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presents

Passive Foreign Investment Company Tax Regulations

Navigating Complex Tax Features of Foreign Investments Absent Clear IRS Guidance

A Live 110-Minute Teleconference/Webinar with Interactive Q&A

Today's panel features:

Michael J. Miller, Partner, **Roberts & Holland**, New York
Carol P. Tello, Partner, Tax Practice Group, **Sutherland Asbill & Brennan LLP**, Washington, D.C.
J. Richard Duke, Principal, **Duke Law Firm**, Birmingham, Ala.

Thursday, April 8, 2010

The conference begins at:

1 pm Eastern

12 pm Central

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Passive Foreign Investment Company Tax Regulations Webinar

April 1, 2010

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Today's Program

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Background Fundamentals

J. Richard Duke, Duke Law Firm

The Basics: What Is A PFIC?

- A. Income test
- B. Asset test
- C. CFC overlap rule
- D. Look-through rules



Income Test And Asset Test

- **Income test**
 - 75% or more passive income, or
- **Asset test**
 - 50% or more of the assets held to generate passive income



PFIC And Controlled Foreign Corporation (CFC) Overlap Tax Classification

- Corporation can be PFIC, even if foreign persons own virtually all stock.
- CFC depends on stock ownership (generally not income or assets of foreign corporation).
- A foreign corporation can be subject to both the PFIC and CFC (subpart F income) rules.



CFC Takes Precedence Over PFIC

- When CFC and PFIC rules overlap; IRC Sect. 1296(f)
 - U.S. shareholders relieved of complying with PFIC rule
 - Relief available only for U.S. shareholder with QEF election
 - Most U.S. shareholders make QEF elections



CFC Defined

- CFC: U.S. shareholders own more than 50% of the stock (by vote or value)
 - U.S. shareholder: U.S. person who own 10% or more of the stock
 - U.S. shareholders' ownership interests are aggregated



Subpart F Income Disadvantages

- CFC with passive investment income subpart F income — two disadvantages:
 - Capital gains rate is not available.
 - Losses cannot offset gains (until corporation is liquidated).



Avoiding Subpart F Income Disadvantages

- Foreign entity law provides that no owner has personal liability (classified as foreign corporation)
 - International business companies
 - Example: Some LLCs (Nevis and Cook Islands)
- File Form 8832 to elect:
 - Disregarded entity status for one owner
 - Foreign partnership for two or more owners



Overlap Rule: General Consequences

- With most foreign mutual funds, U.S. shareholder is subject to PFIC rules
- With most other investments by foreign corporation, CFC with subpart F income under IRC Sect. 1296(f)



Look-Through Rule

- 25%--owned subsidiary
 - Subsidiary foreign corporation generally pays dividends (likely to meet income test for PFIC).
 - Congress established a subsidiary look-through rule to avoid PFIC status for active trade or business subsidiary.



Requirements For Look-Through Rule

- Foreign corporation owning 25% or more of the stock of a subsidiary does not simply look at dividends received and value of the stock/
 - Looks through the subsidiary to its income and assets
 - Foreign corporation is treated as holding its proportionate share of the assets of the subsidiary.
 - Foreign corporation is treated as receiving directly its proportionate share of subsidiary's income.
 - If subsidiary holds only passive income assets, then PFIC status not avoided.



Requirements For Look-Through Rule (Cont.)

- **Second look-through rule: Passive income does not include items of interest, dividends, rents or royalties.**
 - Received or accrued from a related person
 - To the extent that the items are properly allocable to income of the related person (that is not passive income)
 - No Treas. Regs. on allocation of income



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Tax Treatment Of PFIC Shareholders

Michael Miller, Roberts & Holland LLP

Gain On Sale Of PFIC Stock

- **No LTCG treatment**
- **Gain allocated over HP**
- **Amount allocated to current year is taxed as ordinary**
- **Amount allocated to prior years**
 - **Taxed at highest ordinary income rates**
 - **Interest charge imposed**
- **Silver lining: State taxes**

Sale Of PFIC Shares - Example



Sale



Purchased 1/1/89 for \$1MM
Sold 12/31/08 for \$21MM

Gain = \$20MM
Absent PFIC rules,
Tax at 15% = \$3MM

**Cayman
Fund
Ltd.**

Sale of PFIC Shares - Example

<u>Year</u>	<u>Allocable Gain</u>	<u>Tax Rate</u>	<u>Tax</u>	<u>Interest (4%)</u>	<u>Total</u>
2008	\$1,000,000	35.0%	\$350,000	\$0	\$350,000
2007	\$1,000,000	35.0%	\$350,000	\$14,000	\$364,000
2006	\$1,000,000	35.0%	\$350,000	\$28,560	\$378,560
2005	\$1,000,000	35.0%	\$350,000	\$43,702	\$393,702
2004	\$1,000,000	38.6%	\$386,000	\$65,565	\$451,565
2003	\$1,000,000	39.1%	\$391,000	\$84,711	\$475,711
2002	\$1,000,000	39.6%	\$396,000	\$105,066	\$501,066
2001	\$1,000,000	39.6%	\$396,000	\$125,109	\$521,109
2000	\$1,000,000	39.6%	\$396,000	\$145,953	\$541,953
1999	\$1,000,000	39.6%	\$396,000	\$167,631	\$563,631
1998	\$1,000,000	39.6%	\$396,000	\$190,177	\$586,177
1997	\$1,000,000	39.6%	\$396,000	\$213,624	\$609,624
1996	\$1,000,000	39.6%	\$396,000	\$238,009	\$634,009
1995	\$1,000,000	39.6%	\$396,000	\$263,369	\$659,369
1994	\$1,000,000	39.6%	\$396,000	\$289,744	\$685,744
1993	\$1,000,000	39.6%	\$396,000	\$317,174	\$713,174
1992	\$1,000,000	31.0%	\$310,000	\$270,624	\$580,624
1991	\$1,000,000	31.0%	\$310,000	\$293,849	\$603,849
1990	\$1,000,000	28.0%	\$280,000	\$287,229	\$567,229
1989	\$1,000,000	28.0%	\$280,000	\$309,918	\$589,918
Total Tax					\$10,771,015

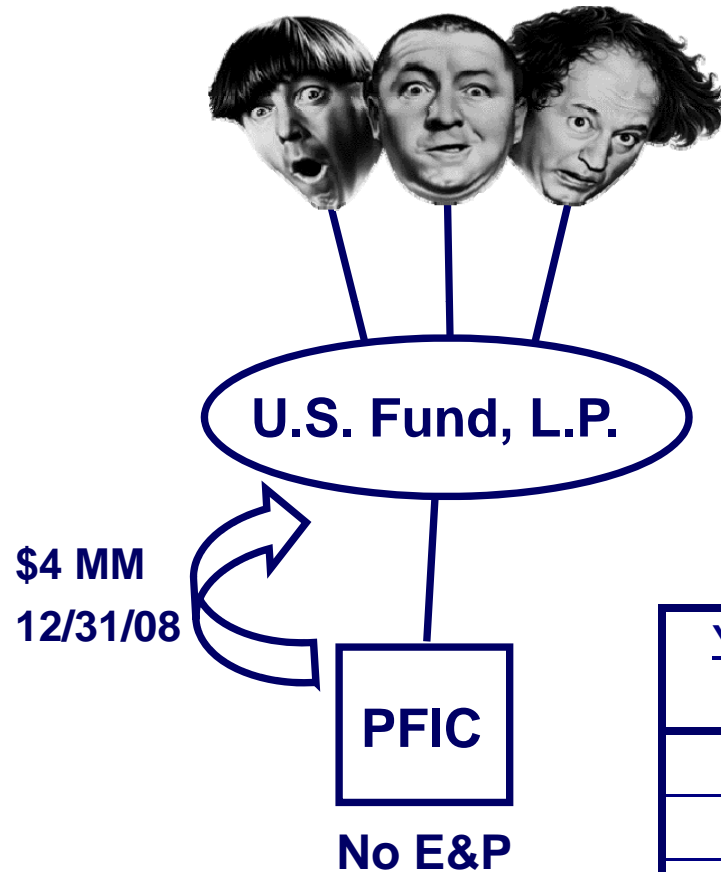
Note: The interest calculation is simplified – and very low.

Taxation Of Distributions

- **“Excess distributions” taxed under same rules as gain**
 - **Excess portion is excess of total distributions for year over 125% of average distributions for prior three years**
 - **Caution: the “base amount” excludes certain prior-year excess distributions**
 - **No E&P requirement (!!)**
- **Non-excess portion taxed under regular rules**
 - **But, no qualified dividend treatment**

Adverse Taxation Of PFIC Investments

- Taxation of Distributions -- Example



PFIC stock

- Purchased 1/1/05 for \$4 MM
- No prior distributions

Entire distribution is “excess”

<u>Year</u>	<u>Allocable Amount</u>	<u>Tax (35%)</u>	<u>Interest (4%)</u>	<u>Total</u>
2008	\$1,000,000	\$350,000	\$0	\$350,000
2007	\$1,000,000	\$350,000	\$14,000	\$364,000
2006	\$1,000,000	\$350,000	\$28,560	\$378,560
2005	\$1,000,000	\$350,000	\$43,702	\$393,702
Total Tax				\$1,486,262

Managing The Excess Distribution Rules

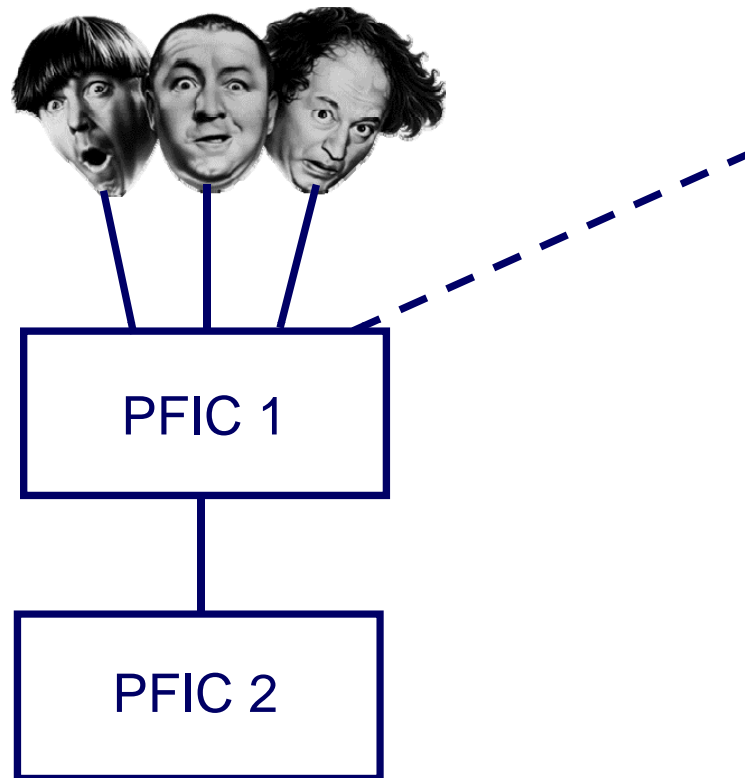
<u>Year</u>		Distribution	Base	Excess
2005		\$100,000	\$100,000	\$0
2006		\$125,000	\$125,000	\$0
2007		\$140,625	\$140,625	\$0
2008		\$152,344	\$152,344	\$0
Investment made in 2005. If prior, very different analysis; more difficult to build up base.				

- **Given sufficient flexibility, can greatly limit impact of excess distribution rules**

Indirect Distribution/Disposition Rules

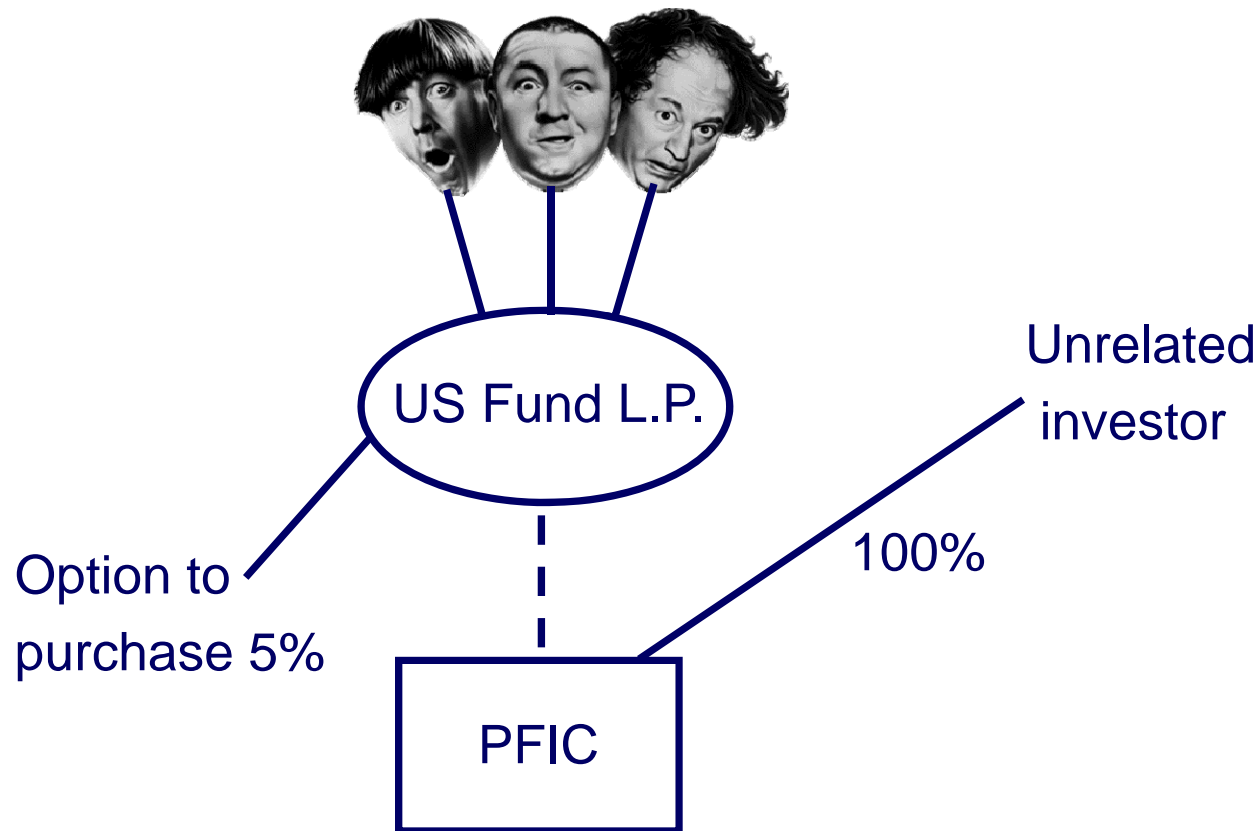
- **Indirect U.S. investor taxed if:**
 - **U.S. investor sells interest in intermediate entity (through which U.S. investor owns PFIC shares)**
 - **Intermediate entity receives excess distribution from a PFIC**
 - **Intermediate entity sells PFIC shares at a gain**
- **Under proposed regulations, U.S. investor may be taxed on any other transaction that reduces U.S. investor's interest in the PFIC (!!).**

Indirect Disposition - Example



- U.S. investor taxed on:
 - Sale of PFIC 2 shares by PFIC 1
 - Excess distribution by PFIC 2 to PFIC 1
 - Issuance of new PFIC 1 in an IPO (!!)

Option Attribution



- U.S. investor generally treated, for PFIC purposes, as if it held the PFIC shares that would be received upon exercise of the option
- Sale of option subject to PFIC rules

Other Consequences To PFIC Shareholders

- **Override of non-recognition treatment**
- **No basis step-up at death**

Market-To-Market Election

- **PFIC stock must be marketable**
- **Marked-to-market annually**
 - Includes unrealized appreciation
 - All gain ordinary
- **Mark-to-market**
 - Losses allowed (to extent of prior inclusions)
- **PFIC “toll charge” for “late” election**

QEF Election

- **Electing U.S. investors taxed currently on share of net capital gain and ordinary earnings (“QEF inclusion”)**
 - **Must elect on timely return (generally)**
 - **PFIC must provide annual information statement**
 - **Get it in writing!!**
- **No flow-through of losses, STCGs or qualified dividends**
- **“Pedigreed” QEF**
 - **Must elect for first PFIC year in HP**
 - **Once a PFIC, always a PFIC rule is N/A**
 - **No QEF inclusion for non-PFIC years**
- **Unpedigreed QEF – PFIC rules still apply**
- **No QEF election for options (!!)**

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Unanticipated PFIC Status

Carol P. Tello, Sutherland Asbill & Brennan LLP

Once A PFIC, Always A PFIC

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Sect. 1298(b)(1)

Stock of a foreign corporation is treated as stock of a PFIC if, at any time, a foreign corporation or its predecessor was treated as a PFIC that did not make a QEF election unless a “purging” election is made.

Deemed dispositions that Trigger Sect. 1291

- PFIC taint carries over on death
- PFIC taint carries over to a gift
- Expatriation under Sect. 877A triggers Sect. 1291
- Pledge of PFIC stock
- Non-recognition transactions such as a Sect. 351 contribution to the capital of a corporation
 - Indirect transfers may not trigger Sect. 1291 if the shareholder’s interest in or basis in the PFIC is not changed.

Unanticipated PFIC Status

- Start-up companies
 - Exception
- Cash build-up
- Service companies
- Holding companies
 - Minority interest investments
 - No active operating companies

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**Tax-Planning Strategies;
Eliminating The PFIC
“Taint”**

J. Richard Duke, Duke Law Firm

Tax-Planning Strategies: Eliminating The PFIC "Taint"

- A. Pedigreed QEF
- B. Unpedigreed QEF
- C. Late QEF elections
- D. Purging elections



Pedigreed QEF

- PFIC that has been qualified electing fund with respect to the shareholder for all taxable years during the shareholder's holding period while the corporation was a PFIC [Treas. Reg. Sect. 1.1291-9(j)(2)(ii)]



Unpedigreed QEF

- PFIC for a taxable year if:
 - Company is a QEF for the taxable year, but
 - Company has not been a QEF for the years required for pedigreed status, and
 - Shareholders have not made a purging election under IRC Sect. 1291(d)(2)



Late QEF Elections

- Allowed under certain conditions
 - Unable to elect unless shareholder files a “protective statement” with a timely filed return for the first taxable year
 - More flexible late elections for a shareholder owning less than 2% of the stock of a foreign corporation
 - IRS may allow late election for shareholder who relied on qualified tax advisor and contacts IRS
 - PFIC issue raised on audit



Purging Elections

- Shareholder cannot avoid interest charge by filing QEF election before sale or distribution
- IRC Sect. 1291(b)(1) exemption not applicable during any year company was *not* a QEF — with two exceptions:
 - General purge rule, and
 - Special purge rule



Purging Elections (Cont.)

- General purge rule — IRC Section 1291(d)(2)(A) election — “A” election
- Allows shareholders to elect to recognize gain on the first day of QEF status
 - Gain based on the FMV of the stock
 - Also an interest charge
 - Increased stock basis and new holding period
 - Timing of election: Applies only for the *first* taxable year that foreign corporation is a QEF (PFIC taint cannot be purged in later year)



Purging Elections (Cont.)

- **Special purge rule for CFCs — IRC Sect. 1291(d)(2)(B) election — “B” election**
 - May apply if PFIC becomes a QEF and is also a CFC
 - Basic conditions and effects of election same as general purge rule
 - But, no gain, and shareholder reports a dividend of his share of corporation’s post-1986 earnings and profits



Election To Purge PFIC Status: Company Becomes “Pedigreed QEF”

- The A election and B election
 - Are made on the shareholder’s return for the taxable year that includes the foreign corporation’s first year as a QEF
 - Shareholder may elect on an amended return for that taxable year — filed within 3 years of the due date for the original return (including extensions)
 - Elections made by checking a box on Form 8621 (including extensions)



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Recent PLRs And Other IRS Guidance

Carol P. Tello, Sutherland Asbill & Brennan LLP

Sect. 1297(c) look-through treatment on dispositions of subsidiary stock - PLR 200015028

1. IRS ruling

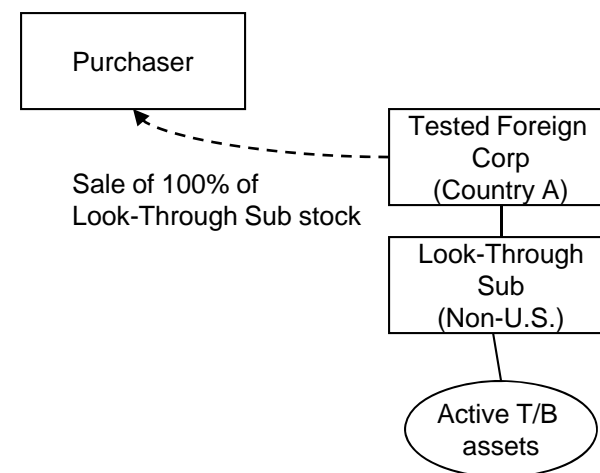
- Gain on sale of look-through sub stock was not passive, for PFIC purposes

2. Change-of-business exception

- Change-of-business exception under §1298(b)(3) was applied to treat gain on the taxable distribution of the shares of the look-through sub as active income.
- Because the tested foreign corp disposed of the stock, and not assets of an active trade or business, the IRS must have assumed the disposition of the stock was equivalent to the disposition of the look-through sub's active business, for purposes of the exception.

3. PFIC income test

- In applying look-through treatment, the amount of gain from the sale of look-through stock, for PFIC income test purposes, was determined by reference to the amount of gain at the stock level.
- In this regard, the ruling concludes that the tested foreign corporation “will not be treated as a PFIC for the year of the distribution because the gain from the disposition of [the look-through stock] will not be characterized as passive income for purposes of § 1297(a).”

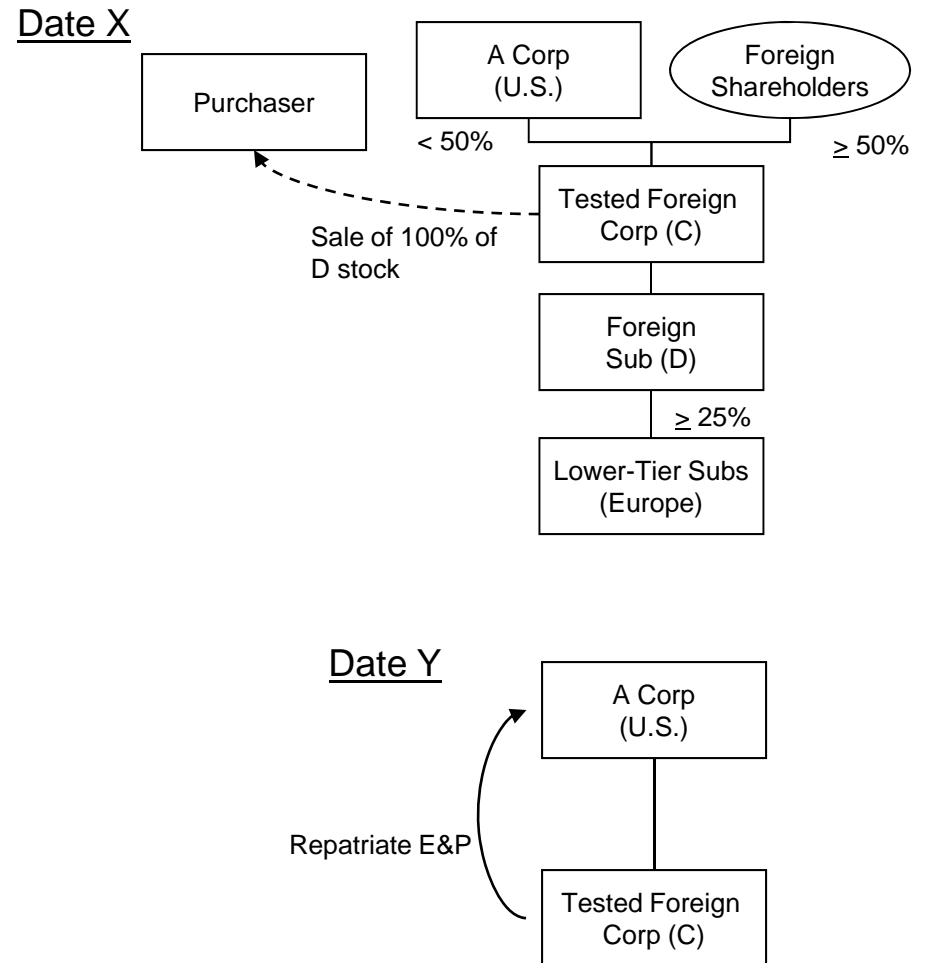


PFIC PLRs (Cont.)

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Sect. 1297(c) look-through treatment on dispositions of subsidiary stock - PLR 200604020

1. Sale transaction on date X
 - C sold all of the stock of D
 - C was not a CFC at this time
2. Repatriation strategy
 - A, a U.S. corporation, subsequently became the 100% owner of C.
 - A wanted to repatriate C's earnings to take advantage of the dividends-received deduction ("DRD") under §965.
 - Issue was whether C was treated as a PFIC in the year of the sale.
 - This would make it a PFIC in the year of the anticipated distribution under the "once a PFIC, always a PFIC" rule of §1298(b)(1).



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PFIC PLRs (Cont.)

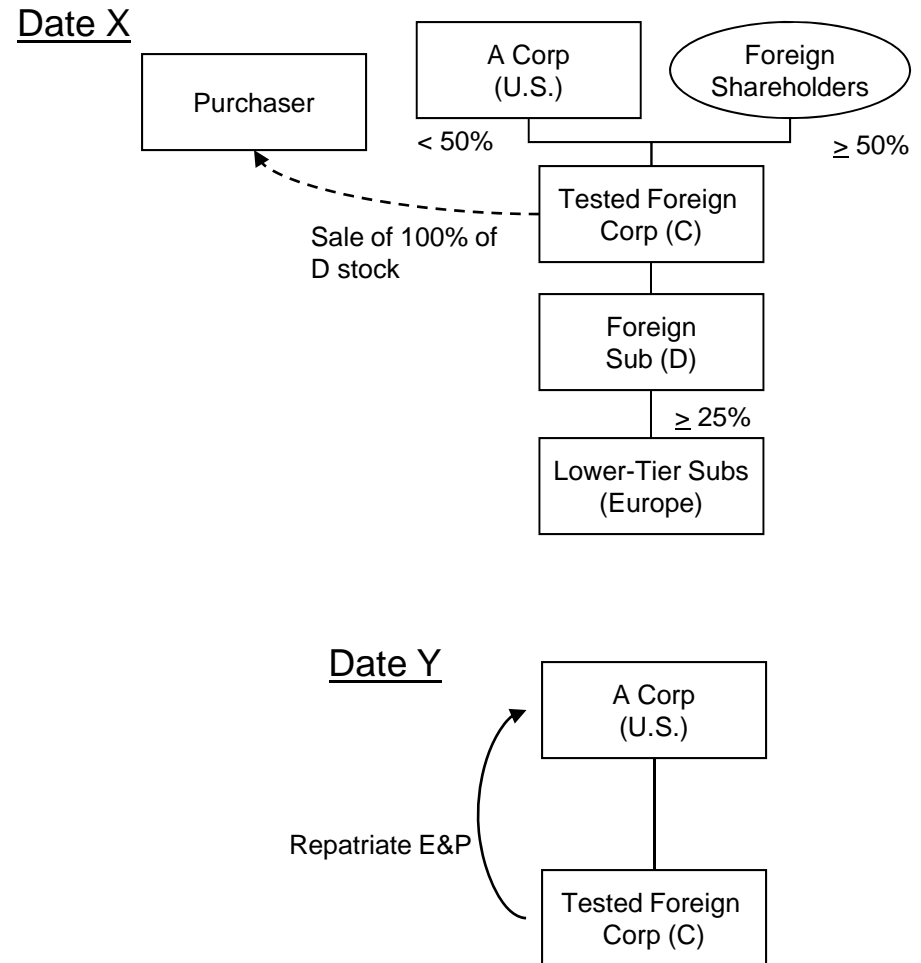
Sect. 1297(c) look-through treatment on dispositions of subsidiary stock - PLR 200604020 (Cont.)

3. Ruling

- For PFIC-testing purposes, “whether C's gain from selling the stock of D is ‘passive income,’ under §1297(b)(1), is determined by treating C as if it sold its proportionate share of the underlying assets of D and of those subsidiaries of D of which C indirectly owns (by value) at least 25%.”

4. Implications for §1297(c) general look-through rule

- Ruling provides that the amount of income that is taken into account is based on the gain on the disposition of the subsidiary's stock, rather than on the deemed disposition of its underlying assets.
- Ruling provides that the active or passive character of such gain is determined based on the character of the underlying assets.



PFIC PLRs (Cont.)

Sect. 1297(c) look-through treatment on dispositions of subsidiary stock - PLR 200813036

1. Sale transaction

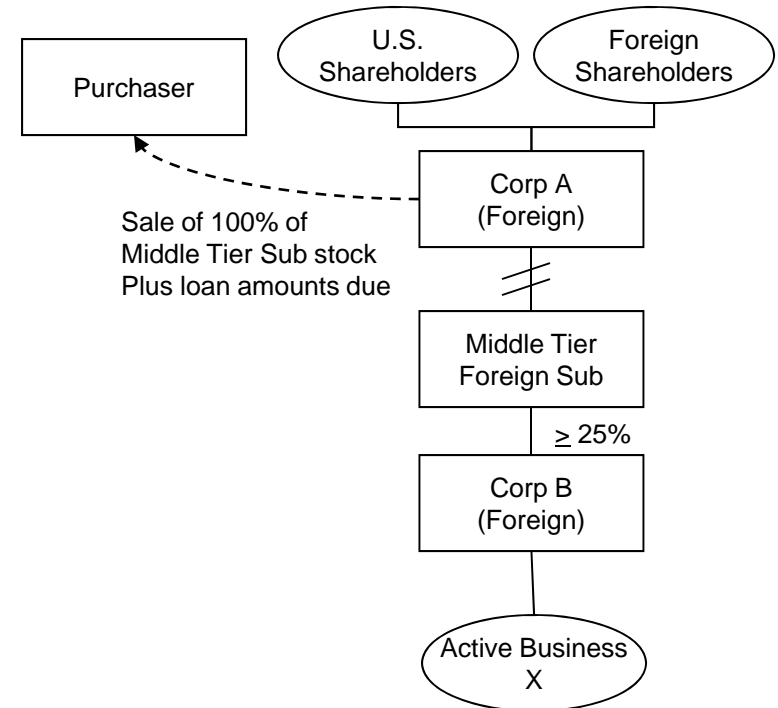
- Middle Tier Foreign Sub, which was a wholly owned indirect subsidiary of Corp A, was sold to an unrelated third party, along with certain loan amounts due, for cash.

2. Rulings

- Citing PLR 200604020, in applying the PFIC income test, the character (active or passive) of the gain attributable to the disposition of the Corp B stock should be determined by reference to the percentage of active or passive assets in the disposed-of subsidiary at the time of the sale.
- Citing PLR 20015028, for purposes of §1298(b)(3), which provides an exception to PFIC status for a company that sells a business, the disposition of the Corp B stock was treated as a disposition of an active trade or business by Corp A.
- Interpreted §1298(b)(3) as available to Corp A for purposes of avoiding PFIC status in either the year of disposition or the year immediately after such disposition (but not both years).

3. Implications of ruling

- Important taxpayer-friendly ruling, because the statute is silent as to the taxable year to which the exception may be applied.

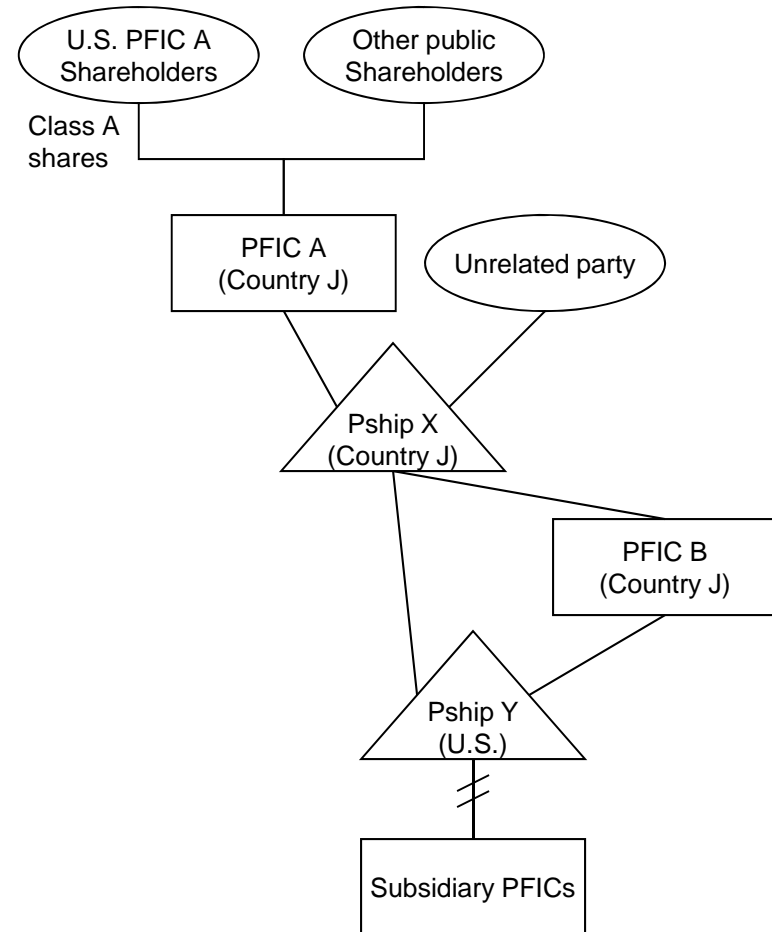


PFIC PLRs (Cont.)

Effect of intermediary U.S. partnership on QEF- and MTM-electing shareholders — PLR 200838003

1. Background

- PFIC A, organized in country J by an investment fund, had two classes of stock outstanding: (1) class A, which had limited voting rights and was traded on Exchange M and (2) class B, which had full voting rights.
- U.S. investors owned some of the class A shares of PFIC A (“PFIC A shareholders”).
- PFIC A, together with another party, formed Partnership X under the laws of country J. Partnership X was the sole shareholder of PFIC B, also organized in country J.
- Partnership X and PFIC B formed Partnership Y, a U.S. partnership. Partnership Y owned directly and indirectly interests in various PFICs (“subsidiary PFICs”).
- Certain PFIC A shareholders were expected to make a QEF or MTM election with respect to their direct interest in PFIC A, and to make QEF elections with respect to their indirect interest in PFIC B (“electing shareholders”).



PFIC PLRs (Cont.)

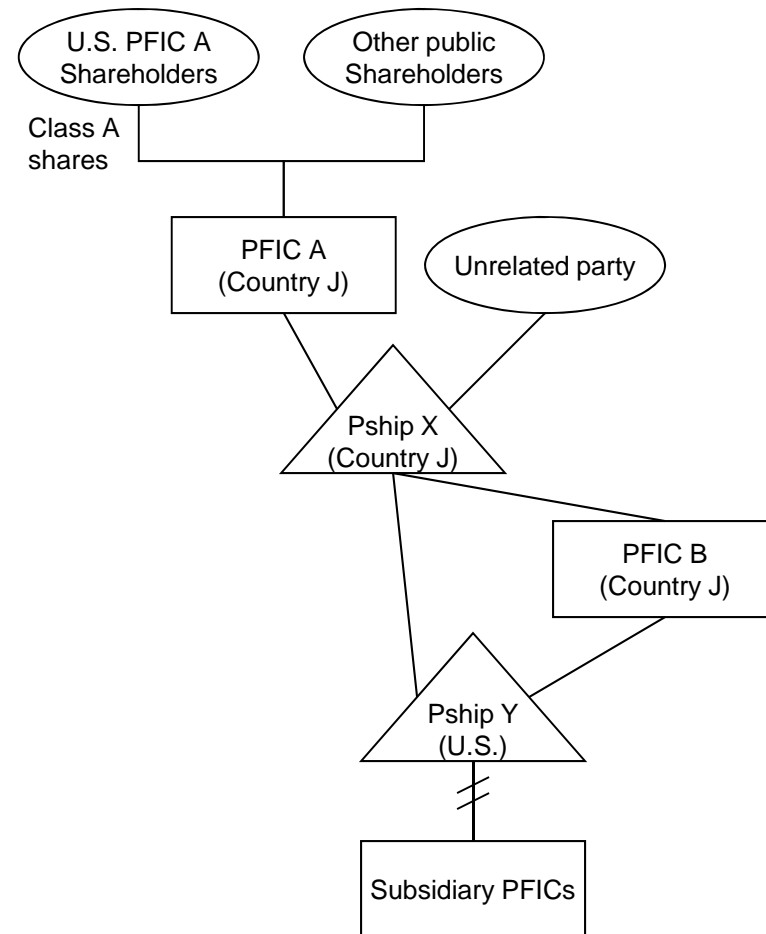
Effect of intermediary U.S. partnership on QEF- and MTM-electing shareholders — PLR 200838003 (Cont.)

1. Background

- Similarly, Partnership Y was expected to make QEF elections with respect to its direct and indirect interests in Subsidiary PFICs.
- Each of PFIC A, PFIC B, Partnership X and Partnership Y adopted (or were required to adopt) a taxable year ending on Nov. 30 in order to allow the subsidiary PFICs additional time to provide accurate annual information statements.

2. Ruling

- With respect to the electing shareholders, the Service ruled, subject to representations, that Partnership Y was the first U.S. person in the chain of ownership and was, for PFIC purposes, treated as the sole U.S. owner of the subsidiary PFICs. An electing shareholder for these purposes was not deemed to own the shares of the subsidiary PFICs. To be an electing shareholder, a U.S. person needed to make either a QEF or an MTM election as to PFIC A and a QEF election as to PFIC B. Partnership Y was required to have a QEF election in effect for all periods in which it held stock in a subsidiary PFIC.

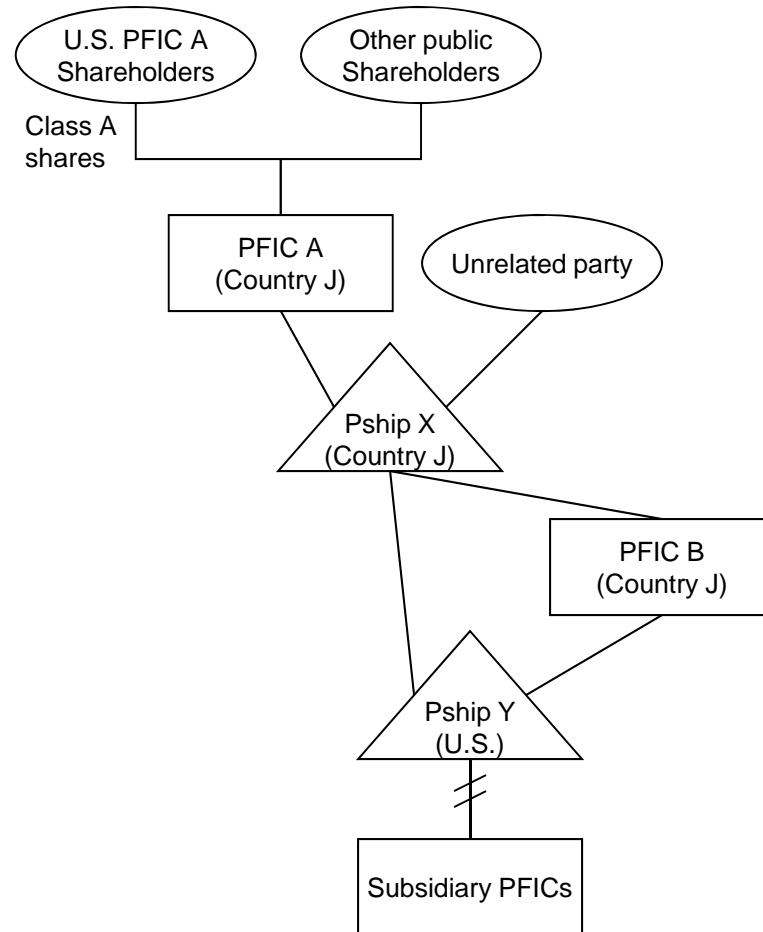


PFIC PLRs (Cont.)

Effect of intermediary U.S. partnership on QEF- and MTM-electing shareholders — PLR 200838003 (Cont.)

2. Apparent purpose of structure

- The singular purpose for the structure would appear to have been to reduce the compliance burden imposed on electing shareholders under a publicly traded, multi-tier PFIC structure that actively buys and sells annually numerous investments that are (or may be) PFICs and to reduce the information-reporting complexities of each of these subsidiary PFICs in providing annual information statements and access to their books and records to hundreds (if not thousands) of unrelated public shareholders.
- For electing shareholders who made QEF elections as to PFIC A and PFIC B, the Partnership Y structure aimed to ensure that the character, timing and amount of the QEF inclusions with respect to the subsidiary PFICs approximated the character, timing and amount of the QEF inclusions in a multi-tier PFIC structure where no U.S. partnership was interposed, without violating the policy of the PFIC regime of eliminating deferral and avoiding character conversion.

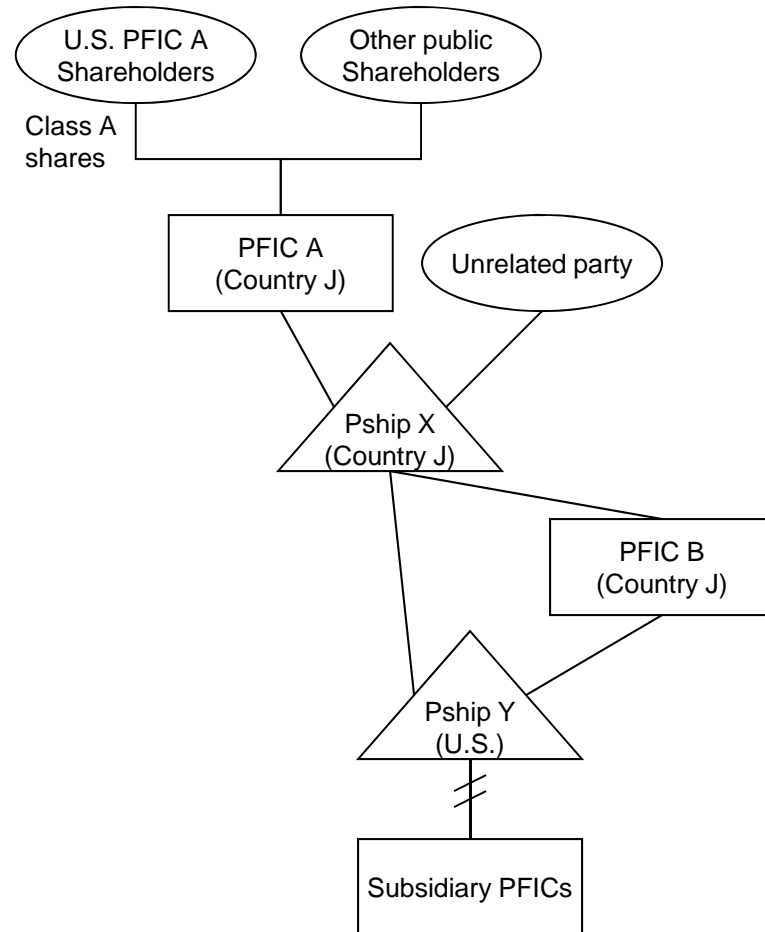


PFIC PLRs (Cont.)

Effect of intermediary U.S. partnership on QEF- and MTM-electing shareholders — PLR 200838003 (Cont.)

2. Apparent purpose of structure (Cont.)

- For electing shareholders who made MTM elections as to PFIC A and QEF elections as to PFIC B, the Partnership Y structure provided a more integrated approach than a publicly traded multi-tier PFIC structure, while preserving the principal goals of avoiding deferral and character conversion of the PFIC regime, and reducing administrative burdens to the electing shareholders, subsidiary PFICs and U.S. government — and more closely achieving the expected legislative benefits of MTM elections and significantly avoiding timing and character mismatch under the MTM rules.



PFIC PLRs (Cont.)

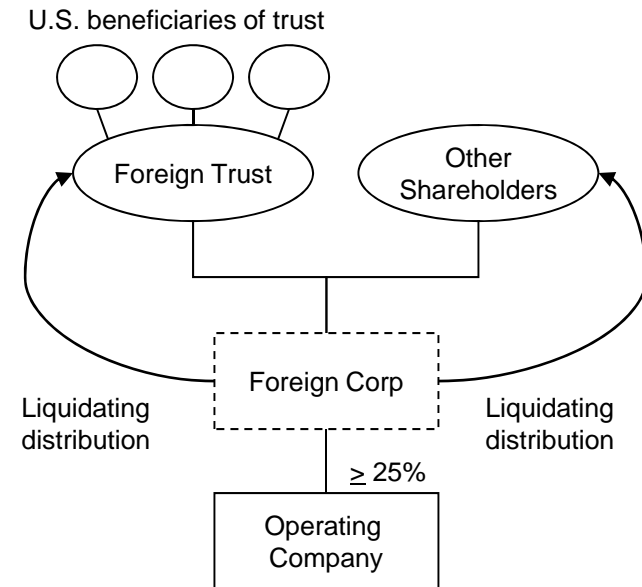
Application of § 1298(b)(5) to trust beneficiaries — PLR 200733024

1. Background

- The U.S. beneficiaries had an ascertainable interest in a trust, which held stock of a foreign corporation, whose only asset was stock in an operating company.
- If the foreign corporation were treated as owning 25% or more (by value) of the operating company, the look-through rule of § 1297(c) would apply to deem such proportional share of assets and income as if owned by the foreign corporation, presumably defeating its PFIC status.
- The taxpayer argued that the § 318 rules apply to interpret the “directly or indirectly” language, so that the ownership of a related individual would be counted.

2. Sect. 318 constructive ownership ruling

- The IRS determined that the § 318 constructive ownership rules do not apply, because § 1297(c) does not contain or reference constructive ownership rules.

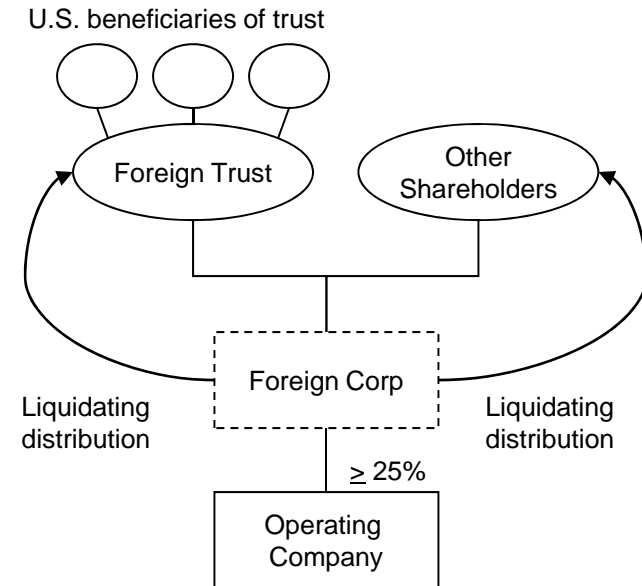


PFIC PLRs (Cont.)

Application of § 1298(b)(5) to trust beneficiaries — PLR 200733024 (Cont.)

3. Ruling on the treatment of the U.S. beneficiaries on the liquidation of the foreign corporation

- Sect. 1298(a)(3) provides that stock owned directly or indirectly by a trust is treated as owned proportionately by its beneficiaries.
- Further, § 1298(a)(5) addresses the disposition of an indirectly owned PFIC, which in this case is the foreign liquidating corporation, and treats a trust beneficiary (as a result of § 1298(a)(3)) as having made an indirect disposition of PFIC stock.
- Although proposed regulations under § 1291 provide general rules for the application of § 1298(b)(5), the proposed regulations reserve with respect to trusts and beneficiaries.
- The taxpayer argued that because there are no regulations, § 1298(b)(5) cannot apply.

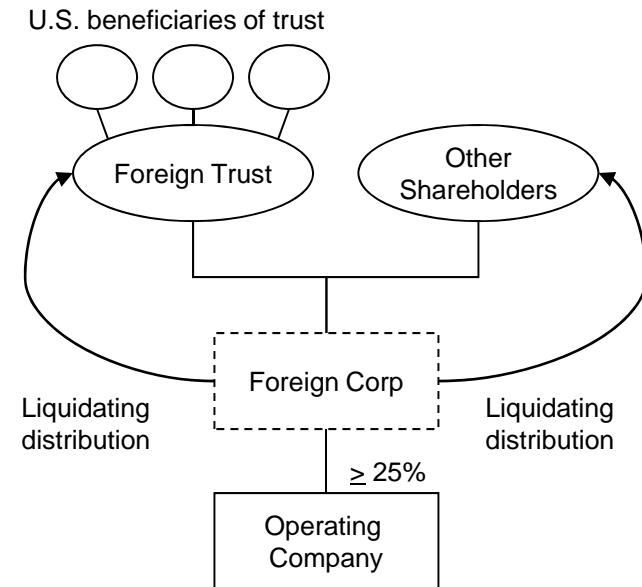


PFIC PLRs (Cont.)

Application of § 1298(b)(5) to trust beneficiaries — PLR 200733024 (Cont.)

3. Ruling on the treatment of the U.S. beneficiaries on the liquidation of the foreign corporation

- The IRS, however, disagreed that the lack of regulations should prevent § 1298(b)(5) from applying, because the intent of the statute was clear on its face.
- Consequently, the IRS concluded that § 1291(a) applied to impose on the U.S. beneficiaries PFIC tax and interest charges on the gain from the liquidation of the foreign corporation stock, which was treated as a disposition of the stock.



PFIC PLRs (Cont.)

Application of § 1297(d) to PFIC shares held by a U.S. partnership — PLR 200943004

1. Status of Corporation F

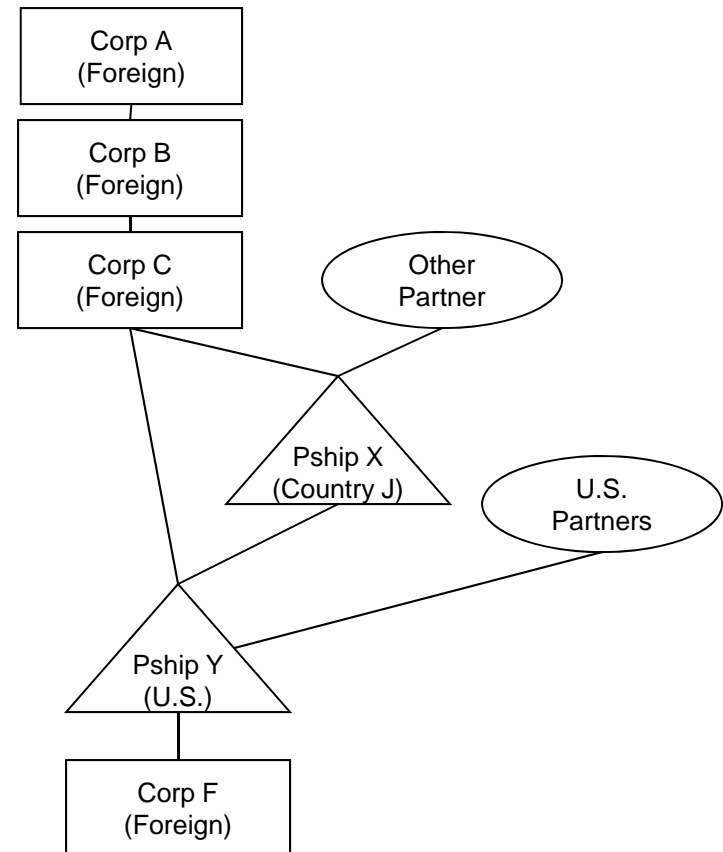
- CFC and a PFIC (but for § 1297(d))

2. IRS ruling

- Corporation F was not a PFIC as to Partnership Y nor the U.S. partners pursuant to § 1297(d) during the portion of Partnership Y's holding period that it actually owned Corporation F stock, to the extent Corporation F qualified as a CFC during such period.

3. Notice 2009-7

- PLR 200943004 did not apply with respect to a U.S. person who beneficially owned an interest in Partnership Y, directly or indirectly, through a CFC. This fact pattern implicated the concerns of Notice 2009-7.
- Notice 2009-7 described the use of a domestic partnership as a Subpart F blocker. The U.S. taxpayer owned all of the stock of CFC 1 and CFC 2, which were the sole partners in the U.S. partnership, which in turn owned all of the stock of CFC 3, which generated Subpart F income.
- Without the U.S. partnership, this Subpart F income would be included in the U.S. taxpayer's gross income under § 951(a). However, with the U.S. partnership, the U.S. taxpayer argued that Subpart F income is reportable (if at all) only by the U.S. partnership.



PFIC PLRs (Cont.)

QEF inclusions treated as qualifying Income for RIC and PTP purposes — PLR 200728025

1. Corp X

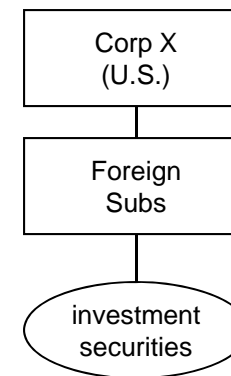
- Holding company

2. Foreign subs

- Invested in fixed-income assets (*i.e.*, commercial and residential mortgage-backed securities, corporate securities, consumer and commercial asset-backed securities, loans and trust preferred securities)
- Each was treated as a CFC under § 957(a) or as a PFIC under § 1297(a).
- Each PFIC made a QEF election.

3. IRS ruling

- X's income (Subpart F and QEF inclusions) from subsidiaries would be qualifying income under §§ 851(b)(2)(A) (for regulated investment company purposes) and 7704(d)(4) (for publicly traded partnership purposes), without regard to whether the income had been distributed or resulted from a Subpart F or QEF inclusion or was in excess of cash distributions.



Strafford

Reporting Issues And Enforcement Trends

Michael Miller, Roberts & Holland LLP

Reporting Obligations And Trends

- **Form 8621**
 - Election, distributions and dispositions
- **Annual reporting requirement under the HIRE Act**
- **Foreign Bank Account Report: TD F 90-22.1**
 - 2008 instructions require filing for foreign mutual funds
 - **Great hedge fund panic of 2009**
 - Infamous teleconference
 - Voluntary disclosure FAQs
 - Notices 2009-62 & 2010-23
 - FinCEN notice of proposed rulemaking
 - Traps: June 30 due date, redundant reporting, LLCs
- **NYC Bar and NYSBA reports**
- **Voluntary Disclosures: PFIC issues abound!**