The Trouble with QEF Reporting

By Mary Beth Lougen

Mary Beth Lougen examines the issues surrounding the sale of a fiscal year qualified electing fund (QEF) by passive foreign investment companies (PFICs).

Practitioners that work with clients who have international connections often have to run the gauntlet of Code Secs. 1291–1298, the portion of the statute that covers passive foreign investment companies or PFICs. As someone who frequents the PFIC regulations, I am always in awe of this section of the Internal Revenue Code ("the Code"). The men and women who took the directive provided by Congress in the Tax Reform Act of 1986 and put to paper how we are to treat passive foreign investment companies on a U.S. tax return were geniuses. They have woven an intricate and complex web of "if this, then that" rules that speak to many other sections of the Code—if the PFIC is also a CFC, then … , if the shareholder becomes a U.S. person after already owning an investment that became a PFIC the minute they crossed into U.S. personhood, then … , if the investment was owned prior to 1987 when the regulations came into play, then … . But there is one place where the interaction between the PFIC rules and the rest of the regulations is not in sync, this is the case when there is a sale of a fiscal year qualified electing fund (QEF) during the period between the end of the fiscal reporting year and the taxpayer's calendar year end.

It is widely thought that QEF election is the best solution to a bad problem—but I am going to have to disagree, or at least disagree when the PFIC reports on a fiscal year. But I digress for a moment to go back and review the basics of PFICs—the definition and taxation options for anyone who has not had the pleasure of spending enough time with them to know them by heart.

PFICs are foreign corporations that meet one of the two tests:

- The income test is met if greater than 75 percent of the corporation's gross income for its tax year is passive income.
- The asset test is met if 50 percent or more of the average gross value of the assets in the foreign corporation produces passive income.

Passive income for this purpose includes income generally considered to be passive, such as interest, dividends, rents, royalties, annuities, foreign currency gain and other types of foreign personal holding company income.[1] Essentially, a PFIC is a non-U.S. corporation whose assets or income are predominantly passive.

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The most common PFICs are mutual funds based outside the United States.

The IRS requires annual reporting from U.S. persons who directly or indirectly receive distributions from, recognize gain on, are making an election for, are required to report information as a result of an election or who directly own an aggregate $25,000 ($50,000 MFJ) in PFIC investments on the last day of their tax year. The $25,000 threshold drops to $5,000 if the PFIC is indirectly owned.

Even though at this point in time Form 8621 does not carry a monetary penalty if the filing is missed, it is still very important to identify PFICs and report them each year the client meets the requirements since not filing for any year it is required will toll the statute of limitations on the entire tax return.[2] With reasonable cause you may be able to have the open statute apply only to the income items flowing from Form 8621.[3] In fact, taxpayers who otherwise do not need to file a tax return must still file form 8621 directly with the Ogden Service Center of the IRS. I find this surprising given that the form does not contain a jurat and signature line like most standalone forms.

There are three taxation regimes under which a PFIC may be taxed, with a few sub-elections that provide various ways to purge accumulated unrealized gain inside the investment when a QEF or mark to market (MtM) election is not being made in the first year. Each of the methods is multi-layered calculations performed per PFIC share or block of shares that have been purchased at the same time. Basis and unreversed inclusions (only applicable to MtM elections) must be adjusted and tracked per share or block of shares. And just to make things a little more complicated, consider the minefield presented by various state tax codes and options for income inclusion for the Net Investment Income Tax.

The default method of PFIC taxation is laid out in Code Sec. 1291. Code Sec. 1291 taxation is event based and punitive. Any distribution or disposition of a share of Code Sec. 1291 stock will trigger multiple calculations and the requirement to file Form 8621. A Code Sec. 1291 PFIC with only purchases and no other activity will not create income inclusions nor tax. Code Sec. 1291 also includes a deferred or throwback tax when distributions are made or the shares are sold for a gain. This deferred taxation is meant to mirror when the income would have been included in the taxpayer's income had the investment been based in the United States by allocating gains over the entire holding period. Once the amount of "gain per day" has been computed, the regime turns ugly and the income for each year is taxed at the highest tax rate imposed for that year—currently this is 39.6 percent as well as adding interest to the tax for each year on the value of the deferral. Interest is calculated from the due date of the tax return for the year of attribution until the due date of the year of disposition (or deemed disposition).

The other two methods—MtM and QEF—both require making an election that will apply to the current and all subsequent years. Once either election is made, the taxpayer will be required to file Form 8621 each year. Both methods require the inclusion of phantom income each year and for adjustments to the cost basis of the shares.

The MtM election values each share at the end of each year and any amount of capital appreciation will be added to Form 1040 line 21 and taxed as ordinary income. Since the regulations say that the calculation of appreciation is done per share keep in mind that gains and losses of shares purchased on different dates may not offset each other. Shares that have dropped in value do not create income, and the unrealized losses are allowed only up to the amount of gain previously included in income (unreversed inclusions) for those shares. Unreversed inclusions like everything else must be tracked by share or block of shares. Any unused unreversed inclusions when the related shares are sold are dropped from the available pool. There is no capital gain treatment for income. Losses on disposition are ordinary losses up to the amount of unreversed inclusions attributable to the shares disposed of, and capital losses for the loss over and above the unreversed inclusions. There is also a special alternate resolution MtM computation that is allowed for taxpayers in the Offshore Voluntary Disclosure Program (OVDP), but that is a different animal and not relevant for our purposes today.

And finally, today's subject—QEFs. Taxation under Code Sec.1293 does not include annual distributions from the investment in income but instead includes an amount of ordinary income and capital gains that the fund would have distributed had it distributed all its earnings at the end of each year into taxable income.[4] Any amounts of this phantom income included in income will increase the cost basis, and any actual distributions received will reduce the basis. Again remember that the income inclusions and basis adjustments are tracked per share. The best part of QEF is that any gain on a sale of the shares is allowed capital gains treatment. This is very similar to the taxation of domestic mutual funds. Another really great feature of QEF elections is that it appears as though the mutual fund company has done all the work for us by providing a PFIC Annual Information Statement that gives us the amounts of ordinary income and capital gains to add to our client's tax return.

Although the PFIC is making the annual reporting of income inclusions easy for us, do not forget to track the basis of each share by adding the amount in income and subtracting any actual distributions or dividends so that when the shares are sold you have correct basis numbers. This leads us into the main problem I see with PFIC taxation under Code Sec. 1293. QEF funds will report ordinary income and capital gains based on its accounting year, and if that year happens to be a fiscal year you only have a correct basis up to the end of that fiscal year. What happens when the taxpayer sells or otherwise disposes of shares between the end of the PFIC's fiscal tax year and the end of the taxpayer's calendar tax year? You will not have the information needed to calculate the basis of those shares after the PFIC year end of the current year until the PFIC Annual Income Statement has been received for the following year. Since there is no provision in the Code to allow a basis adjustment to capital assets sold in the previous year, you will have to amend the year of sale every time. Let us take this step by step through the applicable regulations so you see what I mean.

Passive foreign investment companies are defined in Proposed Reg. §1.1291-1(b)(1):

> *In general.—A passive foreign investment company (PFIC) is a foreign corporation that satisfies either the income test of section 1296(a)(1) or the asset test of section 1296(a)(2). A corporation will not be treated as a PFIC with respect to a shareholder for those days included in the shareholder's holding period before the shareholder became a United States person within the meaning of section 7701(a)(30).*
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> *(ii) PFIC characterization continued.—A corporation will be treated as a PFIC with respect to a shareholder even if the corporation satisfies neither the income test nor the asset test of section 1296(a), if the corporation (or its predecessor in a reorganization described in section 368(a)(1)(F)) was a section 1291 fund with respect to the shareholder at any time during the shareholder's holding period of the corporation's stock.*

Once identified as a PFIC, an investment is further categorized as types of PFICs in the next section, Proposed Reg. §1.1291-1(b)(2). For our purpose, I only present the definition of a QEF:

> *(i) QEF.—A PFIC is a qualified electing fund (QEF) with respect to a shareholder that has elected under section 1295 to be taxed currently on its share of the PFIC's earnings and profits pursuant to section 1293.*

Next an election to tax the PFIC as a QEF is made[5] by filing form 8621 and ticking the appropriate box in Part II. The election can generally only be made for a PFIC that provides the taxpayer with a PFIC Annual Information Statement or Annual Intermediary Statement[6] that provides the income amounts and amounts deemed to have been distributed. When the election is made in the first year of ownership, the PFIC is called a pedigreed QEF. Any investment for which the election was made in a year other than the first year of ownership is called a "non-pedigreed" QEF. Pedigreed status can also be achieved by purging any prior Code Sec. 1291 gain in a nonpedigreed QEF.

Taxation of pedigreed QEF investments is broken into two distinct calculations under two different parts of the Code—the annual taxation (Code Sec. 1293) and the taxation on disposition of the investment as a capital gain (Code Sec. 1(h)). The treatment of gains or losses on disposition of a nonpedigreed QEF reverts back to taxation under the punitive default method outlined in Code Sec. 1291.

Both pedigreed and nonpedigreed QEF funds are taxed the same on an annual basis. The PFIC will send the shareholder an annual statement[7] that will provide the information necessary to compute the income inclusions and basis adjustments for the year. The taxpayer will include on their tax return the income for the fiscal year of the PFIC that ends during the tax year the taxpayer is filing a return for.[8] This results in a timing issue that defers the reporting of some of the annual income inclusions until the subsequent year. For example, a PFIC that uses a year end of March 31, 2016, will send the amount of income the taxpayer will include on their 2016 tax return as ordinary income and capital gains based on the earnings of the fund from April 1, 2015, to March 31, 2016. Any income earned by the fund from April 1, 2016, to December 31, 2016, will be included on the 2017 tax return. Keep in mind that providing the information necessary for the taxpayer to make a QEF election requires that the PFIC essentially keep a second set of books to conform to U.S. rules, and although a PFIC may choose any date for its year end, many companies choose a fiscal year end to allow themselves more time to prepare the numbers to report the annual QEF income to their investors.[9]

Taxation on dispositions of QEF shares depends on whether the QEF is pedigreed or nonpedigreed. The clearest explanation I have seen on this subject is in the 1986 Blue Book, "General Explanation of the Tax Reform Act of 1986,"[10] Title XII(D)(6) Coordination of Code Sec. 1291 with taxation of shareholders of QEFs.

Pedigreed QEF:

> Gain recognized on the disposition of stock in a PFIC by a U.S. investor is not taxed under section 1291 if the PFIC is a qualified electing fund for each of the

> fund's taxable years which begin after December 31, 1986 and which include any portion of the investor's holding period. This provision allows any *unrealized appreciation in the stock of the qualified electing fund to be taxable as capital gain income* (if the stock is a capital asset) and without the imposition of an interest charge.
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> Nonpedigreed QEFs:
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> Any shareholder who owns stock in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxation year may elect to be taxed on the unrealized appreciation inherent in his or her PFIC stock up through the first day pf the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment. Thereafter the shares will be taxed under the rules applicable for qualified electing funds. *Absent this election, U.S. investors will be taxed under both provisions applicable to qualified electing funds and section 1291, and will, consequently pay deferred tax and interest not only on gain attributable to the years in which the PFIC is not a qualifying electing fund but also on gain attributable to the period during which an investor is taxed currently on his on her share of PFIC earnings.*

The information above makes it pretty clear so far what we need to do with a QEF PFIC. The technical guidance disappears as soon as our calendar year taxpayer sells or otherwise disposes of a QEF (pedigreed or nonpedigreed) between the end of the fiscal year and the calendar year. Consider that we will not know the true basis of the shares that were sold until the PFIC sends the next year's annual statement.

Below is an example based on the purchase and sale of an actual QEF showing the income, distributions and share prices using the PFIC annual information statements and spot currency conversion rates.

On August 5, 2013, a U.S. citizen residing in Canada purchases 10,000 shares of RBC O'Shaughnessy U.S. Value Fund—Class A (RBF552). The cost per share is $12.5578.

USD (13.05 CAD) for a total purchase price of $125,578 USD. If the taxpayer is planning on making a QEF election for the mutual fund, in 2013 the taxpayer is required to file Form 8621 under Code Sec. 1298(f) but only part I and only because their aggregate PFIC investments are in excess of $25,000 on the last day of their tax year.

In 2014, RBC provides a PFIC Annual Information Statement to the taxpayer, which indicates the following income inclusions and distributions per share of RBF552 owned for the period of July 1, 2013–June 30, 2014, in USD:

- Ordinary Earnings—$0.0010755706 per share per day
- Net Capital Gains—$0.0061606207 per share per day
- Cash/Property Distributions—$0.2751653668 per share annually

The shares were owned for 330 days during the PFIC's fiscal year, and we would need to include income based on 330 days of ownership. Further we need to adjust basis up by the amounts included in income and adjust basis down by the *pro rata* amount of the distribution for 330 days.

Resulting in a new basis per share of $14.6969 after adjustments as follows:

- Ordinary earnings: 0.0010755706 per share per day
- Net cap gains: 0.0061606207 per share per day
- Distributions: 0.0007538777 per share per day (0.2751653668/365)
- Adjustment per share per day: 0.0064823136
- Number of days: 330
- Total adjustment per share: $2.1392

The 2014 tax return entries would be:

- 1040 Line 21 = $3549 => 0.0010755706 × 10,000 × 330 days
- Schedule D = $20,330 => 0.0061606207 × 10,000 × 330 days

The basis of the entire 10,000 share investment as of June 30, 2014, would be $146,969 calculated in one of two ways:

- $14.6969 new share basis × 10,000, or
- $125,578 original cost + $3549 ordinary income + $20330 cap gains – $2488 distributions.

Now let us assume the taxpayer sells all 10,000 shares on December 1, 2014, for $14.1490 per share ($16.06 CAD)—total proceeds are $141,489 USD. The last basis you have is $146,969 ($14.6969/sh) as of June 30, 2014, but no idea what the basis of the shares was on the sale date. Under the general rules, sales of capital assets are reportable in the year of sale. With the information you have, the taxpayer has a long-term capital loss of $5,480 ($141,489 – 146.969) and this is what you report on their 2014 Sch D.

The following year when the taxpayer receives their 2015 PFIC Annual Information Statement from RBC they find the following income inclusions and distributions for the period of July 1, 2014–June 30, 2015, in USD:

- Ordinary Earnings—$0.00 per share per day
- Net Capital Gains—$0.0021925004 per share per day
- Cash/Property Distributions—$0.9945971661 per share annually

Even though the investor sold all the shares before the beginning of 2015, they still have to file Form 8621 and include the ordinary earnings and capital gains into their 2015 income for the number of days they owned the shares during the PFIC's tax year. In this case 154 days.

Resulting in a new basis per share of $14.6149 after adjustments as follows:

- Ordinary earnings: 0.00 per share per day
- Net cap gains: 0. 0021925004 per share per day
- Distributions: 0.002724924 per share per day (0.9945971661/365)
- Adjustment per share per day: –0.000532423
- Number of days: 154
- Total adjustment per share: –$0.8199

The 2015 tax return entries would be:

- 1040 Line 21 = $0=> 0.00 × 10,000 × 154 days
- Sch D= $3,376 => 10,000 × 0.0021925004/365 × 10,000 × 154 days

This amount will be added to the basis of the investment.

At the time of sale December 1, 2014, the actual basis of the 10,000 shares is $146,149 instead of the $146,969 we used on the 2014 Schedule D. The actual capital loss is $4661, an overstatement of basis in the amount of $820 from what was reported on the 2014 schedule D.

Even though the amounts are generally minimal in the grand scheme of things, when the return was prepared the preparer and taxpayer had to sign under the penalty of perjury that the return is true, complete and accurate. We knew the return was not true, complete and accurate at the time it was filed due to a pending adjustment to the basis of a capital asset that was disposed of. Since the basis rules in Code Secs. 1011–1016 do not have a provision for basis adjustments occurring in a year after the year of disposition, has the lack of being able to make the adjustment on the subsequent year's return created an obligation to amend the return for the year of disposition? I cannot imagine that this was the intent of the drafters of the PFIC regulations. But unfortunately for the taxpayers, the tax practitioners and the IRS, this is what we are required to do when there has been an understatement of income or overstatement of basis. Certainly, neither we nor the IRS need any extra work on our desks, and the clients do not need the additional costs and headaches that come with opening up an already filed return, but last time I checked we are not allowed to "make it up as we go" just to make the process easier.

About a year ago, I contacted the Office of the IRS Associate Chief Counsel (International) with the hopes that an alternative could be made available so we are not faced with constant amending when clients have QEF elections on their fiscal year PFICs. I specifically asked if we could make a one-off adjustment in the year of income inclusion to either add back any decrease of basis, or subtract any increase of basis due to the current year income inclusions and distributions reported on the PFIC statement. Unfortunately, there was nothing offered other than "That's not what the regs say," so we must continue to cost our clients extra money and the IRS extra work or knowingly disregard the *jurat* at the bottom of the tax return.

My proposal would be to add a section to Code Sec. 1016 to address QEF shares along the lines of:

> In the case of the disposition of shares of a qualified electing fund which reports ordinary income, long term capital gain, and distributions to a United States shareholder on a tax year ending that is not the same as the United States shareholder, an adjustment to income in the year of income inclusion made be elected to be made with respect to any shares disposed of during the period between the end of the qualified electing fund tax year and the US shareholder tax year. This adjustment would be a capital gain or loss in the amount of the net basis adjustment required for the shares disposed of in the immediately preceding tax year.

To illustrate from the example above, the taxpayer would include an additional $820 on their 2015 Schedule D. With this simplified way to correct a small oversight in an otherwise impressive piece of Code, QEF would once again be the best PFIC election in all cases where it is allowed.

ENDNOTES

1. Code Sec. 1297(b)(2)(D).
2. Code Sec. 6501(c)(8)(A).
3. Code Sec. 6501(c)(8)(B).
4. Code Sec. 1293(b).
5. Reg. §1.1295-1(f).
6. Reg. §1.1295-1(g).
7. Mention exceptions to the requirement to provide a statement.
8. Code Sec. 1293(a).
9. *See www.fidelity.ca/cs/Satellite/en/public/products/regulatory_documents/pfic.*
10. *See www.jct.gov/jcs-10-87.pdf.*