Treatment of Indian Mutual Funds for USA Citizens/Residents Subject to PFIC Rules

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Abstract

For the purpose of determining the PFIC Income Test, all of the gross income that the Tested Foreign Corporation has earned during the taxable year is taken into consideration. PFIC Asset Test is calculated by taking into consideration the average quarterly value of the assets of the Tested Foreign Corporation, as measured on the final date of each quarter of the corporation's taxable year. This value is then used to establish the tax liability of the corporation. A Tested Foreign Corporation, on the other hand, may be required or permitted, depending on the circumstances, to use the adjusted basis of its assets rather than their fair market value for the purposes of the PFIC Asset Test. This is one of the different ways in which the PFIC laws might be applied. In order to fulfill the requirements of the PFIC Asset Test, liabilities are not taken into consideration. This results in the PFIC Tests being applied on a gross basis, which is a characteristic that results in a variety of technical challenges when it comes to the implementation of the look-through criteria. In addition, the United States tax law does not consider them to be "look-through" transparent organizations. Any taxpayer in the United States who has Indian mutual funds, whether they are equity, debt, hybrid, or ELSS, is required to comply with the PFIC requirements.

Keywords: *Treatment; Indian; mutual funds; PFIC rules; residents.*

1. Introduction

Passive Foreign Investment Companies, sometimes known as "PFICs," provide major tax issues for individuals from the United States who engage in foreign businesses, whether they do so directly through ownership or indirectly through vehicles such as foreign funds, partnerships, or trusts. The Permanent Foreign Investment Corporation (PFIC) regime was enacted as a component of the Tax Reform Act of 1986 with the intention of preventing taxpayers from the United States from postponing U.S. tax on passive income received through foreign firms and converting ordinary income into capital gains upon sale.

The regulations of the PFIC are discussed in this article, as well as the ways in which ownership of foreign firms, exchange-traded funds (ETFs), or mutual funds might expose individuals in the United States to the risk of PFIC exposure.

Background and definition of a PFIC

To limit the capacity of foreign firms to evade U.S. taxation and to prohibit the transformation of economically ordinary income into capital gains upon sale of their shares, Congress established the PFIC regime. Through sections 1291–1298 of the Internal Revenue Code ("IRC"), the regime assaults both deferral and character-conversion issues.

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To be considered a PFIC, a foreign corporation (sometimes called a "Tested Foreign Corporation") must meet two conditions during the tax year: (1) its gross income must be 75% or higher and be passive (the "PFIC Income Test"); or (2) its assets must be held for the production of passive income at least 50% of the time (the "PFIC Asset Test"). Hereafter, the "PFIC Tests" will refer to both the PFIC Income Test and the PFIC Asset Test.

To calculate the PFIC Income Test, the Tested Foreign Corporation's total gross income for the tax year is considered. Consideration of the Tested Foreign Corporation's average quarterly asset value, as calculated on the final day of each quarter of the corporation's taxable year, is used to compute the PFIC Asset Test. Instead of using their fair market value, Tested Foreign Corporations are required or allowed by the PFIC guidelines to utilize their adjusted basis for assets when calculating the PFIC Asset Test. When calculating assets, the PFIC Asset Test does not include liabilities. This results in a lot of technical problems with the look-through rules because the PFIC Tests are implemented on a gross basis.

In an effort to curb US taxpayers' use of offshore assets to avoid or postpone US tax payments, the IRS enacted the PFIC laws. Since passive income accounts for at least 75% of a mutual fund's total revenue, Indian mutual funds are often considered PFICs. Living in the US as an NRI causes a lot of tax trouble. The usual tax rates for qualifying dividends and regular long-term capital gains are 15% and 20%, respectively. Investors are taxed far worse under the default Excess Distribution Method for PFICs; US tax residents pay 37% plus interest from previous years.

We'll define PFICs, discuss the rationale behind classifying Indian mutual funds as such, and go over your tax treatment choices. You will find out what the IRS requires in order to stay out of trouble with audits and fines.

Any foreign firm that satisfies one of two yearly standards is considered a passive foreign investment company (PFIC):

- **Income test**: Dividends, interest, royalties, rent, and capital gains account for at least 75% of the company's total income.
- **Asset test**: Passive income generates at least half of the company's assets.

An investment may be deemed a PFIC in one year but not in another due to the fact that these rules are performed annually.

The main perk of using a foreign business is that its revenue from outside sources is not taxed in the United States until it is distributed as a dividend to a shareholder in the United States. Congress was worried that some types of income may remain untaxed indefinitely due to the lack of a requirement to repatriate them, given the deferral privilege's potentially infinite lifespan. Another perk is that American shareholders might possibly take advantage of favorable tax rates for capital gains by selling their shares in the foreign company instead of receiving dividends. This would allow them to generate cash in the US at a lower effective tax rate. U.S. owners of specific foreign corporations are currently subject to taxation on their proportionate share of specific types of income, as defined by the CFC rules enacted by Congress in 1962. This income is typically considered to be easily transferable from the U.S. to an offshore tax haven, allowing for "tax deferral."

U.S. taxpayers could take advantage of deferral by holding minority stakes in non-U.S. ("foreign") mutual funds that were intended to accumulate earnings instead of distribute them annually. This was because the CFC regulations were originally crafted to apply based on majority U.S. ownership (or at least 10% U.S. ownership on an individual basis), but Congress ultimately felt that this limitation left a loophole. By reducing the ability of U.S. people to postpone tax in this way and thereby equalizing the treatment of foreign and U.S. investment vehicles, Congress adopted the PFIC provisions as part of the Tax Reform Act of 1986.

Interests in offshore businesses and investment vehicles can be caught by the PFIC laws, even though they were initially intended to target U.S. people' interests in offshore mutual funds. Any U.S. citizen or permanent resident who has a financial stake in a foreign company whose primary source of revenue is investment income is subject to the regulations. Even foreign public corporations can be regarded as PFICs for U.S. tax purposes, as there is no minimum amount of stock ownership necessary by a U.S. person to be subject to the PFIC laws. Therefore, there are substantial reporting and tax implications even for a little amount of ownership. Although attributed or "constructive" share ownership does not typically lead to income inclusion, the CFC and PFIC regulations do take into consideration indirect ownership through foreign corporations, partnerships, trusts, and estates, as well as direct ownership, where shares of foreign corporations are owned outright by a U.S. person.

The goal of this column is to give readers a high-level summary of the main laws for taxing PFIC interests, such as the qualified electing fund regime, the excess distribution regime, and the mark-to-market system. American shareholders of a CFC or PFIC are subject to stringent reporting and record-keeping requirements in addition to the substantive regulations. Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund," is required for all U.S. shareholders of PFICs to report distributions or sales of interests in a PFIC, as well as to make certain elections; however, the record keeping and reporting obligations are not covered in this paper. Certain transactions involving the U.S. shareholder and the foreign firm may necessitate extra filings; for instance, Form 926, "Return of a US Transferor of Property to a Foreign Corporation," is used to document transfers of assets to the foreign company. After a brief overview of the regulations' substance, this column will focus on their shortcomings and provide some suggestions for how they could be improved.

2. Objectives Of The Study

i. To study on Rules for Applying the Income and Asset Tests
ii. To study on Indian Mutual Funds Fall Under PFIC Rules

Look-Through Rules for Applying the Income and Asset Tests

Related Person Look-Through Rule (1297(b)(2)(C))

According to the guidelines, passive income from related individuals, such as interest, dividends, rents, and royalties, is not allowed provided that it is allocable to the payor's non-passive income. The term "related" refers to a control (vote or value) that is more than fifty percent. For these purposes, a person is considered to be a "related person" in relation to a foreign corporation if the following conditions are met: (a) the person in question is an individual, corporation, partnership, trust, or estate that controls, or is controlled by, the foreign corporation; or (b) the person in question is a corporation, partnership, trust, or estate that is controlled by the same person or persons that control the foreign corporation. When referring to a company, the term "control" refers to the ownership, either directly or indirectly, of stock that possesses more than fifty percent of the total voting power of all classes of stock that are eligible to vote or of the entire value of stock held by such a corporation. When referring to a partnership, trust, or estate, the term "control" refers to the ownership, either directly or indirectly, of more than fifty percent (by value) of the beneficial interests in the partnership, trust, or estate in question.

General Look-Through Rule (1297(c))

A corporation that is being tested is considered to be holding proportional assets and getting proportionate income from a subsidiary if it owns at least twenty-five percent (by value) of another firm, which is referred to as a "look-through subsidiary." For the purposes of section 1297(c), the principles of section 958(a) and the rules that are outlined in that section are relevant for establishing whether the foreign corporation owns 25 percent of the other corporation either directly or indirectly.

Domestic Look-Through Rule (1298(b)(7))

In accordance with 1298(b)(7), a foreign corporation that is subject to the 531 accumulated earnings tax and that owns at least twenty-five percent (by value) of the stock of a United States corporation is permitted to classify the stock of the United States corporation's non-REIT/RIC/S corp subsidiaries as nonpassive assets or income.

Exceptions to PFIC Regime

A foreign firm may not be classed as a PFIC even if it satisfies the income or asset standards, but there are several circumstances that prevent this from happening. Particularly noteworthy is the fact that a foreign corporation that is just getting started might be exempt from paying taxes on its gross income during its first taxable year provided the standards outlined in 1298(b)(2) are met. Any criteria that is not met will result in a retroactive PFIC categorization for the year that the startup was conducted. Furthermore, for taxable years starting after 1997, a company that is handled as a controlled foreign corporation (often known as a "CFC") with respect to a shareholder from the United States (as defined in section 951(b)) is typically not taxed as a foreign financial institution (PFIC) with respect to that respective shareholder.

Taxation under PFIC Regime to Shareholders

For shareholders in the United States who own PFICs, the PFIC system offers three different tax structures to choose from. When stockholders in the United States sell appreciated PFIC shares or get a "excess distribution," they are subject to tax and interest charges under the default regime. The gain or excess dividend is distributed throughout the shareholder's holding term, with the part that is allotted to each preceding year being taxed at the highest available ordinary income tax rate for that shareholder in that year, in addition to an interest charge on the deferred tax. Instead, a shareholder has the option of selecting the qualified electing fund (QEF) treatment, which necessitates the annual inclusion of the shareholder's pro rata share of the PFIC's ordinary income and net capital gain. This allows the shareholder to avoid the excess-distribution interest charge and maintain capital gain treatment in situations where it is applicable. In addition, a shareholder in certain PFICs whose stock is "marketable" has the option of electing mark-to-market (MTM) treatment for years after 1997. This allows the shareholder to recognize the unrealized gain or loss in the PFIC shares in current income each year.

Indian Mutual Funds Fall Under PFIC Rules

India mutual funds provide a significant obstacle for non-resident Indians (NRIs) who are situated in the United States. Due to the fact that the PFIC structure is applicable to almost all investment vehicles in India, the regulations governing taxes are rather complicated.

Why Indian equity and debt funds qualify

Mutual funds can be structured as either trusts or companies under Indian law. The PFIC spotlight is now squarely on them because of this. Dividends, interest, and gains on capital are the main ways that these funds generate income. You can't classify them as US mutual funds or real estate investment trusts. They are also not considered "look-through" transparent businesses under US tax law. So, PFIC regulations are something that US taxpayers who own equity, debt, hybrid, or ELSS mutual funds in India will have to deal with.

Differences between equity and debt mutual funds

The Internal Revenue Service applies the same PFIC regulations to equity and debt mutual funds. Importantly, both kinds provide passive income, which means that the 75% mark is met. It may come as a surprise to many non-resident Indians (NRIs) who believe SIP investments are immune from PFIC restrictions, but this is not the case.

Effect of pooled investment structures

The determination of PFIC status is made by the pooled investment structure. The PFIC regulations do not apply to direct investing in equities in India. This opens the door to the possibility of avoiding PFIC issues by investing in specific Indian stocks rather than mutual funds. No matter the account type—TFSA, non-registered, or any other—PFIC taxes will be applied to these investments.

The Three Taxation Methods for 2025

You are required to record each fund on Form 8621 when you submit your 2025 taxes in 2026. Depending on your "election" determines your tax responsibility.

Method	Tax Rate	Penalty/Interest
Section 1291 (Default)	**Highest Marginal Rate (37%)**	**Yes.** Interest accrues daily for each year kept.
Mark-to-Market (MTM)	**Ordinary Income Rates**	**No.** The deadline for paying taxes on "paper gains" is December 31st.
Qualified Electing Fund (QEF)	**Capital Gains Rates**	**No.** The Indian fund house must provide an annual statement, which is rather unusual. .

The $25,000 "Hidden" Reporting Risk

There is a filing barrier ($25,000 for single taxpayers and $50,000 for joint filers), but major consequences await those who surpass it without submitting Form 8621:

- **Incomplete Return:** Your whole tax return's statute of limitations will stay open indefinitely if Form 8621 is not filed when needed. Because of a single missing mutual fund document, the IRS has the authority to audit your income and deductions even after a decade has passed.
- **FBAR Linkage:** Your FBAR (FinCEN 114) must additionally include these accounts if your total foreign balances over $10,000. In the year 2025, fines for failing to do so begin at $16,536 per infraction.

Cross-Border Transparency in 2025

Under FATCA, data sharing between the IRS and the Income Tax Department of India has increased to record highs, aligning with the worldwide trend toward more financial openness.

- **The Risk:** The data discrepancy is a key audit trigger if you report your mutual fund revenue in India but "forget" to submit Form 8621 in the US.
- **The Solution:** To avoid red flags in both nations, make sure your Indian tax declarations are in line with your U.S. filings (Form 8621).

How KKCA Secures Your Status

The IRS estimates that filing for PFICs can take 20 hours or more per fund, and the process is infamously tedious. Here at KKCA, we make it easy for H1B workers.:

- **MTM Strategy:** To "lock in" regular rates and avoid the default method's compounding interest, we assist you in making the Mark-to-Market option on your first U.S. tax return.
- **Streamlined Catch-Up:** To ensure compliance with minimal fines, we utilize Streamlined Filing Procedures in case you missed past years.

- **Portfolio Review:** We check your Indian portfolios for PFICs and identify the ones that are exempt from these regulations, such as direct stocks.

3. Conclusion

Due to its strict regulations that remove tax deferral and character conversion benefits, the PFIC system is nevertheless an important factor for U.S. individuals with international interests to consider. If U.S. shareholders are well-versed in the PFIC tests, look-through provisions, exclusions, and applicable options like QEF or MTM, they may maximize their tax results, minimize punitive interest costs, and complete Form 8621 on time. The main perk of using a foreign business is that its revenue from outside sources is not taxed in the United States until it is distributed as a dividend to a shareholder in the United States. Congress was worried that some types of income may remain untaxed indefinitely due to the lack of a requirement to repatriate them, given the deferral privilege's potentially infinite lifespan. Another perk is that American shareholders might possibly take advantage of favorable tax rates for capital gains by selling their shares in the foreign company instead of receiving dividends. This would allow them to generate cash in the US at a lower effective tax rate. Mutual funds can be structured as either trusts or companies under Indian law. The PFIC spotlight is now squarely on them because of this. Dividends, interest, and gains on capital are the main ways that these funds generate income. You can't classify them as US mutual funds or real estate investment trusts. They are also not considered "look-through" transparent businesses under US tax law. So, PFIC regulations are something that US taxpayers who own equity, debt, hybrid, or ELSS mutual funds in India will have to deal with.

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