In these provisions, a different technique for eliminating the benefits of deferral was adopted. Instead of treating the U.S. shareholder as having received a share of the undistributed income of the foreign investment company for the tax year as a constructive dividend, the PFIC provisions eliminate the economic benefit of deferral by imposing additional U.S. tax when the U.S. person owning stock in the PFIC disposes of the PFIC stock at a gain or receives a so-called "excess distribution" from a PFIC, tax is imposed at that time which is increased by an interest charge based on the value of the tax deferred.

The only way to avoid or mitigate the PFIC computations stated in the Internal Revenue Code is to make a qualified electing fund or mark to market election.

Below, please see Illustration 1. and Illustration 2. which demonstrate a typical sale of PFIC stock or mutual fund in which qualified electing fund or mark to market elections were not timely made:

Illustration 1.

Grandma is a U.S. citizen who likes to invest in mutual funds. On the advice of her broker, on January 1 of year 1, she buys 1 percent of FORmut, a mutual fund incorporated in a foreign country for $1. FORmut is a PFIC. Not having any knowledge of international tax or the PFIC rules, Grandma and her accountant fail to make a QEF election. During years 1, 2, and 3, FORmut accumulates earnings and profits. On December 31 of year 3, Grandma sells her interest in FORmut for $300,001. Because Grandma has never made a QEF election, Grandma must throw the entire $300,000 gain received over the entire period that she owned the FORmut shares - $100,000 to year 1, $100,000 to year 2, and $100,000 to year 3. For each of those years, Grandma will pay tax on the throw-back gain at the highest rate in effect that year with interest.

It is easy to envision significantly more complex scenarios. Such a scenario is described in Illustration 2 which is based on an example in Staff of Joint Comm. On Tax'n, 100 Cong., 1st Sess., General Explanation of the Tax Reform Act of 1986, at 1027-28 (1987).

Illustration 2.

On January 1 of year 1, Samantha, a U.S. citizen, acquires 1,000 shares in FC, a foreign corporation that is a PFIC. She acquires another 1,000 shares of FC stock on January 1 of year 2. During years 1 through 5, Samantha receives the following dividend distributions from FC:

Date of Distribution	Amount of Distribution
Dec. 31 of year 1	$500
Dec. 31 of year 2	$1,000
Dec. 31 of year 3	$1,000
Dec. 31 of year 4	$1,000
Apr. 1 of year 5	$1,500

Oct. 1 of year 5 $500

Under Internal Revenue Code Section 1291, none of the distributions received before year 5, are excess distributions since the amount of each distribution with respect to a share is 50 cents. However, with respect to distributions during year 5, the total distribution with respect to each share is 37.5 cents ($1 minus 62.5 cents (1.25 times 50 cents)).

Accordingly, the total excess distribution for FC's tax year ending December 31 of year 5 is $750 (37.5 per share times 2,000 shares). This excess distribution must be allocated ratably between the two distributions during year 5. Thus, $562.50 (75 percent of the excess distribution, i.e., $750 times $1,500/$2,000) is allocated to the April 1 distribution and $187.50 (the remaining 25 percent of the excess distribution, i.e. $750 $500/$2,000) is allocated to the October 1 distribution. These amounts are then ratably allocated to each block of stock outstanding on the relevant distribution date. For distribution on April 1 of year 5, $281.25 of the excess distribution is allocated to the block of stock acquired on January 1 of year 1, $281.25 is allocated to the block of stock acquired on January 1 of year 2, and $281.25 is allocated to the block of stock acquired on January 1 of year 3. The $187.50 excess distribution on October 1 of year 5 is also allocated evenly between the two blocks of stock outstanding on the date of the distribution.

The federal tax due in the year of disposition (or year of receipt of an excess distribution) is the sum of (1) U.S. tax computed using the highest rate of U.S. tax for the shareholder (without regard to other income or expenses the shareholder may have) on income attributed to prior years (called "the aggregate increase in taxes" in Section 1291(c)(1)), plus (3) U.S. tax on the gain attributed to the year of disposition (or year of receipt of the distribution) and to years in which the foreign corporation was not a PFIC (for which no interest is due). Items (1) and (2) together are called the "deferred tax amount" in Section 1291. Item (2), the interest charge on the deferred tax, is computed for the period starting on the due date for the prior year to which the gain on distribution or disposition is attributed and ending on the due date for the current year in which the distribution or disposition occurs.

The above examples demonstrate the complexities of PFIC calculations and how the PFIC calculations could easily generate a significant tax liability. Given these complexities, in each case involving PFIC, we carefully analyze the transactions to determine the most beneficial position we can take on behalf of our clients, including, making qualified fund elections and mark to market elections.

If you hold an interest in a foreign financial account or are considering investing in a passive foreign investment such as a mutual fund, these complicated rules may impact you. You should know, if you do not properly plan for the PFIC taxing regime, the federal tax consequences could easily exceed your foreign investment. Let the international tax attorneys at Moskowitz LLP review your foreign portfolio to determine the most beneficial method to report your foreign transactions.