U.S. TAX ALERT

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Understanding the filing requirements for PFICs and CFCs

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U.S. persons (U.S. citizens or green card holders) living in Canada or abroad who have investments outside the U.S. should be aware of the potentially onerous tax filing requirements imposed by the IRS, and how those rules will apply to their investments. IRS rules can be particularly complex when investments in foreign companies or funds earning passive income are involved.

This article expands upon the discussion in the companion piece, "U.S. tax pain: Canadian mutual funds and ETFs," in this *U.S. Tax Alert*. This article digs deeper into the intricacies of the definitions and the filing requirements for PFICs and CFCs.

Passive foreign investment companies

A passive foreign investment company (PFIC) is a foreign-based corporation that earns at least 75 per cent of its gross income from passive activities, or that sees at least 50 per cent of its assets produce passive income. Passive income includes interest, dividends, royalties, rent, annuities and most capital gains. Common investments generally qualifying as PFICs include mutual funds, exchange-traded funds (ETFs), real estate investment trusts (REITs), and income trusts. Investments in private corporations earning primarily investment or rental income are also considered PFICs. Indirect ownership in PFICs through trusts or corporations may also be caught. Investments held in certain Canadian registered accounts, such as RRSPs and RRIFs, are not subject to the PFIC rules.

Taxation of PFICs

Shareholders receiving distributions of earnings and profits from PFICs are required to report the income in the year it is received. If the distributions for any year are greater than 125 per cent of the average distributions received in the previous three years, the excess amount is taxed under the excess distribution provisions. An excess distribution is allocated pro-rated to each day that the PFIC is held, with any amounts allocated to prior years subject to tax at the highest marginal rate for the prior year, plus an interest charge on the resulting taxes.

Example: Assume a taxpayer has owned shares in a foreign corporation since June 30, 2012, and that the foreign corporation is considered a PFIC. The company did not pay a distribution or dividend for any previous year and in 2017 it pays the taxpayer $90,000.

Under the excess distribution regime, there are no tax implications to the taxpayer for the 2012 through 2016 taxation years as no distributions were made. However, the distribution in 2017 is subject to the excess distribution rules:

Taxation year	Number of days	Income Allocated ($)	Tax rate	Tax ($)	Interest charge ($)
2012	184	8,238.81	35.0%	2,883.58	609.26
2013	365	16,343.28	39.6%	6,471.94	1,251.15
2014	365	16,343.28	39.6%	6,471.91	1,023.74
2015	365	16,343.28	39.6%	6,471.94	803.02
2016	366	16,343.28	39.6%	6,471.94	64.72
		$73,656.72		28,789.07	3,751.89

The distribution apportioned to 2017 would not be subject to the excess distribution provisions but would be taxed as ordinary income in the year.

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Finally, the disposition of a PFIC subject to the excess distribution regime is denied the normal treatment as a capital gain, with the gain instead being treated as an excess distribution.

Alternatives to excess distribution

Fortunately, there are alternatives to the punitive excess distribution rules. The taxpayer may choose to elect to have the PFIC taxed under the qualified electing fund (QEF) rules or the mark-to-market provisions.

QEF election

The most common option is to elect for the PFIC to be treated as a QEF. The taxpayer must annually include their pro-rated share of income and net capital gains from the PFIC, regardless of whether the income was distributed.

A QEF election must be made on the later of the date on which the investment becomes a PFIC or that it's acquired in a timely filed income tax return for that year. Additionally, the PFIC must supply the investor with an Annual Information Statement.

Mark-to-market election

Alternatively, a mark-to-market election is available if the PFIC does not provide an Annual Information Statement or if it is otherwise difficult to determine the pro-rated share of income from the PFIC. In most cases, this election must be made on the later of the date on which the investment becomes a PFIC or that it's acquired. The PFIC shares must be regularly traded on a securities exchange.

If this election is made, the taxpayer includes the increase in market value of the PFIC in its annual income. The fair market value at the end of the year would then become the cost basis for the following year. Deductions for losses are only allowed to the extent that mark-to-market gains have been recorded in prior years.

Late-filed elections

If an election is not made in a timely manner, a taxpayer will have the option of continuing to be subject to the excess distribution rules as outlined or making a deemed sale election, treated as having sold the PFIC at the commencement of the current taxation year. If certain conditions are met, a deemed dividend election may be made where the accumulated deferred income is taxed in the current year. Both elections are subject to the excess distribution rules. The PFIC would then be eligible to make the QEF election or the mark-to-market election for future years.

PFIC reporting requirements

A separate Form 8621 must be filed for any PFIC for which a U.S. person:

1. has received a direct or indirect distribution;
2. has disposed of a PFIC stock;
3. is reporting QEF or mark-to-market information; or
4. is making certain elections, some of which were discussed above.

Controlled foreign corporations

A controlled foreign corporation (CFC) is any corporation organized outside the United States that is more than 50 per cent owned by U.S. shareholders. For the purposes of the CFC rules, a U.S. shareholder is defined as a U.S. person who owns 10 per cent or more of the voting stock of the company.

It is a common misconception that an individual taxpayer (or a related group) must have control of the company for it to be a CFC; in fact, this is not necessary. For example, if five unrelated

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shareholders are all U.S. persons, and each owns 11 per cent of the company, the company would be considered a CFC.

Taxation of CFCs

A U.S. shareholder of a CFC must include "Subpart F income" in their income for the taxation year regardless of whether the company makes a distribution in the year, subject to certain limitations. Foreign source passive income is a component of Subpart F income. Look for a deeper discussion of Subpart F income in a future *U.S. Tax Alert.*

PFIC/CFC overlap

A CFC earning Subpart F income generally will meet the criteria to be considered a PFIC as well. To avoid double taxation, there is an exception for shareholders of stocks that meet both definitions. When a U.S. shareholder of a CFC includes in income their pro-rated share of Subpart F income, they generally will not be subject to the PFIC provisions, including the filing of Form 8621.

Should a taxpayer hold shares of a PFIC for which neither the QEF nor mark-to-market elections were made, and in a later year the criteria to be treated as a CFC are met, other actions may be required before the PFIC exception above could be applied. The PFIC likely will have accumulated deferred income that will need to be cleared by a deemed sale election or deemed dividend election. The shareholder would be subject to the excess distribution rules, but the shares would then be eligible for the PFIC exception going forward.

Additional reporting requirements

Form 5471 may be required if the taxpayer is:

1. a U.S. person who is an officer or director of a foreign corporation in which any U.S. person has acquired at least 10 per cent of the value of the corporation's stock or at least 10 per cent of the voting rights;
2. a U.S. person who:
    a) acquires stock in a foreign corporation and holds at least 10 per cent stock ownership either before or after the transaction, or
    b) disposes of sufficient stock to drop below 10 per cent ownership, or
    c) becomes a U.S. person in the year they're meeting the 10 per cent stock ownership requirement;
3. a U.S. person who had control (over 50 per cent of the total voting power or total value of all stock issued) of a foreign corporation for at least 30 consecutive days during the corporation's tax year; or
4. a U.S. person who owns at least 10 per cent stock in a foreign corporation that is a CFC for at least 30 consecutive days during the corporation's tax year, and who owned the stock on the last day of the fiscal year.

Each of the IRS forms mentioned above has its own set of complex rules that vary depending on the specific situation. If you have questions regarding the U.S. filing requirements of your foreign investments, please contact your local Collins Barrow U.S. tax advisor for more information.

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