HAVE YOU INHERITED A P.F.I.C.? – WHAT IT MEANS TO BE A U.S. BENEFICIARY

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In today's global environment, it is not surprising to find that a beneficiary of a foreign estate or trust is living in the U.S. An interest in a foreign trust can be problematic for the beneficiary if the trust invests in a foreign "blocker" corporation that holds passive assets (such as stocks and securities) or a foreign mutual fund. U.S. tax law imposes special rules on U.S. direct and indirect owners of passive foreign investment companies or ("P.F.I.C.'s").

A P.F.I.C. is defined as a foreign corporation if it meets either the income test or the asset test:

- ***The Income Test*** – At least 75% of its gross income is "passive income."
- ***The Asset Test*** – At least 50% of its assets constitute passive assets (*i.e.*, assets producing, or held for the production of, passive income).[1]

Passive income is defined by reference to special rules applicable to controlled foreign corporations ("C.F.C.'s"), namely the rules applicable to foreign personal holding company income defined under Code §954(c) with certain exceptions. If either of the entities meets one of the tests described above, a foreign company will be classified as a P.F.I.C. A foreign company cannot be both a C.F.C. and a P.F.I.C. The C.F.C. rule trumps the P.F.I.C. regime.[2] Therefore, if a foreign corporation meets the definition of a C.F.C., it will not be taxed as a P.F.I.C.

A U.S. person will be subject to the P.F.I.C. regime if he or she is a direct or indirect owner of P.F.I.C. shares. This often occurs (i) upon the death of a foreign grantor when his or her revocable trust, taxed as a grantor trust during his or her lifetime, becomes a foreign non-grantor trust or (ii) simply upon the death of a foreign grantor. In some cases, the U.S. person may not even be aware of the existence of such a trust.

For example, stock owned through a corporation or partnership will be attributed to the U.S. person, while stock owned through a foreign trust or a foreign estate is considered to be owned proportionally by its beneficiaries.[3] A disposition of P.F.I.C. stock by the foreign estate or the foreign trust may also be treated as a disposition by a U.S. beneficiary.[4]

If an individual owns a share in a P.F.I.C. either directly or indirectly, the shareholder's holding period begins on the earlier date of the following: (i) the first day that the shareholder owned the stock of the P.F.I.C. directly, or (ii) the first day that the

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1 Code §1297(a).

2 Code §1297(d).

3 Code §1296(g)(1).

4 Treas. Reg. §§1.1291-2, 1.1291-3.

shareholder was an indirect owner of the P.F.I.C. stock (or the stock of another preceding P.F.I.C.).

There is some uncertainty in determining a beneficiary's interest in the case of a discretionary trust or a foreign estate prior to final settlement and termination.

If an indirect shareholder is taxable on a disposition of P.F.I.C. shares, he or she will recognize gain equal to the *pro rata* share of the gain the actual owner would have realized on an actual disposition of the stock.

Generally, a direct or indirect owner of a P.F.I.C. may elect to be taxed under one or two of the three P.F.I.C. taxation regimes:

- ***Code §1291 Fund*** – Under this rule, a taxpayer is subject to a punitive tax on "deferred tax amounts" of P.F.I.C. "excess distributions." An excess distribution is the amount by which the shareholder's current year (direct or indirect) distribution exceeds 125% of the average distributions received by the shareholder for the three preceding years. This is the default rule that applies unless the taxpayer makes a timely Qualified Electing Fund ("Q.E.F.") election or Mark-to-Market ("M.T.M.") election.

- ***Q.E.F. Election*** – If a Q.E.F. election is made, the taxpayer will include his or her *pro rata* share of the P.F.I.C.'s ordinary earnings and net capital gains for the year in income on an annual basis. Under this election, loss is not recognized. Generally, this election should be made for the first year of ownership.

- ***M.T.M. Election*** – If an M.T.M. election is made, the taxpayer will include the increased value of the P.F.I.C. shares as ordinary income on an annual basis, to the extent that the fair market value at the end of the year exceeds the taxpayer's basis in the shares. Unlike a Q.E.F. election, losses under an M.T.M. election can be deducted to a certain extent. To make an M.T.M. election, the P.F.I.C. shares must be "marketable" (as discussed in detail below).

REPORTING OBLIGATION

Generally, a U.S. taxpayer with a P.F.I.C. interest has an obligation to file Form 8621, Return by a Shareholder of a Passive Foreign Investment Company or Qualified Election Fund. This form must be filed every year for each P.F.I.C.

However, there is an exception to the filing obligation for U.S. beneficiaries of a foreign nongrantor trust or foreign estate that owns P.F.I.C. stock and has not made a Q.E.F. or M.T.M. election (unless the beneficiary is treated as receiving an excess distribution from the P.F.I.C. during the beneficiary's taxable year). This is a taxpayer friendly and sensible regulation, as many foreign estate or nongrantor trust beneficiaries do not know or have sufficient information concerning their status.

Filing Form 8621 can be expensive. Therefore, not making an election and waiting to file when the beneficiary receives a distribution can sound tempting. However, the beneficiary should consider the benefits of making an election. If a foreign estate or a foreign trust does not make a distribution for years, the punitive tax regime that accompanies an excess distribution could wipe out significant value of the P.F.I.C. interest.

Q.E.F. ELECTION

One is not required to be a direct owner of P.F.I.C. stock in order to make a Q.E.F. election.[5] Generally, a foreign estate or a foreign trust with a U.S. beneficiary can make an election on Form 8621. If the election is not made at the first level of ownership, the first U.S. owner in the chain of ownership can make the election.

For P.F.I.C. stock to qualify for the Q.E.F. election, a direct or indirect shareholder must comply with complex administrative rules requiring the P.F.I.C. to provide annual accounting statements. Unless the P.F.I.C. is a closely-held family corporation, it is usually difficult for a minority shareholder to obtain this information.

"An excess distribution is the amount by which the shareholder's current year (direct or indirect) distribution exceeds 125% of the average distributions received by the shareholder for the three preceding years."

M.T.M. ELECTION

Similar to the Q.E.F. election, the M.T.M. election can be made by either a direct or indirect owner of the P.F.I.C. This election is made by filing Form 8621 with the applicable tax return or on an amended return, provided that the amended return is filed on or before the election due date.[6]

If the P.F.I.C. stock was acquired by bequest, devise, inheritance, or a decedent's estate, and if an M.T.M. election was in effect as of the date of the decedent's death, then the basis of the P.F.I.C. stock owned by the U.S. beneficiary is the adjusted basis of the stock immediately before the death of the decedent or, if lesser, the basis as determined under Code §1014.[7]

To make an M.T.M. election, the P.F.I.C. stock must be considered a marketable stock. A marketable stock generally is a stock that is regularly traded on a sufficiently regulated exchange.[8]

CONCLUSION

It is important for the U.S. beneficiary to understand the repercussions of direct or indirect ownership of foreign corporations taxed as P.F.I.C.'s. As soon as a beneficiary learns about the P.F.I.C. interest, he or she is advised to consult with a tax professional to determine if it is beneficial (or possible) to make the special elections applicable to P.F.I.C.'s and assess the potential costs of not making these elections.

There are important *de minimis* rules to consider. In general terms, a P.F.I.C. shareholder is not required to file Form 8621 if (i) the aggregate value of the P.F.I.C. stock does not exceed $25,000 ($50,000 when filing a joint tax return) or (ii) the P.F.I.C. is owned indirectly and the value does not exceed $5,000. The *de minimis* exception may not apply if a Q.E.F. or M.T.M. election is made.

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5 Treas. Reg. §1.1295-1(d)(1)

6 Treas. Reg §1.1296-1(h)(1)(i).

7 Code §1296(h)(i).

8 Code §1296(e); Treas. Reg. §1.1296-2.

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