Bloomberg BNA

Tax Management
Weekly State Tax Report™

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Tax Base

The taxation of Passive Foreign Investment Companies is incredibly complicated because of the various ways these companies can be treated federally. In this article, Mary Beth Lougen of Expat Tax Tools brings up frequently asked questions intended to make tax professionals think about what their clients with state residency or domicile who also own a PFIC are facing.

The Nightmare of PFICs at the State Level—Answers to FAQs

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If the federal treatment of passive foreign investment companies (PFICs) under I.R.C. §§1291–1298 isn't enough to send you screaming from the room, have you ever considered how the various states view that same investment?

Once you start looking closely at the multiple federal treatments and how many ways a state can view those treatments, you quickly realize that the number of considerations and potential issues awaiting your clients is on a scale that is so large it can overwhelm the most seasoned professional. This article will bring up more questions than it answers and is intended to have you really think about what you are dealing with when you have a client with a U.S. state residency or domicile who also owns a PFIC.

You need to stop and thoughtfully evaluate how the state will treat income that is included in federal AGI but does not meet the definition for constructive receipt,

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income that is constructively received but not included in federal income, losses that are taxed differently than gains for the same investment, losses that are accounted for in different years than gains, income not included in AGI but instead subject to an additional tax by the IRS and just as many variations of basis adjustments.

As I see it, the main issues are:

- determining when state adjustments are required to accurately reflect state income,
- how to recognize when state and federal basis may be different due to timing of income inclusions, and
- lack of guidance by many state tax codes.

Let's start with the basic concepts of PFICs and how the federal regulations may create confusion when preparing the state tax return for a client who has a PFIC.

Under federal code, a U.S. person with ownership in a foreign corporation is not taxed until the corporation makes a distribution or is disposed of. The Tax Reform Act of 1986 (TRA86) introduced the concept of passive foreign investment companies and enacted IRC §§1291-1297[1] in order to prevent U.S. persons from indefinitely deferring taxation of passive income inside of foreign corporations.

A foreign corporation is a PFIC if it meets either the income test or the asset test. The income test[2] is met if greater than 75 percent of the corporation's gross income for its tax year is passive income. Passive income includes income you generally consider to be passive, such as interest, dividends, rents, royalties, annuities, foreign currency gain and other types of foreign personal holding company income. [3] The asset test[4] is met if 50 percent or more of the average gross value of the assets in the foreign corporation produce passive income. Essentially, a non-U.S. corporation whose assets or income are predominantly passive.

The most common PFICs are mutual funds based outside the United States, although the debate is heated over whether foreign mutual funds are truly subject to the PFIC rules since their structure may be a trust in the country of origin, which may not necessarily have been vetted as a corporation under U.S. Code—but that is a different article for a different day. The non-U.S. mutual fund is the type of investment referred to in this article.

The IRS requires annual reporting from U.S. persons who 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.[5] The $25,000 threshold drops to $5,000 if the PFIC is indirectly owned. Keep in mind that each of these triggers for mandatory filing of Form 8621 is in regard to not only shares owned directly by the individual, but also indirectly. Indirect ownership rules will kick in when a person owns a PFIC that owns a PFIC, when they own 50 percent or more of a domestic or foreign corporation that owns a PFIC, or they have an interest in foreign or domestic pass through entities that own PFICs. One must also consider that this will have some individuals reporting income owned by another taxable entity.

Below are some frequently asked questions about the taxation of PFICs.

If the income does not directly belong to the taxpayer and has not been distributed yet, is it really taxable at the state level, especially in a year where it has not been received, actually or constructively?

There is no clear answer for this question for most U.S. states. The states have a wide variance in how they recognize—or not—passive foreign investment income that falls under federal regulations 1.1291-1.1298.

There are several ways to treat passive foreign investment companies for federal tax purposes, ranging from extremely punitive to almost mirroring the taxation of domestic mutual funds. Let's briefly and broadly look at potential state issues that you will need to resolve before preparing a state return for a client with a PFIC investment. There are real issues to be considered as far as how two independent yet interrelated tax codes will work together when one strays from the tax logic we have all become accustomed to. These include the timing of when gain or loss is recognized, the character of the income inclusions or deductions, capital loss carry forwards and differences in adjusted cost base as a result.

When should you adjust state income to include realized gains that are not included in federal taxable income or remove unrealized income that is included?

The first vexing section of Internal Revenue Code we will delve into is §1291, also known as "unqualified funds" or "1291 stock." These are PFIC shares for which no federal election has been made to elect a gentler tax treatment under mark-to-market (MTM) or as a qualified electing fund (QEF). It is the "default" tax treatment of PFICs. The §1291 treatment and filing of Form 8621 is mandatory to report dividends paid, distributions received or any shares that have been sold or otherwise deemed disposed of. Distributions and gain on §1291 shares are taxed as either ordinary income or as an excess distribution. No capital gains treatment is allowed for §1291 income. A taxpayer who is otherwise not required to file Form 8621 and wishes to make the MTM election will also be required to calculate 1291 tax for any unrecognized gain in the investment. The 1291 treatment is optional at the time the QEF election is made, but must be computed by the time the shares are sold. If the 1291 tax is computed in order to "purge" the prior unrecognized gain from the PFIC, and the taxpayer still owns the shares, the purge will result in income being included on the federal return that is unrealized.

Will the state want to tax investment income that is not constructively received?

California will not. California states very clearly that "California does not recognize IRC §§1291-1298. A foreign corporation is treated as a regular corporation. In-

[1] IRC §§1296 & 1297 were renumbered to 1297 & 1298 in 1997.
[2] IRC §1297(b).
[3] IRC §954(c).
[4] IRC §1297(e).
[5] TD 9650; 2014 Instr. Form 8621.

come will not be recognized, nor taxes imposed, until a distribution is received or a disposition has occurred.''[6] But Wisconsin will—''Excess distributions from PFIC investments not included in federal income are an addition to income on Form 1 line 4 Code 05.''[7] Others are just silent.

Taxation of excess distributions is meant to be harsh and is calculated using some of the most difficult tax regulations currently on the books. Excess distributions on dividends or distributions occur when the amounts received in a tax year exceed 125 percent of the average distribution received in the previous three years, or when a sale or deemed disposition of shares results in a gain and the shares were acquired prior to January 1 of the current tax year. Amounts that are considered excess distributions are allocated to years before the current tax year and taxed at the highest tax rate for the year of allocation.

For actual or deemed sales of shares, each date of purchase is considered a ''block'' of shares and all calculations are done ''per block.'' You cannot net gain and loss from different blocks of shares; each block stands alone throughout the period it is owned. A taxpayer can end up with a large number of blocks if the PFIC happens to be a non-U.S. mutual fund that issues dividends monthly or quarterly, and the taxpayer reinvests them to purchase more shares. For each block of shares, you must convert the purchase to USD on the date of purchase and the sale proceeds to USD on the date of disposition or deemed disposition, calculate the amount of gain for each block, divide the gain by the number of days the block was owned and allocate the gain to each year of ownership based on the number of days in each year the block was owned. Gain allocated to the current year is entered on Form 1040 as ordinary income, and gain during the earlier years is not income on the return. Instead, a separate tax is computed using the highest tax rate in place during each respective tax year and is added as an additional tax to the regular income tax liability on Form 1040 line 44 (and finally you compute interest from the due date of the earlier tax years and drop that on Form 1040 line 62). Any blocks that are sold at a loss will result in capital losses, which cannot be netted against gains to reduce the amount subject to the §1291 tax and interest calculations. Blocks that are losses in a deemed disposition situation are simply ignored. This is very similar in concept to accumulated trust distributions, but much nastier math.

Let's assume a taxpayer has a Canadian mutual fund which was first purchased on July 1, 2010, (Block 1) with a second purchase of shares in February 2011 (Block 2). The taxpayer never made any elections as to the tax treatment of the investment for U.S. federal purposes. The taxpayer sold both blocks on December 31, 2014. Block 1 was owned a total of four-and-a-half years and the taxpayer had a gain of $4,500 USD on the disposition. Block 2 was sold the same day but for a $3,200 loss. $1,000 will be included on 2014 Form 1040 on line 21 as ordinary income, and the $3,500 balance of the gain will not be included in taxable income—instead the §1291 tax is calculated and an additional $1,271[8] of tax will be added to regular tax on line 44. The $3,200 loss cannot be used to offset the $4,500 of §1291 income; instead it will be on Schedule D subject to the regular rules for capital losses and the $3,000/$1500 limit.

What is the state's take on the difference in the character of income for federal purposes?

In the example, the gains are reported as both ordinary income and not income—but rather subject to the throwback tax, which means the IRS is ''accepting'' that the income has been ''included in income'' and taxed and the losses are capital losses.

Will the state allow you to treat the gain as capital gain and allow an offset by the capital losses?

If it is allowed as a capital gain, the taxpayer could reap additional benefits, such as taking advantage of the Retirement Income Exemption in Georgia, which allows exemption from tax on up to $65,000 of capital gains income for taxpayers over the age of 65.[9] In New Jersey, capital losses cannot be carried forward or backward. They have a use it or lose it policy,[10] so being able to re-characterize the income as capital can save the taxpayer New Jersey taxes.

A different outcome occurs when the computation of 1291 tax is voluntary, such as when the taxpayer makes a deemed sale or deemed dividend election in conjunction with electing QEF status, and the shares have not actually been sold. Only the gain will be recognized on the 1040, just as in the first part of the example—$1,000 as other income, $1,271 as an addition to tax. Since the taxpayer still owns the investment, the basis of those blocks will increase by the amount of income included in the §1291 computation (FMV Dec. 31 in most cases). The losses will be ignored completely and the basis of those shares will remain unchanged.

Will the state recognize income not yet received?

As mentioned before, California will not recognize income on passive foreign investment companies until it is actually received, and you will have to maintain separate accounting for the federal and state cost basis for each block. North Carolina, on the other hand, will recognize it: ''the following additions to taxable income shall be made in calculating North Carolina taxable income, to the extent each item is not included in taxable income: (2) Any amount allowed as a deduction from gross income under the Code that is taxed under the Code by a separate tax other than the tax imposed in section 1 of the Code.''[11]

Many of the other states are silent about PFICs in the specific sense, and you may need to look closely at the state tax codes for other statutes that would encompass

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[6] https://www.ftb.ca.gov/Voluntary_Compliance_Initiative_2/faqs.shtml#ovdi3

[7] 2014 Form 1 Instr.; 1997 WI Act 27 Sec71.05(6)(a)20; WTB 104.

[8] $2,500*35 percent top tax rate for each year 2010-2012 + $1,000*39.6 percent top rate for 2013.

[9] GA Tax Code 48-7-27 (a)(5)(E); 2014 Instr IT-511.

[10] 2014 Instr NJ-1040.

[11] 105-134.6(c)(2).

or exclude PFICs on a broader level. Even looking at how a state deals with accumulated trust distributions may give you some insight.

Also, consider the possible mismatch of capital loss carryovers between the federal and state returns. If the state treats the income as a simple sale of shares, the gains and losses will be allowed to net each other out. Going back to our earlier example of an actual sale, the end result could be federal long-term cap loss carryover of $1,700 ($3,200 cap loss, $1,500 annual limit) and no state level carry forward.

Does your head hurt yet? Because this only gets worse?

The second treatment allowed for PFICs on the federal return is the Mark to Market (MTM) election (§1296). This is very simple-sounding on the surface, but not so much when you really delve into the details. If the FMV of any block of shares at the end of the year is larger than its adjusted cost base, the difference is reported as ordinary income on Form 1040. Basically your client is paying tax each year on the unrealized gain in the investment. If the FMV has dropped over the year, the unrealized loss may or may not be allowed, depending on how much income has been included in federal income prior to the current tax year under the MTM election.

Basis and unreversed inclusions (a fancy way to say prior unrealized gains included on the tax return) must be tracked per block of shares. This level of tracking is daunting and prone to error. If the election is not made in the first year of ownership any prior unrecognized gain must be ''purged'' under the §1291 rules and the new basis for all shares that were deemed to have a gain will step up to the FMV on Dec. 31. Shares that are under water will have the losses disregarded for purposes of §1291 and the basis will remain unchanged.

When shares are sold under the MTM regime, if the FMV of a block of shares on the date of disposition is larger than the cost basis, the gain will be ordinary income, and all unreversed inclusions associated with that block are dropped (they cannot be transferred to a different block of shares for future use). If the FMV is less than the cost basis, the loss to the extent of unreversed inclusions are ordinary losses and capital losses to the extent they exceed unreversed inclusions.

Have you figured out what the potential issues are with this federal election?

First of all, if §1291 tax is computed before the shares are sold, this is not yet ''real'' income under most tax precepts. When the taxpayer has not received any cash or property from the investment, they are paying tax on income that, under the regular rules of constructive receipt,[12] and income inclusion for sale of investment shares[13] would not be reportable on a tax return yet, if not for the fact it is a passive foreign investment company. Some states will not tax income until it is actually received in a taxable event. As I mentioned before, California is one such state. I am referring to California often because they make it very clear what we as tax practitioners are to do with this income, and I respect any clear guidance that just simply says ''put it here.'' California has dedicated an entire chapter in their Water's Edge Manual to the subject of PFIC taxation.[14] It provides a well-written explanation of the basics of PFICs and what adjustments California requires. In addition, FAQ #3 for their OVDI program[15] directly addresses the use of MTM on personal returns by stating, ''you may not use the mark to market approach simply due to the fact that you hold stock in a PFIC. California does not conform to the PFIC rules contained within IRC Sections 1291-1298; therefore, the corporation in which you hold stock will be treated as a regular corporation for California purposes. As such, you must meet the requirements of IRC Section 475 in order to elect the mark to market approach. If you do not meet the requirements to elect the mark to market approach, you must recognize the capital gain or loss on any stock that you hold in a PFIC at the time of the stock's disposition. . .'' So now you have different timing for income inclusions, different basis and the different types of income for California and the IRS. Ohio, on the other hand, works with the same timing for income inclusion as the IRS, and the basis will remain the same for both. I could not find this fact in writing, but I called the Ohio Department of Revenue and had my call escalated to someone who could answer my questions. He said it is not written, but Ohio will include income when included by the IRS and allow losses when allowed by the IRS. The Instructions to Ohio IT-1040 state that ''In all cases, line 1 of your Ohio income tax return must match your federal adjusted gross income as defined in the Internal Revenue Code.'' As a side note, §1291 income not included in federal AGI would be added back to Ohio income on line 37f with a statement of explanation.

Finally, we move to the final and gentlest of the federal treatments, called the qualified electing fund or QEF election. It may be gentler, but it isn't simpler. The IRS will allow the taxpayer to calculate tax on gains from sales as capital gain if they elect to include their share of the fund's ordinary income and capital gains in U.S. federal income each year. The mutual fund company must provide a ''PFIC Annual Information Statement'' each year to the taxpayer that provides these amounts. Dividends are not included in income on Schedule B; the ordinary income amount goes on Form 1040 line 21, and the capital gains amount on Schedule D as long-term gains. Basis is increased by earnings included in income and decreased by distributions received (this is where the dividends come in). And once again all transactions in the investment must be calculated per block of shares. The QEF election, like MTM, is including unrealized income on Form 1040 and not including in income monies that the taxpayer may have received.

What is the state's position on not including actual dividends received in lieu of prorate share of ordinary income as calculated by the fund? Could failure to include the dividends be considered understating income?

Another fly in the ointment is that unless the QEF election is made in the first year, the person owns the

[12] §451.

[13] §1222.

[14] CA FTB IPM Water's Edge Manual Rev Sept 2001.

[15] https://www.ftb.ca.gov/Voluntary_Compliance_Initiative_2/faqs.shtml#ovdi3

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investment. The prior unrecognized capital appreciation in the account will need to be addressed at some point. The taxpayer has the choice of whether to purge the 1291 gain in any year or wait until the fund is sold. When the purge happens, you are back to dealing with the income inclusion, timing and basis issues outlined in the 1291 section of this article.

Unfortunately, it is easier than you might think to end up owning PFIC shares. Many of the popular exchange-traded funds known as ishares are PFICs. Mutual funds based outside the U.S. are widely accepted as PFICs (even if they own all U.S. investments), and even money market funds outside the U.S. can be PFICs.

In the world of state taxation of PFIC investments, ambiguity is the only thing you can be sure of.