BNA, INC.

DAILY TAX REPORT

VOL. 2010, NO. 216 NOVEMBER 10, 2010

# What to Do if Your Foreign Account Is a PFIC

BY ROBERT W. WOOD AND CHRISTOPHER A. KARACHALE

Foreign bank accounts have been in the news a great deal over the last two years and there has been particular focus on the Internal Revenue Service's underscoring of the long-standing rule that U.S. taxpayers must report all worldwide income; likewise, there has been a new push to enforce the often ignored requirement to disclose any and all bank accounts abroad.

With some high-profile prosecutions, IRS is expanding its tentacles well beyond Switzerland's UBS to many other countries and financial institutions.

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Many U.S. taxpayers have already come forward. Many others are in the process of doing so. Others still who have not yet probably eventually will. Some of these will be quiet disclosures, not drawing IRS attention or, hopefully, IRS ire. For these and other reasons, more stealthy approaches may be increasingly tempting.

*Robert W. Wood is a tax lawyer with Wood & Porter, a nationwide practice (http://www.woodporter.com). The author of more than 30 books, including* **Taxation of Damage Awards & Settlement Payments** *(4th Ed. 2009 www.taxinstitute.com), he can be reached at wood@woodporter.com.*

*Christopher A. Karachale is an associate with Wood & Porter in San Francisco.*

*This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*

Some of the most forthright of taxpayers may be those participating in the first wave of IRS voluntary disclosures with an initial submission deadline of Oct. 15, 2009. For those taxpayers and for some seeking to make disclosures since then, one of the most nettlesome practical issues has become the extent to which the person—wittingly or not—invested in a passive foreign investment company (PFIC). Many investors and their advisers are ruefully hearing the PFIC moniker for the first time.

## The Basics

A foreign corporation is a PFIC if 75 percent or more of the corporation's gross income is passive income (the income test), or at least 50 percent of the average percentage of assets it held during the year are assets that produce passive income (the asset test). A U.S. taxpayer who owns shares in a PFIC (directly or indirectly) is taxed under one of the most Byzantine regimes in the tax code (Sections 1291 through 1299).

Generally speaking, a shareholder of a PFIC can choose to be taxed on his or her interest in one of three ways:

- Treat the interest as a qualified electing fund (QEF). The shareholder must include his or her pro rata share of the QEF, both for ordinary income and capital gain.
- Elect to mark the PFIC stock to market, provided the stock of the PFIC is traded on some U.S. or foreign exchange. Under the mark-to-market regime, the taxpayer is taxed at ordinary rates on the yearly increase in the stock.
- Defer taxation until selling the stock in the PFIC or until the PFIC makes an "excess distribution." At that time, the taxpayer is subject to tax at the highest rate even on the gains from those prior years, plus an interest charge.

## Foreign Mutual Funds = Mutual Pain

As part of the voluntary disclosure program that ended in October 2009, taxpayers were required to account for all their undisclosed offshore earnings and the delinquent reporting associated with the accounts in which those earnings accumulated.

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For some taxpayers, the unreported income arose from ownership of simple interest bearing accounts. For others, the funds were held in foreign money market accounts. As money market accounts held by a foreign company, these accounts represented an interest in a PFIC. Consequently, these individuals—and the IRS agents who were assigned to review their cases—have been forced to address the PFIC rules.

Individuals who opened the foreign money market accounts with UBS or other offshore banks probably never considered whether they were investing in a PFIC. Indeed, many had their mail retained, and never contemplated having to provide historical data regarding the cost basis and holding periods of their interests in PFICs.

The lack of records and general confusion regarding the PFIC rules created problems for all parties in the voluntary disclosure process—taxpayers confused about how their investments would be taxed, IRS agents scratching their heads about how to verify reporting positions, and many practitioners and preparers scrambling to provide the relevant information.

## Alternative Resolution

As the voluntary disclosure process unfolded, it became clear that something had to be done to address the foreign money market accounts. In September, IRS announced an ''alternative resolution'' program for individuals with interests in PFICs. Under the alternative resolution program, a ''mark-to-market'' methodology is applied to every PFIC investment during the voluntary disclosure six-year period.

''Mark-to-market'' means that gain or loss for an asset is recognized as if it were sold for its fair market value on the last business day of the taxable year, and such gain or loss is taken into account for that taxable year.[*] In effect, mark-to-market means there is no need for a realization event. Tax is assessed each year based merely on the changes in value of the particular asset.

Under IRS's alternative resolution program for PFICs, a tax of 20 percent is applied to the yearly marked-to-market net gains, as well as any gains from dispositions of PFIC interests during the voluntary disclosure period. There is also a special 7 percent interest charge that is applied to the first year of tax, normally 2003. Finally, losses in the mark-to-market calculation are limited to ''unreversed inclusions,'' which generally means previously reported gains.

## The Application

The alternative resolution methodology has been published by IRS, and is currently available on the IRS website at http://www.irs.gov/newsroom/article/0,,id=228621,00.html. Yet in practice the computation is far from easy. However, provided you are dealing with a UBS client, and you have received the assets statements and income statements related to the account, you should be able to derive the mark-to-market gain and resulting tax liability under the alternative resolution program.

First, determine which foreign accounts represent PFICs. Foreign mutual funds certainly are within the class. However, ownership in any foreign entity generating substantial passive earnings appears to come within the PFIC regime. Based on interaction with various IRS agents, it appears that if the account is traded in shares of a foreign entity, IRS will take the position that it is a PFIC unless the taxpayer can show otherwise.

Second, make sure you calculate the taxable gain by taking into account both the gain attributable to the changing value in the stock of each of the mutual funds and the gain from disposition of stock of the mutual funds during the various years. You may end up creating complicated spreadsheets that track the changing cost basis of the shares of the mutual fund. However, asset statements will often provide the market price of the shares at the end of each year. This should allow you to mark the shares to market.

Similarly, where the taxpayer disposed or purchased additional shares of foreign mutual funds, the new cost basis is often provided on the income statements. This information, in conjunction with the asset statements for the particular year, should allow you to calculate the gain from the disposition of shares.

Once you arrive at the gain, both from mark-to-market changes in value and the dispositions of shares, calculate the taxpayer's tax liability. Apply a tax at a 20 percent rate to the gain for each year. Add this PFIC tax liability (along with the 7 percent interest calculation from tax year 2003) to the taxpayer's total original tax liability, whether regular or alternative minimum tax. Provide this information on the amended return itself—and not on Schedule D—along with a schedule showing your calculations, and you should be on your way to resolving the client's foreign mutual fund mess.

## Picture Perfect PFICs?

For practitioners, return preparers, IRS agents, and taxpayers alike, the voluntary disclosure program has served as a crash course in the tax implications of PFICs. Although the mark-to-market calculations may appear to be daunting, they are actually quite manageable. Bear in mind that most IRS agents dealing with voluntary disclosures are also playing catch up on this PFIC issue. However, some agents appear to have received special training on processing UBS account statements and calculating the PFIC liability.

In any event, do not be hesitant to call the agent handling your case and describe your calculations. More often than not, they appear willing to help.

There may be no picture perfect PFIC. Moreover, this discussion has been decidedly general. Taxpayers must apply IRS's alternative resolution program to their particular facts.

However, if you or your client have a foreign account with foreign mutual funds and if you have ordered all the account information, you should hopefully have the information necessary to determine the tax liability under the voluntary disclosure program's alternative resolution program.

[*] See, e.g., I.R.C. Section 475(a).

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