First published by the Canadian Tax Foundation in February 2009 Vol 17, no. 2 *Canadian Tax Highlights*.

CANADIAN TAX Highlights

Downturn Begets PFIC Status

Not all of the negative fallout from the global financial downturn has galvanized the mainstream media's attention. For example, non-US public companies and their advisers should heed the potential for the severity of the current economic downturn to trigger passive foreign investment company (PFIC) status. Any investment by a US investor in a non-US public company that is or may be a PFIC is made less appealing by the imposition of onerous tax rules.

A non-US company is a PFIC if at least 75 percent of its income, or at least 50 percent of its assets, is considered passive. The asset test may be particularly problematic because the current financial markets have depressed many a public company's market capitalization, the means usually used (after corporate liabilities are added) to value a public company's assets for PFIC testing purposes. Thus, the proportionate value of passive assets in a non-US public company may be much higher than it would be in a more normal marketplace, even for a company with an active business.

The PFIC rules were enacted in 1986 to discourage a US person from investing in a non-US company with passive investments (such as mutual funds) by imposing much higher taxes on a US shareholder who repatriates funds from such a company relative to the tax imposed on a US passive company subject to current US taxation. The ability to defer US tax continues under the PFIC rules, but the offset is that the investor is taxed at the highest US income tax rate and must pay an interest charge to reflect the deferral of US tax on certain distributions from, or dispositions of, stock in a PFIC. The US investor may mitigate these adverse US tax consequences by making certain tax elections reporting the company's financial information to the IRS, an option that the company may find burdensome and unappealing. Moreover, once a company is determined to be a PFIC vis-à-vis a US shareholder, it always retains that status for that shareholder, even if it actually meets the PFIC requirements for only one year.

Unfortunately, little legislative or administrative guidance exists to assess whether a non-US company's income and assets are deemed passive for the PFIC rules. Passive income includes interest, dividends, royalties, rents, annuities, and gains from the sale of property that produces passive income. For an active company, gross operating income for PFIC purposes includes revenue from sales less the cost of goods sold; usually such a company is thus unlikely to meet the income test for PFIC status as long as it is profitable on its sales. If the company is not profitable, it will have a PFIC problem if it has any passive income, even a small amount of interest income in a bank account. Passive assets are those that produce passive income; the value of passive assets is determined quarterly and averaged for the year. The IRS interpretation of which assets are passive is particularly problematic for a company (such as a service or high-tech company) that has few hard assets: cash on hand, even if it is committed to a particular purpose or held for working capital, is deemed passive under the PFIC rules. This characterization of cash on hand can also be problematic for a company engaged in raising money from investors, because money raised is often not deployed immediately and is deemed to be passive while it remains on the company's books.

At the heart of the PFIC asset test is the question of how to value a company's assets. More than a decade ago, a congressional committee said that a public company will "generally" value its total assets as an average based on its market capitalization at the end of each quarter, plus the corporation's liabilities. Market capitalization means the company's stock price multiplied by shares outstanding. In the present financial meltdown, however, the use of the market capitalization method may cause many previously unaffected companies to fall into PFIC status because, for example, the market value of the

company is close to or even less than the amount of cash on hand. This unprecedented situation poses a challenge for a non-US public company that has or wishes to have a significant US investor base.

One possible solution is to consider an alternative to the market capitalization approach to establish a value for the company. The only legislative, administrative, or judicial guidance on the appropriate valuation method for a public company is the brief comment referred to above--that the market capitalization approach will "generally" be used. However, it is questionable whether in the current financial environment the market capitalization method can fairly determine a public company's value; other valuation methods may be more appropriate. Although it is not clear that the IRS will be receptive to a deviation from the market capitalization approach, it seems clear that in today's unusual financial markets the traditional approach produces results that are inconsistent with the PFIC rules' intent.

A non-US public company that is or may be a PFIC may need to disclose that status to investors; under US securities law, PFIC status may be a material factor requiring disclosure in securities filings. A non-US company and its advisers should carefully consider whether they need to address PFIC concerns, especially if the company has or wishes to have US investors. If PFIC status is a concern, consideration of alternative approaches to valuing the company may prove essential to ensuring the development and/or maintenance of a strong US investor base.

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