the taxable year. For this exception to apply, the taxpayer must not have been treated as receiving any excess distributions from the PFIC (for example, no distributions were made to the shareholder.)

This exception may be of interest to those who have recently acquired a PFIC interest and have time to dispose of it quickly and avoid reporting requirements. Note that the regulations do not address the issue of whether this exception may apply to an individual who has held an interest in a PFIC for several years while not a US taxpayer, but disposes of it within the first 30 days of having US tax residency.

Bona fide residents of certain US territories

A shareholder of a PFIC is not required to file Form 8621 for a taxable year if the person is:

- a bona fide resident of Guam, the Northern Mariana Islands, or the United States Virgin Islands, and
- is not required to file an income tax return with the IRS with respect to such taxable year.

Note that not all US territories are included in this exception because they do not have so-called mirror code jurisdictions. As a result, residents of Puerto Rico and American Samoa may still be subject to PFIC reporting, even if they are not required to file US income tax returns.

This exception, and the two others listed above, apply to the taxable years of shareholders ending on or after December 31, 2013 (in effect, taxable years ending on or after the issuance of the 2013 temporary regulations.) For example, the exception for bona fide residents of certain US territories is generally retroactive to tax years ending on or after this date.

Clarifications to existing reporting exceptions

The final regulations provide various clarifications; those that may be of interest to employers of mobile individuals include the following:

PFIC stock held by certain foreign pension funds

The temporary PFIC regulations provided an exception for certain foreign pension funds. Specifically, no Form 8621 must be filed for PFIC interests that are owned through a foreign trust that is a foreign pension fund operated principally to provide pension or retirement benefits where an income tax treaty essentially

provides that the earnings from the pension fund are not taxable until distribution. Effectively, this exception only applied to those foreign pension funds treated as foreign trusts under entity classification rules for US tax purposes.

The final regulations expand this exception to include all applicable foreign pension funds (or equivalents) under any type of arrangement regardless of their classification for US federal tax purposes. This exception applies for any beneficiary of, participant in, a plan, trust, scheme, or other arrangement that is treated as a foreign pension fund if an income tax treaty states that any income from the fund is only taxed when it is paid to the shareholder.

There are several treaties that include such a provision, though many apply only if the IRS has specifically agreed that the foreign plan generally corresponds to a US plan which may require a specific competent authority request submission (some provide for 'automatic' treatment for plans). Certain treaties provide relief only for contributions to foreign pensions, but not earnings, and thus this exception would not apply.

Note that general employee trusts – as opposed to foreign pension funds – are not PFICs. The former is a much more common occurrence with respect to mobile employees.

De minimis exceptions

Under current law, a shareholder need not file Form 8621 if the shareholder is not (i) treated as receiving an excess distribution from the fund, and (ii) the value of all PFIC stock owned as of the last day of the taxable year is \$25,000 (or \$50,000 for shareholders that file joint returns) or less. This exception also applies to certain indirect ownerships of a PFIC.

The final regulations do not increase this amount for US individuals living abroad. This is in contrast to higher de minimis thresholds that were put into place for those living abroad with respect to Form 8938 reporting.

Other guidance about how and when to file Form 8621

US persons not required to file income tax return

The final regulations restate that Form 8621 can still be required even if the individual is not required to file a US income tax return for the year. The regulations clarify that such individual should file Form 8621 as provided by the instructions in the form, which directs filers to send the form directly to a designated IRS address.

Note that this rule is another departure from foreign financial asset reporting rules which provide an exception to Form 8938 filing for those not required to file Form 1040.

Practitioners should have a critical eye to when Form 8621 reporting is required as more detailed analysis may apply. For example, those individuals who are filing Form 1040 only due to a Section 6013(g) or (h) election are not considered US persons for PFIC purposes as these elections only apply for purposes of chapters 1 and 24.

Consolidated reporting not allowed

We understand that many taxpayers may have been using consolidated Form 8621 filings in the past without notice or penalty, although not specifically permitted or denied by the IRS. For example, this could include a consolidated Form 8621 that would include all of the person's PFIC interests and relevant information on an attached supporting schedule. The preamble to the final regulations, however, specifically states that

consolidated Form 8621 filings are not permitted. As a result, penalties could arise for those who continue to file in such a manner.

No need for protective filings

A comment requested that the final regulations allow a 'protective' Form 8621 to be filed by shareholders of a foreign corporation that are unsure whether such entity is a PFIC due to factors beyond their control (e.g., no access to the entity's books and records). Such protective filing would be aimed at deferring any potential filing requirements so as not to suspend the period of limitations on assessment for the shareholder's entire return if the foreign corporation were subsequently determined to have been a PFIC in the year to which the protective filing relates.

The preamble to the final regulations, however, clarifies that no such protective filings are needed if the failure to file such information is due to reasonable cause and not willful neglect. Rather, the 'reasonable cause' exception under Section 6501(c)(8)(B)

can provide proper relief. Thus, the final regulations did not adopt this comment.

The takeaway

Annual PFIC reviews still essential

The recently released final regulations provide important filing exceptions and other clarifications that could impact determinations of the tax and filing obligations for US persons holding PFIC interests. The regulations provide welcome relief for those individuals that may inadvertently hold PFIC interests. The new exceptions, in particular, could spare some individuals from having to perform annual calculations, analysis, and reporting.

Notwithstanding, mobility professionals should be cautious to review all investments by the individual and perform proper due diligence of all investments in foreign entities in order to conclude whether the PFIC rules apply or not. The best starting point for an analysis is

typically whether a foreign investment qualifies as a foreign corporation under the US entity classification rules.

Unfortunately the PFIC rules can be a trap for the unwary if investments of mobile individuals are not properly identified in the year they are acquired or prior to establishing US residency. If such investment qualifies as a PFIC, and does not distribute monies to the holder, PFIC filing obligations should still be evaluated at that time to determine whether certain elections should be made, as well as proper reporting to the IRS.

Final regulations could be subject to withdrawal by Trump Administration

It is important to note that these new regulations were issued prior to the memorandum issued by the White House Chief of Staff freezing the publication of new regulations. They were published in the Federal Register on December 28, 2016 and appear to be currently effective. However, future action may change the current status.

Let's talk

For a deeper discussion of how this might affect your business, please contact:

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