



CLIENT BRIEFING • INTERNATIONAL TAX

Passive Foreign Investment Companies

Reporting Obligations, Tax Traps, and Planning Elections for U.S. Persons Holding Foreign Investments

For U.S. citizens and green card holders with investments abroad, one of the least understood — and most punitive — corners of the tax code is the passive foreign investment company (“PFIC”) regime. A PFIC can be a foreign mutual fund, an offshore pension wrapper, a holding company, or even an early-stage foreign venture. Its defining feature has nothing to do with size or intent: it is a mechanical test applied to a foreign corporation’s income and assets, and once it is met, the consequences follow automatically.

This briefing explains how a PFIC is identified, why the default tax treatment is so severe, the elections available to soften it, and the annual reporting obligations that apply whether or not any of those elections are made. It is intended as a plain-language reference for clients who hold, or are considering acquiring, an interest in a foreign investment vehicle — not as a substitute for a return-specific analysis.



What Is a PFIC?

A foreign corporation is a PFIC for any tax year in which it meets either of two tests, applied to its income and assets for that year. There is no minimum U.S. ownership percentage — even a one-share holding in a foreign corporation that meets either test makes that holding a PFIC interest.

THE TWO TESTS (EITHER ONE IS ENOUGH)

- Income test — 75% or more of the corporation's gross income for the year is "passive income": dividends, interest, rents, royalties, annuities, and net gains from property that produces those types of income.
- Asset test — 50% or more of the corporation's average gross assets for the year (measured quarterly, by fair market value or, for a CFC, adjusted basis) produce, or are held for the production of, passive income. Cash is always treated as a passive asset, even working capital.

A subsidiary look-through rule can pull a holding company's status into or out of PFIC territory.

Where a foreign corporation owns 25% or more (by value) of a subsidiary, it is treated as directly owning its proportionate share of the subsidiary's assets and receiving its proportionate share of the subsidiary's income for purposes of both tests. A holding company that itself does little more than hold an operating subsidiary is tested on a look-through basis rather than by reference to the value of its own shares.

Because the test is applied annually, a corporation's status can change from one year to the next — but once it has been a PFIC at any point during a shareholder's holding period, a special rule (discussed below) generally keeps it a PFIC as to that shareholder indefinitely.

Where PFICs Commonly Turn Up

PFIC exposure rarely announces itself. It is most often discovered well after the fact, in the course of preparing a return or responding to a foreign account question, in holdings that clients did not think of as "investing in a foreign corporation" at all.



FOREIGN MUTUAL FUNDS, ETFS, AND POOLED INVESTMENT VEHICLES

The Single Most Common PFIC

Non-U.S. mutual funds, unit trusts, and exchange-traded funds are almost always organized as corporations under local law and almost always derive their income from dividends, interest, and capital gains. That combination satisfies the income test in nearly every case, which is why a UCITS fund purchased through a UK ISA, an Australian managed fund, or a Canadian mutual fund trust is, for U.S. tax purposes, treated as a PFIC.

FOREIGN PENSIONS AND RETIREMENT ACCOUNTS

Structure Determines Treatment

Many foreign pension and retirement arrangements are treated as trusts, not corporations, under U.S. tax principles, in which case the PFIC rules do not apply directly — but the underlying investment options inside the plan (the mutual funds the pension actually holds) can themselves be PFICs, reached through the trust's look-through treatment. Whether a given foreign pension is respected as a trust, treated as a foreign grantor trust, or disregarded requires a plan-by-plan analysis; it should never be assumed away.

FOREIGN HOLDING COMPANIES AND FAMILY INVESTMENT VEHICLES

A Common Trap for Inheritances and Family Structures

A foreign holding company set up to hold a family's investment portfolio, real estate, or a stake in an operating business is frequently a PFIC even when the family does not think of it as an "investment fund." U.S. persons who inherit an interest in such a structure, or who become U.S. tax residents while already holding one, step directly into PFIC exposure with no advance warning.

NEW VENTURES, START-UPS, AND CAPITAL-INTENSIVE PROJECTS

A Trap for the Unwary Founder or Early Investor

A foreign start-up that has raised capital but has not yet generated active revenue, or a company mid-way through a large construction or development project, can fail the asset test simply because its cash and investment balances outweigh its (as yet undeployed) operating assets. Companies that sell a significant asset and have not yet redeployed the proceeds face the same risk. As a rule of thumb: any foreign corporation in which a U.S. person holds 50% or less of the stock warrants a PFIC check.



Once a PFIC, Always a PFIC

If a foreign corporation is a PFIC with respect to a shareholder for even one year during that shareholder's holding period, the shareholder's interest is treated as an interest in a PFIC for all subsequent years — even if the corporation later fails both the income and asset tests — unless the shareholder makes a “purging election” (discussed below) or has made a timely, unbroken “pedigreed” QEF election from the first year of ownership.

INDIRECT AND ATTRIBUTED OWNERSHIP

- A U.S. person who owns an interest in a foreign partnership, trust, or estate is treated as owning a proportionate share of any PFIC stock held by that entity.
- A U.S. person who owns 50% or more (by value) of a non-PFIC foreign corporation is treated as owning a proportionate share of any PFIC stock that corporation holds.
- A U.S. person who owns any interest in a PFIC is treated as owning a proportionate share of any PFIC stock owned, directly or indirectly, by that PFIC.
- These attribution rules apply successively through a chain of ownership, so a PFIC held several layers down through foreign entities can still reach a U.S. taxpayer at the top.

OVERLAP WITH THE CFC RULES

- A foreign corporation can be both a PFIC and a controlled foreign corporation (“CFC”) — a foreign corporation more than 50% owned by U.S. shareholders who each own 10% or more.
- Where both tests are met, a U.S. shareholder who owns 10% or more of the corporation is taxed under the CFC (Subpart F / GILTI) rules, not the PFIC rules, for that period.
- U.S. persons who own less than 10% of the same corporation remain subject to the PFIC rules even while other shareholders are taxed under the CFC regime — the two regimes can apply side by side to different shareholders of the same company.



Three Ways a PFIC Interest Is Taxed

Every PFIC interest is taxed under one of three regimes. The default rules apply automatically and are punitive by design; the two elections available to a shareholder — the qualified electing fund (“QEF”) election and the mark-to-market election — exist to soften that result, but each comes with its own cost and each is only available in limited circumstances.

REGIME ONE — THE DEFAULT RULES (SECTION 1291)

Excess Distributions and the Interest Charge

Absent a QEF or mark-to-market election, a PFIC shareholder generally owes no tax on the investment until it is sold or a distribution is received — but that deferral is an illusion, because the tax code claws back the benefit of deferral through an interest charge once a taxable event finally occurs.

A distribution is tested against the shareholder’s average distributions over the prior three years; the portion exceeding 125% of that average is an “excess distribution.” The entire gain on a sale of PFIC stock is treated as an excess distribution as well — capital gain treatment is not available, and a loss on sale is not entitled to any special treatment under these rules.

HOW AN EXCESS DISTRIBUTION IS TAXED

- The excess distribution (or sale gain) is allocated ratably to every day in the shareholder’s holding period for the stock.
- The portion allocated to the current year, and to any period before the corporation’s first PFIC year, is taxed as ordinary income at the shareholder’s current marginal rate.
- The portion allocated to each prior year in which the corporation was a PFIC is taxed at the highest marginal rate in effect for that year — regardless of the shareholder’s actual bracket that year — and is subject to a nondeductible interest charge computed as if it were an underpayment of tax from that year forward.
- No capital loss carryforward is available for PFIC-related losses, and qualified dividend treatment is never available for PFIC distributions.



ILLUSTRATIVE EXAMPLE

- Shares purchased for \$1,000, held three years, sold for \$4,000: a \$3,000 gain, with no dividends paid over the holding period.
- Absent PFIC treatment, a 15% long-term capital gains rate would produce roughly \$450 of tax.
- Under the excess-distribution rules, the \$3,000 gain is instead spread evenly over the three-year holding period (\$1,000 per year); the two “prior year” shares are taxed at the top marginal rate then in effect plus an interest charge running from each of those years to the filing date.
- The result is a combined tax and interest cost of roughly 35–40% of the gain — an effective rate well above what the same gain would have borne outside the PFIC regime.

REGIME TWO — THE QUALIFIED ELECTING FUND (QEF) ELECTION

Turning a PFIC Into a Modified Flow-Through

A QEF election converts the PFIC into something closer to a pass-through entity for the electing shareholder: instead of deferral followed by a punitive catch-up, the shareholder includes its pro rata share of the fund’s ordinary earnings and net long-term capital gain in income every year, whether or not any cash is actually distributed.

WHAT A QEF ELECTION REQUIRES

- The election is made by the shareholder — not the fund — by attaching Form 8621 to a timely filed U.S. return, and it applies to the PFIC’s tax year ending with or during the shareholder’s tax year, and to every later year the corporation remains a PFIC.
- The fund must be willing and able to supply an annual PFIC Annual Information Statement (or open its books and records) so the shareholder can compute its share of ordinary earnings and net capital gain; many foreign mutual funds, particularly smaller or retail-oriented ones, will not do this for minority U.S. investors.
- Domestic partnerships, S corporations, and non-grantor trusts that hold PFIC interests are themselves treated as the “shareholder” for purposes of making the election, and the common parent of a consolidated group makes the election on behalf of the entire group.



THE PAYOFF FOR A TIMELY (“PEDIGREED”) ELECTION

- No interest charge and no excess-distribution treatment on inclusions or on sale of the stock, provided the election was made for the shareholder’s entire holding period.
- Net long-term capital gain retains capital gain character and current preferential rates; net losses do not flow through or reduce a later year’s inclusion.
- Distributions of previously taxed amounts are received tax-free, and stock basis is increased for amounts included in income and decreased for tax-free distributions, so the same economic gain is never taxed twice.
- A separate election under Section 1294 allows the tax on undistributed QEF earnings to be deferred until an actual distribution is received, subject to an interest charge and, potentially, a bond requirement.
- If the election is not made until after the first year of ownership (a “non-pedigreed” QEF), the default Section 1291 rules and the QEF rules apply simultaneously unless the shareholder also makes a purging election — without a purging election, the built-in gain as of the election date remains exposed to the interest-charge regime.

REGIME THREE — THE MARK-TO-MARKET ELECTION

Available Only for Marketable Stock

A mark-to-market election under Section 1296 is available only for PFIC stock that is “marketable” — in practice, stock regularly traded (on at least 15 days each quarter, more than a de minimis amount) on a qualifying U.S. or foreign exchange, or, in narrower circumstances, an interest in a U.S.-style open-end fund. Because most foreign mutual funds and closely held foreign corporations do not meet this standard, mark-to-market is unavailable far more often than QEF.

HOW THE ELECTION WORKS

- The shareholder includes as ordinary income, each year, the excess of the stock’s fair market value over its adjusted basis at year-end; if basis exceeds value, an ordinary deduction is allowed, but only to the extent of “unreversed inclusions” — net mark-to-market gains taken into income in prior years.
- Gain on an eventual sale is ordinary income; loss is an ordinary loss, but again only to the extent of prior unreversed inclusions — losses beyond that amount receive no special treatment.



- The election must be made no later than the first year the stock is a PFIC to avoid the same “unpedigreed” problem described above for QEF elections, and it applies to all subsequent years unless the stock ceases to be marketable or the shareholder obtains IRS consent to revoke.
- Because inclusions and gains are always ordinary — never eligible for capital gain rates — mark-to-market is generally less favorable than a timely QEF election where both are available, but meaningfully better than the default interest-charge regime.

Purging Elections and Late-Election Relief

A shareholder who wants QEF or mark-to-market treatment but did not elect it in the first year of ownership is not necessarily stuck with the default regime for the built-in gain that has already accrued. A purging election lets the shareholder recognize that built-in gain now, under the default rules (including the interest charge), in exchange for clean QEF (“pedigreed”) treatment going forward.

THE TWO FORMS OF PURGING ELECTION

- Deemed sale election — the shareholder treats the PFIC stock as sold for fair market value as of the beginning of the election year; the resulting gain is taxed as an excess distribution under the default rules, and the PFIC is a pedigreed QEF from that point forward.
- Deemed dividend election — available where the PFIC is also a CFC; the shareholder is treated as having received a dividend equal to its share of the corporation’s post-1986 earnings and profits, taxed the same way as an excess distribution.

Where a shareholder acquires stock reasonably believing the corporation is not a PFIC, a “protective” QEF election can be filed along with a statement explaining that belief and a consent extending the statute of limitations for PFIC-related tax on the stock. Separately, a taxpayer who missed a QEF or purging election altogether may apply to the IRS by private letter ruling for permission to make it retroactively, on a showing of reasonable cause — typically, reliance on the advice of a qualified tax professional — and no reduction in the government’s net tax recovery for the years affected. Consent must be requested before the IRS raises the PFIC issue on audit.



Annual Reporting: Form 8621

Since the reporting rules enacted in the 2010 HIRE Act, a U.S. person who is a shareholder of a PFIC generally must file Form 8621 for every PFIC held, every year — including years with no distribution, no disposition, and no election in effect. The obligation exists simply because the PFIC interest exists; it does not depend on any tax being due for the year.

WHO MUST FILE

- Generally, the first U.S. person in a chain of ownership treated as holding the PFIC stock under the attribution rules described above.
- A domestic partnership or S corporation is itself treated as the PFIC shareholder for reporting purposes and can generally file on behalf of its partners or shareholders — except for a partner or shareholder who receives an excess distribution directly, or who is reporting the status of a Section 1294 deferral election, in which case that person files separately.

DE MINIMIS EXCEPTIONS TO FILING

- No Form 8621 is required for a year in which the aggregate value of all PFIC stock the person owns, directly and indirectly, is \$25,000 or less (\$50,000 for married couples filing jointly), provided no excess distribution is received and no election is made that year.
- For PFIC stock owned only indirectly (for example, through another foreign entity), the threshold for the exception is \$5,000 rather than \$25,000.
- Additional exceptions can apply to tax-exempt shareholders and to PFIC interests held through certain foreign pension funds.

Because the filing obligation attaches to the PFIC interest itself, PFIC exposure should be identified as early as possible — during onboarding, at the time a foreign account or foreign inheritance is first disclosed, or before a foreign investment is made — rather than discovered after several years of unfiled Forms 8621 have accumulated. A qualified tax professional should perform PFIC due diligence any time a client holds a minority interest in a foreign corporation, even where the client does not believe an issue exists.



Practical Planning Considerations

ACTION STEPS

- Inventory every foreign investment, foreign pension, foreign inheritance, and foreign business interest at intake, regardless of how small the stake appears — there is no minimum ownership threshold for PFIC status.
- Decide on a QEF or mark-to-market election, if either is available, in the first year of ownership; a late election generally requires a costly purging election or IRS consent to reach the same result.
- Request PFIC Annual Information Statements from foreign fund managers before relying on a QEF election — confirm in writing that the fund will supply this information annually, since many funds will not.
- File Form 8621 for every PFIC every year, even when no distribution, disposition, or election makes a filing feel necessary — the obligation is independent of whether any tax is due.
- Revisit foreign holding company and family investment structures whenever a U.S. person inherits an interest, immigrates, or otherwise becomes a U.S. tax resident while already holding one.
- Coordinate PFIC analysis with FBAR and Form 8938 foreign asset reporting, since the same foreign account or investment often triggers more than one reporting regime.

This briefing is provided for general informational purposes and does not constitute legal or tax advice. PFIC status and the availability of the QEF and mark-to-market elections depend on the specific facts of each investment and shareholder; please contact Crossbridge Global Tax before relying on any of the general statements above in connection with a specific holding.