PASSPORTS TO A WORLD OF TAX TROUBLE:
Passive Foreign Investment Companies and the Potential Pitfalls of Foreign Investment

By Brandon Mourges

Many investors and their advisors have increasingly included foreign investments in their investment portfolios. While the merits of such investments are often carefully considered from a financial perspective, tax compliance can sometimes be an afterthought. With the Internal Revenue Service's ("IRS") increased focus on offshore activities and enforcement, investors should be mindful of the separate tax regime and reporting requirements that accompany investments in Passive Foreign Investment Companies ("PFICs").

What is a PFIC?
A PFIC is defined as a foreign corporation where either 75% or more of its gross income is passive income in a tax year or 50% or more of its assets produce or are held for the production of passive income in a tax year. 26 U.S.C. ("I.R.C.") § 1297(a). Most PFICs are foreign mutual funds or companies engaging in financial activities; however, other investments can qualify as a PFIC and, thus, be subject to the reporting requirements set forth below.

How are PFICs treated under the Internal Revenue Code?
For those investing in PFICs, the tax reporting and recognition requirements can be quite onerous, particularly if the PFIC is not identified as a PFIC at initial investment. The PFIC reporting provisions, found at I.R.C. §§ 1291-1298, are aimed at curbing perceived abuses related to tax deferral through investment in foreign mutual funds and attempt to place owners of offshore investments on the same footing as those investing in U.S. mutual funds. In short, these provisions require U.S. investors in PFICs to recognize their pro rata share of income (e.g., dividends or capital gains) on an annual basis, regardless of whether the investor receives distributions in a particular year. Investors who identify a potential PFIC within the first tax year of ownership can affirmatively elect to treat the PFIC under the "mark-to market" methodology ("MTM"), set forth at I.R.C. § 1296, or the "qualified electing fund" methodology ("QEF"), set forth at I.R.C. § 1295, either of which can alleviate some of the tax reporting requirements associated with PFICs. If eligible, investors may recognize income based upon the change in fair market value of their holding (MTM) or based upon their pro rata share of income items (QEF), as reported by the PFIC. In both cases, the PFIC is required to furnish a base level of information in order for the investor to be eligible to make the election.

If an investor does not elect to be treated under the MTM or QEF, the investor must report their PFIC interest under the "excess distribution" methodology set forth at I.R.C. § 1291. From a tax compliance perspective, the excess distribution methodology can be daunting. Simply put, in most situations, this methodology requires investors to allocate distributions (e.g., dividends) received from the PFIC for the entire period the investment is held. From there, the investor is required to impute tax and interest associated with the allocated distributions to determine their current tax liability. The purpose of these allocations is to simulate the tax consequences if distributions had been recognized on an annual basis.

Changing Regulatory Environment Affects Foreign Investment
The IRS recently issued new regulations regarding the reporting of PFICs, which may have a material impact on investors with indirect or *de minimis* holdings in PFICs. U.S. taxpayers with foreign investments also need to be mindful of the changing legislation regarding the reporting of their interests in closely-held corporations and partnerships, other foreign assets, and foreign bank

accounts. Navigating this statutory and regulatory environment can be quite complex and non-compliance can result in sizeable penalties, both civil and criminal. If you have questions regarding your foreign investments, assets or accounts, and would like to discuss the related tax implications or the available programs designed to bring U.S. taxpayers into compliance, please contact an attorney in our tax controversy group:

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