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Search Funds Beware: Strategies for Avoiding PFIC Adverse Tax Consequences

Because Search Funds seek to invest in active businesses, searchers and their US investors are often surprised to learn that they may be subject to the Passive Foreign Investment Company ("PFIC") rules for US federal income tax purposes. While this should not be an issue for Search Funds organized in the US, any Search Fund organized as a foreign corporation for US tax purposes should be aware of the potential tax consequences of PFIC treatment.

PFIC status is relevant – and to be avoided if possible – because it imposes much higher tax rates on an investor's income than would otherwise apply. The good news is that, with careful planning described below, it's possible for foreign Search Funds and their US investors to mitigate the adverse tax effects.

Please note, this article is not a complete summary of US tax issues that could be applicable to Search Funds investing in or acquiring foreign business. Examples of other tax issues that could arise include the US federal rules applicable to controlled foreign corporations ("CFCs"), subpart F income, and global intangible low-taxed income ("GILTI") rules. If you are investing (directly or indirectly) in any type of foreign entity, we recommend consulting with your tax counsel so that you do not face unexpected liabilities.

When will a Search Fund be deemed a PFIC?

In general, a foreign corporation will be classified as a PFIC for US federal income tax purposes for any taxable year if either:

- 75% or more of its gross income for such year is "passive income," which for this purpose generally includes dividends, interest, royalties, rents and gains from commodities and securities transactions, and gains from assets that produce passive income (the "Income Test"); or
- 50% or more of the value of its assets (based on an average of the quarterly values of the assets) during such year is attributable to assets that produce passive income or are held for the production of passive income (e.g., cash, stocks, bonds) (the "Asset Test").

A Search Fund's lifecycle and time between the initial financing for the search phase and acquisition of an active business will often cause the Search Fund to be caught by one or both of the above PFIC tests. During the search phase, a Search Fund's assets will likely be predominantly passive assets like cash and cash equivalents. Under the Asset Test, cash is always treated as a passive asset even if used in an active business or used by the searcher to actively search for an active business target. Similarly, under the Income Test, it may be that during the search phase the only gross income generated by the Search Fund is interest income or other passive income resulting from holding the initial funding in cash or money market funds. If the Search Fund does not generate other income from active activities, the passive portion of gross income for the year may be greater than the 75% threshold.

Even after the initial search phase, a Search Fund may be considered a PFIC under the Assets Test if the Search Fund takes on significant growth financing (50% or more of the value of the Search Fund's assets).

What is the tax result of PFIC classification?

Unless it makes a QEF election, described below, where a foreign corporation is classified as a PFIC, gain and certain "excess

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distributions" recognized by US taxable investors are treated as follows:

- The gain is first allocated ratably to each taxable year during the investor's holding period for the PFIC stock;
- The gain allocated to each taxable year is taxed at the highest ordinary income tax rate in effect for that year (rather than at the lower capital gain rates); and
- An interest charge is imposed on the tax liability attributed to any prior tax years during the investor's holding period to which gain was allocated.

In addition, even when the search fund/business eventually generates enough active income to avoid PFIC treatment, classification as a PFIC in a prior tax year will cause the Search Fund to continue to be classified as a PFIC unless the shareholder makes an election to purge the PFIC taint and pay the PFIC taxes as if the Search Fund stock were sold for fair market value – and this may result in a potentially significant "dry" tax liability (meaning a tax bill but no cash liquidity to pay it) to US investors desiring to eliminate the PFIC taint.

The following example illustrates how a capital gain would be taxed under the default PFIC rules described above, often referred to as the "excess distribution" rules:

On July 1, 2019, a US person ("USP") made a $1m investment in a foreign corporation that is a PFIC. On June 30, 2021, USP exits the foreign investment and receives $1.8m. The $800,000 gain would be taxed as follows:

- The gain is allocated over the period the PFIC investment was held, i.e. July 1, 2019 to June 30, 2021.
- The portion of the gain that relates to 2019 and 2020 (75% of gain or $600,000) is taxed at the highest applicable tax rate for the year, i.e., at 37%. The portion of the gain that relates to 2021 (25% of gain or $200,000) is taxed as ordinary income.
- In addition, there is an interest charge on the tax arising on the portion of the gain that relates to 2019 and 2020 based on the prevailing IRS underpayment interest rates in effect for such period (which were as high as 6% in 2019 and 5% in 2020).

To put the tax cost into context, in this example the total tax cost under the default PFIC rules would have been nearly $310,000 on $800,000 of gain, well in excess of the approximately $160,000 federal tax liability that could have been achieved if adverse default PFIC rules were avoided.

How can PFIC early income recognition be minimized? QEF Elections.

A US investor in a Search Fund organized as a foreign corporation may mitigate or avoid entirely the adverse US federal income tax consequences that would otherwise apply under the PFIC default rules by making a "qualified electing fund" election ("QEF Election").

If the QEF Election is made for the first year in the US shareholder's holding period for which the foreign corporation is a PFIC, such US shareholder will be subject to tax currently on its proportionate share of the ordinary earnings and net capital gain of that foreign corporation on a "flow-through" basis — regardless of whether the foreign corporation actually distributes cash or other property to the US shareholder — but only for those taxable years in which the foreign corporation is classified as a PFIC under either the Income Test or the Asset Test described above. Once the foreign corporation ceases to be classified as a PFIC under both of these tests, the default PFIC rules no longer apply to gain or any distributions.

In the foreign Search Fund context, the ability to make a valid QEF Election for the first year of a US investor's holding period in which the foreign Search Fund is classified as a PFIC may enable US investors to minimize or eliminate the adverse tax consequences that would otherwise result from the Search Fund being classified as a PFIC. In a common Search Fund life cycle, if a timely QEF Election is made by a US investor, during the search phase in which the foreign Search Fund is most likely to be classified as a PFIC, often the Search Fund will not generate positive taxable income for which a US investor would be required to pay tax on a "flow through" basis because the Search Fund will be expending the cash raised to fund the search phase as it seeks to identify a target business to acquire. Then, after the search phase when the Search Fund has acquired an active business, it's likely that the Search Fund will no longer be classified as a PFIC and, as a result, US investors would not be required to pay tax on the business income generated on a "flow through" basis and will not be subject to the adverse default PFIC rules on exit.

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The Excess Distribution Rules; a Trap for the Unwary?

Searchers, and foreign searchers in particular, and US investors are often unaware of the potential application of the PFIC rules to a foreign Search Fund organized as a foreign corporation, and the failure to make the timely QEF Election with a US investor's tax return can make a later cleansing election prohibitively costly. However, with careful planning, the PFIC rules are manageable for US investors through the QEF Election, or certain other elections not generally available in the Search Fund context.

In summary, it is key for US investors in a foreign Search Fund, and the Search Fund itself (to the extent it's anticipated to raise material search capital from US investors), to consult with their tax advisors to consider the potential application of the PFIC rules to their specific facts, and to ensure that any information required to make the QEF Election and any related reporting obligations are appropriately addressed in the definitive legal documents.

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