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## PFIC: What U.S. Investment Funds Should be Particularly Aware of and Newly Proposed Regulations

By [Idan Netser](#) and [Kris Hatch](#) • January 8, 2020

U.S.-based venture capital and other funds that invest in foreign companies must be careful to avoid the passive foreign investment company (PFIC) rules, which could substantially increase the tax owed on exit for U.S. taxpaying investors. U.S. persons who are limited partners (LPs) of funds must also be aware of the PFIC rules, as they are liable for their own tax reporting and payment of taxes.<sup>1</sup>

Failure to adhere to the PFIC rules could result in significant tax consequences for U.S. taxpayers. Ignorance of the rules could result in taxes, interest

and penalties significantly greater than the potential tax liability of an adequately monitored and managed PFIC.

The PFIC rules are not new; they have been around for many years. However, in light of substantial changes to the U.S. tax law by the Tax Cuts and Jobs Act, and newly issued proposed PFIC regulations (discussed in greater detail below), we are witnessing a growing trend of funds that require foreign incorporated startup companies to invert to become a Delaware C corporation, thereby avoiding PFIC issues.<sup>2</sup> If a startup remains a foreign corporation, funds now require the inclusion of certain robust tax provisions in the financing documents. These tax provisions may impose liability upon the startup if it is not careful to avoid becoming a PFIC, to timely inform the fund that the startup has or will become a PFIC, or to provide the fund with the much-needed financial information for the fund and its LPs' U.S. tax reporting.

Regardless of how a fund chooses to protect itself from the dangers of PFIC, *some* form of consideration must be made to avoid, or mitigate, PFIC's consequences.

### PFIC Origins

The PFIC regime was developed as a method of preventing US taxpayers from using foreign corporations to defer US tax on investment income. Originally lobbied for by the US mutual fund industry to prevent U.S.-based investors from fleeing to foreign-based mutual funds, the PFIC rules have become rules of broad applicability casting a far wider net than mutual funds.

### Consequences of PFIC

If a foreign company is a PFIC, several consequences arise for its U.S. investors.

*First*, gain on the sale of shares is taxed at ordinary income rates rather than long-term capital gain rates.

*Second*, an interest charge applies to reflect the time value of having deferred the U.S. tax liability on the built-in gain only on sale, rather than as the value accrued over time.

*Third*, additional taxes (and interest charges) are due on excess distributions greater than 125% of the average annual distributions paid in the three preceding taxable years, or, if shorter, the U.S. holder's holding period.

*Fourth*, penalties could apply for failure to report a PFIC.

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Once a startup becomes a PFIC, it remains a PFIC with respect to U.S. shareholders who owned the stock at any time while it was a PFIC, even if the company stops meeting either of the asset or income tests (described below). This is known as the “once a PFIC, always a PFIC” rule. A purging election may be made to remove the PFIC taint by making a deemed sale election or deemed dividend election, with the latter only available if the company is a Controlled Foreign Corporation (CFC).

## How a Foreign Startup Becomes a PFIC

A PFIC is defined as any foreign corporation for which at least 75% of the corporation's gross income is passive income (the “income test”) or at least 50% of the corporation's assets produce passive income (the “asset test”). Passive income is defined as any income that would be foreign personal holding company income under § 954(c).<sup>3</sup> Relevant to startups, passive income generally includes dividends, interest and gains on the sale of stock.

### Example 1: Breakdown of startup income for purposes of income test.

Income Source	Passive or Active?
Operating Business Income	Active
Working Capital (Interest from Bank Accounts)	Passive
Sale of Subsidiary or other Capital Asset	Passive
Dividends from Subsidiaries	Part Active, Part Passive. Depends on the source of the dividends (i.e. whether derived from an active trade or business)

Internal Revenue Service Notice 88-22 (the “Notice”) helped clarify what assets were considered passive assets for purposes of the asset test. The Notice clarified that the asset test is applied on a gross basis (no liabilities are taken into account), that the “average value of assets” for purposes of the asset test generally means the average fair market value<sup>4</sup> of the assets at the end of each quarterly measuring date, and that an asset is passive if it has generated, or will reasonably expect to generate passive income in the hands of the foreign company.<sup>5</sup> The Notice further provides the following “passive” versus “active” characterizations:

- Property used in a trade or business within the meaning of section 1231(b) is non-passive, provided the trade or business in question is one that does not produce passive income.
- Intangible assets (*i.e.*, intellectual property) that produce identifiable amounts of income, such as patents and licenses, are characterized on the basis of income derived from the intangible assets.
- Cash is a passive asset, even if it is held as part of the corporation's working capital.

A venture-backed startup frequently has a balance sheet consisting mostly of cash raised from investors, with the value of the cash often exceeding the value of other assets in the startup such as the intellectual property and tangible assets. A venture-backed startup frequently has no active business income earlier in its life; however, it may very well collect passive interest income on bank deposits and the working capital raised. As a result, an early stage foreign startup company could easily trip the PFIC test, if certain exceptions are not available or if mitigating actions are not taken (as further discussed below).

**Example 2: Balance sheet of a startup.** The cash would be considered a passive asset, therefore the startup would satisfy the PFIC asset test as at least 50% of the startup's gross assets are passive assets.

Asset	Value
Cash	\$1,000,000
Intellectual Property (developed over time since inception of company)	\$500,000

Depreciable Property (computers, servers, etc.)	\$100,000
Accounts Receivable	\$150,000
Inventory	\$150,000
Prepaid Expenses	\$100,000
<b>Total:</b>	<b>\$2,000,000</b>

## Triggering PFIC is more likely if foreign company the fund invests in is a Controlled Foreign Corporation

If a fund invests in a foreign company that is a Controlled Foreign Corporation—a foreign corporation that is more than 50% owned (by vote or value) by U.S. shareholders that own at least 10% of the company—the PFIC rules are more likely to be triggered. If the foreign corporation is a CFC, the foreign corporation must measure the value of its assets based on the *basis* (rather than fair market value) of the assets at the end of each measuring period.

Often, the basis of intellectual property that appears on the balance sheet of a startup is self-developed intellectual property with a zero or near-zero basis, even though the fair market value of the intellectual property could be quite high. This discrepancy could push the value of assets above the 50% threshold of the passive asset test for PFIC, where it otherwise would not be, as depicted by the following simplified example:

### Example 3: Balance sheet of a startup, using fair market value, and assuming the intellectual property is a non-passive asset.

Asset	Fair Market Value	Basis
Cash	\$1,000,000	\$1,000,000
Intellectual Property	\$2,000,000	\$0
<b>Total:</b>	<b>\$3,000,000</b>	<b>\$1,000,000</b>

## PFIC Look-Through Rule

The PFIC rules contain a look-through rule where the foreign corporation has a subsidiary.

Under the subsidiary look-through rule, a foreign corporation is deemed to hold its proportionate share of the assets and receive its proportionate share of income from subsidiaries in which it owns 25% or more of the stock. This rule prevents a fund from using a holding company to invest in foreign companies to circumvent the PFIC rules.

## Helpful Exceptions and Ways to Avoid PFIC Treatment

It can be difficult for startups to avoid PFIC treatment. Most venture-backed startups, especially those that are also CFCs, hold significantly more cash than any other asset on their balance sheets, thereby failing the asset test. Moreover, even if these startups do not fail the asset test, the interest income generated by the cash they hold can cause them to fail the income test. Nevertheless, if converting to a U.S. corporation is not an option, the following options may be available to the startup:

(a) Perform tax planning prior to founder moving to the United States.

If a foreign company is close to becoming a PFIC, such as by reason of the asset test (and having too much cash on the balance sheet), having a founder move to the U.S. and become a United States taxpayer could create further complications. As discussed above, under the asset test, a foreign company measures the value of its assets based on their fair market value at the end of each measuring period; however if the foreign company is a CFC, the foreign corporation must measure the value of its assets based on the basis of the assets at the end of each measuring period. Assume that the capitalization of the startup is as follows:

**Example 4: Cap table of a startup.** If foreign founder becomes a U.S. taxpayer, startup is 65% owned by U.S. shareholders, and is thus a PFIC.

Equity Holder	% Ownership
Foreign Founder	20%
U.S. VC Firm 1 (Series A)	30%

U.S. VC Firm 2 (Series B)	15%
Remaining Foreign Employees	35%
<b>Total:</b>	<b>100%</b>

In the above example, if the foreign founder moves to the U.S., the percentage ownership of the company owned by U.S. taxpayers jumps from 45% to 65%. In that scenario, the foreign company becomes a CFC.<sup>6</sup> Relying on basis to calculate the value of assets for the asset test could push a foreign company into becoming a PFIC.

*(b) Utilize the startup exception.*

Generally, a foreign company that would otherwise meet the PFIC criteria will not be treated as a PFIC for its *first* taxable year in which it earns gross income (the “startup exception”). In order to meet the startup exception, the following requirements must be met<sup>7</sup>:

1. No predecessor of such company was a PFIC.
2. U.S. shareholders establish that such corporation will not be a PFIC for either of the first two taxable years following the startup year.
3. Such corporation is not a PFIC for either of the first two taxable years following the startup year.

Requirements 2 and 3 make the startup exception a narrow exception that only applies in limited situations.

*(c) If corporation is a CFC, research and experiment expenses from the past two years can be capitalized for purposes of the asset test.*

This particularly useful exception permits a CFC startup, under certain circumstances, to capitalize certain research and experiment expenses for purposes of the asset test. Qualified expenses under this rule will create an active asset on the balance sheet that can be measured against working capital, which is treated as a passive asset.

*(d) If corporation is a CFC, ensure all U.S. shareholders own 10% or more of the corporation.*

If the startup meets either of the PFIC tests (the asset test or income test), one method of avoiding the PFIC rules is to ensure that all U.S. shareholders own their interest through a corporation holding a 10% or more interest in the startup. This is because 10% or more shareholders of a CFC are not subject to the PFIC rules<sup>8</sup>, but instead are subject to the GILTI regime, which imposes tax at a 10.5% rate. A discussion of the GILTI regime is beyond the scope of this article.

## Mitigating the Impacts of PFIC status: PFIC Information, Tax Distributions and QEF Election

Most startups generally may not be able to avoid becoming a PFIC. In that event, the startups need to ensure that they provide their U.S. shareholders the information necessary in order to make a qualified electing fund (QEF) election.

A QEF election allows U.S. investors to receive long-term capital gain rates on sales. However, investors that make the QEF election must include in each year’s taxable income a pro rata share of the PFIC’s ordinary earnings and net capital gains. The QEF election is advantageous for U.S. investors as most startups don’t have net income (rather sustain significant losses). Moreover, if the foreign corporation is no longer a PFIC, and the U.S. investor makes a QEF election in the tax year the investment was made, the U.S. investor no longer needs to include their share of profits in income, thus the “once a PFIC, always a PFIC” taint does not harm the QEF-electing shareholder.

A well-informed fund should consider making the QEF election with respect to its foreign investments that may be treated as PFICs. A well-advised fund should also require every foreign company it invests in to provide a mandatory distribution for any ordinary earnings and net capital gains the fund must take into income as a result of the QEF election.

Funds should ensure that in the deal documents that the fund signs with foreign companies they invest in, that the foreign company represent that they are not a PFIC, nor a CFC, such that if the foreign company were to be a PFIC or CFC, they would have to disclose such information to the fund prior to investment.

Funds should require foreign companies that they invest in to use reasonable best efforts to avoid becoming a PFIC. Funds should also require that a company immediately notify each investor if it becomes aware that the company or any subsidiary has become or is reasonably likely to become a PFIC, regularly examine its PFIC status and provide a reputable accountants' report regarding the company's status as a PFIC for such calendar year, and provide any assistance and information necessary to determine whether the company is a PFIC.

Funds should require that the foreign company provide them with the information necessary to assist them in filing the U.S. tax returns, and comply with their reporting requirements. For a U.S. investor to make a QEF statement, the foreign company must provide an annual information statement that meets the requirements of Treas. Reg. section 1.1295-1(g). This statement must provide the U.S. investors with their proportionate share of ordinary income, capital gains, and distributions made within the tax year its PFIC shares were owned. Funds should require their foreign companies to properly complete and duly execute a "PFIC Annual Information Statement" that meets the requirements of U.S. Treas. Reg. section 1.1295-1(g) and provide any other information or assistance required or otherwise necessary to (i) make a timely election to treat the company as a "qualified electing fund" under section 1295, and (ii) timely fulfill their annual election requirements (as described in U.S. Treas. Reg. section 1.1295-1(f)) in each subsequent year in which the fund owns an interest in the company.

## LP Side Letter

An informed LP would be wise to obtain a side letter with the fund they are investing in to address the circumstances in which fund investments are considered PFICs. The LP could require the general partner (GP) and the fund to provide written notice, and the information necessary to make a QEF election, if the GP reasonably believes the company the fund invests in is a PFIC.

## Impact of the Proposed Regulations on PFIC

On July 11, 2019, the Treasury and IRS published a set of proposed regulations and guidance on PFICs. The proposed regulations are not yet effective, and apply to U.S. persons once the regulations become final and are posted in the Federal Register, however taxpayers may choose to apply the proposed regulations as if they were final. The proposed regulations left many of the PFIC rules that would affect funds unchanged, however the following rule changes are of note:

### *(a) Ownership and Attribution Through a Partnership*

In a taxpayer favorable move, the proposed rules provide that attribution rules in a tiered ownership structure are to be applied using a "top-down" approach, starting with the U.S. person and determining which stock is owned at each successive level, rather than using a "bottom-up" approach starting with a PFIC and attributing its ownership upward.

Stock owned directly or indirectly by a partnership is considered owned by its partners.<sup>9</sup> U.S. persons that own 50% or more of the value of a non-PFIC corporation are treated as owning any of the stock owned by that non-PFIC.<sup>10</sup>

If a U.S. fund owns 100% of a non-PFIC corporation which in turn owns 100% of a PFIC, under the "top-down" approach, limited partners in the fund would not be attributed the PFIC stock, so long as they do not own 50% or more of the value of the non-PFIC. Under the "bottom-up" approach, starting with the PFIC, and attributing up to the Non-PFIC and then the investors in the fund, the PFIC stock would have been attributed to the investors.

### *(b) Asset Test Changes*

Proposed rules regarding which assets are passive and which are active are generally consistent with those in IRS Notice 88-22. However, the proposed regulations closed any alternative method of calculating assets that was advantageous to taxpayers. Under both old and new rules, taxpayers must calculate the value of assets at the end of each measuring period, then use the "weighted average" of those values to determine the value of assets for the asset test for the taxable year. Under old rules, "weighted average" arguably could be calculated based on value, or percentage. Prop. Reg. section 1.1297-1(d)(1)(ii) requires the weighted average to be calculated based on the average value at the end of each measuring period.

### *(c) Income Test Changes*

Under the income test, a foreign corporation is a PFIC if at least 75% of its income is passive income. Income that is foreign personal holding company income (FPHCI) under the Subpart F income generally is passive for purposes of the income test. The proposed rules address a number of issues, including FPHCI exceptions.

Neither the FPHCI “same country” exception for related-party payments (receipt of dividends and interest received from a CFC from a related CFC), nor the “look-through” exception (dividends and interest one CFC receives from a related CFC are not treated as FPHCI) apply for PFIC Income Test purposes. However, under the PFIC statute, interest and dividends received from a related person are excluded from passive income so long as they are properly allocable to non-passive income of the related person.

The proposed rules provide guidance to related-party payments. First, unlike under Subpart F rules, related-party interest expense is not allocated first to passive income before non-passive income, and is instead allocated pro rata. Second, dividends are allocated based on the extent to which current year earnings and profit are passive versus non-passive.

The proposed rules also indicate that if a foreign corporation owns 25% or more of a partnership, taxpayers “look through” the partnership, and gain is characterized based on whether partnership assets are passive or non-passive. If less than 25% of the partnership is owned, income (such as dividends and interest) received from the partnership is per-se passive.

*(d) Look-Through Subsidiary Rule*

The proposed regulations establish that if a foreign corporation owns 25% or more of the stock (by value) in another corporation, it is treated as directly owning its proportionate share of the assets or income that corporation has (and the subsidiary is a “look-through subsidiary”). Intercompany payments between a look-through subsidiary and a foreign corporation are eliminated for purposes of the PFIC income test. Gain on the sale of a look-through subsidiary is bifurcated between passive and non-passive based on the assets held by the look-through subsidiary.

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1 Funds taxed as partnerships for U.S. federal income tax purposes “pass-through” items of gain and loss to the LPs. Stock owned by a fund taxed as a partnership is considered to be owned by the LPs, thus any of the PFIC consequences trickle up to the LP level. There is no minimum threshold ownership requirement; thus even if an LP has a 0.01% interest in the fund, and the fund invests in a PFIC, the LP will be liable for its own PFIC tax consequences as a result.

2 In addition to the PFIC rules, there are many other good reasons for funds to require foreign incorporated startups to invert into the U.S., such as to ensure the fund’s eligibility for qualified small business stock (QSBS) treatment, to reduce the burden of U.S. tax reporting, or to avoid Subpart F and GILTI income inclusions.

3 Foreign personal holding company income is generally any income that would be thought of as “passive,” including interest, dividends, rents, royalties and certain other items.

4 A valuation of the assets by a valuation firm should be used to establish the fair market value of the assets.

5 PFIC status is determined on a set of “measuring dates” throughout the year. Generally, these measuring dates are quarterly, however the taxpayer may adjust the measuring periods if so desired.

6 A CFC is defined as any foreign corporation that is owned 50% or more by “United States shareholders” (those that hold a 10% or more ownership interest). Sections 957(a), 951(b).

7 Section 1298(b)(2).

8 Section 1297(d).

9 Section 1298(a)(3).

10 Section 1298(a)(2)(A).



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