BAD TIMES FOR NON-U.S. PUBLIC COMPANIES WITH — OR SEEKING — U.S. INVESTORS

International/Cross-Border Alert
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Certain U.S. tax rules have clearly had a negative impact on Canadian or other non-U.S. public companies that are or might be classified as passive foreign investment companies (PFICs) by making them less appealing to U.S. investors — and, as in so many other areas, the current financial meltdown is making it worse.

A foreign company can be considered a PFIC by the IRS if 75 percent or more of the company's income or at least 50 percent of its assets are "passive." U.S. investors in PFICs are subject to far more onerous U.S. tax rules than their counterparts investing in foreign companies that are not PFICs. The PFIC rules were enacted in 1986, primarily to discourage U.S. persons from investing in foreign holding companies or mutual funds rather than in domestic ones.

The asset test for PFIC status is particularly problematic given the current environment. At the heart of the PFIC asset test is the question of how to value a company's assets. Legislative history suggests that a public company would generally value its total assets based on its market capitalization (stock price multiplied by shares outstanding), plus its liabilities. Now, however, use of this valuation method may cause many companies that never would have been considered PFICs to fall into that status. For example, shares of a foreign publicly traded high-tech company may be trading currently at an extremely low value. If that company has cash on hand (which is considered a passive asset) that is close to or even exceeds its market value, the company is a PFIC. In the present financial environment, however, it is highly questionable whether the application of this method is appropriate because it may cause an otherwise active company to be classified as a PFIC solely because of the global economic crisis. This appears inconsistent with the intent of the PFIC rules.

There are other pitfalls to be aware of. Companies that are or may be PFICs may need to disclose that status in securities filings, for example. Also, once a company is a PFIC with respect to a U.S. investor, it is always a PFIC with respect to that U.S. investor, even if it is only a PFIC in one year. Non-U.S. companies and their advisors should carefully consider how to address PFIC concerns — especially those companies that have or want U.S. investors.

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