

## Legal Updates & News

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#### Drop in Stock Prices Inadvertently May Result in PFIC Classification for Publicly Traded Foreign Companies

April 2009

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In light of the significant decline in stock prices over the past year, many non-U.S. companies that would not otherwise be considered to be “passive foreign investment companies,” or “PFICs,” for U.S. federal income tax purposes may inadvertently be so characterized under the mechanical and often overreaching PFIC tax regime. The reduction in the price of the stock of many publicly traded companies has lowered the value of such companies’ goodwill which is typically calculated based on market capitalization. Consequently, active operating companies that rely heavily on goodwill to avoid PFIC classification may inadvertently become PFICs. PFIC characterization generally results in substantially adverse tax consequences for shareholders of a PFIC that are subject to taxation in the United States.

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The purpose of the passive foreign investment company rules is to reduce the benefit of deferral of U.S. taxation on investment income that might otherwise be achieved by U.S. persons by holding investments indirectly through a foreign corporation that is not itself subject to U.S. income tax. A company will be treated as a PFIC for U.S. federal income tax purposes in any taxable year in which either (i) at least 75% of its gross income is “passive income” or (ii) at least 50% of the value of its assets (including goodwill) is attributable to assets that produce passive income. Passive income for this purpose generally includes, among other things, dividends, interest, royalties, rents and gains from the sale or exchange of property that gives rise to passive income.

In general, operating assets and goodwill are considered active assets, while long-term investments, cash (including working capital), and short-term investments of working capital are considered passive. In calculating goodwill for a publicly traded corporation, because the asset test is applied on the basis of the fair market value of the corporation’s assets, total assets are typically valued based on the corporation’s market capitalization, determined using the market price of its common stock.

Many companies that do not have substantial tangible operating assets but engage in business activities that are generally considered to be active such as sales, providing services or developing intellectual property rely very heavily on goodwill to satisfy the PFIC asset test. As a result of a decrease in goodwill attributable to a drop in its stock price, an active operating company that previously had not been close to

failing the asset test because of the magnitude of its goodwill may inadvertently be deemed to have passive assets in excess of its active assets and therefore become a PFIC with no change in business operations.

There are several strategies that a foreign corporation may be able to employ to mitigate the adverse consequences for its U.S. shareholders of it becoming a PFIC. However, the application of the PFIC rules to a particular foreign corporation is complex and highly individualized. If you believe that there is a risk that you are or could become a PFIC as a result of a drop in your share price, we urge you to contact us for additional guidance on avoiding PFIC characterization or mitigating the adverse tax consequences for U.S. shareholders.