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New PFIC Guidance Provided: But More Remains to Be Done

by Christopher Ocasal, Esq.,
and Carol Tello, Esq.[*]
Sutherland Asbill & Brennan, LLP
Washington, D.C.

INTRODUCTION

On October 23, 2009, the Internal Revenue Service (IRS) released PLR 200943004 addressing the application of §1297(d), which eliminates the overlap of the Passive Foreign Investment Company (PFIC) and Subpart F regimes under certain circumstances. In particular, the ruling addressed the application of §1297(d) to a PFIC owned by a U.S. partnership that had several U.S. partners. This ruling is yet another item of PFIC guidance in a recent string of private letter rulings providing insight into provisions that have been mostly ignored for many years.

In fact, on July 22, 2009, John Merrick, Special Counsel to the IRS Associate Chief Counsel (International), stated at the New York regional meeting of the USA Branch of the International Fiscal Association that the IRS had adopted an ad hoc strategy of providing guidance through letter rulings rather than taking on big regulations projects in the area of PFIC rules. The IRS has recently ruled on PFIC questions involving §1297(c) look-through treatment, partnerships, and trusts. Further, in response to certain comments, the IRS has also modified the PFIC reporting requirements.

And on October 17, 2008, at a Practicing Law Institute conference on corporate tax strategies, Michael Mundaca, since nominated as Treasury Assistant Secretary for Tax Policy, outlined several projects he expected Treasury to complete before the end of the calendar year, including guidance for PFICs that address the look-through rule of §1297(c). At that New York conference, Mr. Mundaca focused his comment particularly on how §1297(c) should apply, if at all, to gain from the disposition of the shares in a 25%-or-more-owned subsidiary.

Moreover, in Notice 2009-43, the IRS invited public comment on recommendations on a broad selection of items that should be included in its 2009–2010 Guidance Priority List, including items relating to the PFIC regime.

The PFIC regime has become relevant to many different provisions of the Internal Revenue Code, including: (1) qualifying dividend

[*] Christopher Ocasal and Carol Tello are partners in the Tax Group of Sutherland Asbill & Brennan, LLP.

income as described under §1(h)(11); (2) related-person deductions under §267(a)(3)(B); (3) the application of grantor trust rules under §672(f); and (4) the constructive ownership rules of §1260. Additionally, several legislative proposals, including the recently introduced Foreign Account Compliance Act of 2009, aim at increasing information reporting requirements for interests in PFICs. Altogether, PFIC guidance is increasingly becoming more imperative with the passage of time.

This article will briefly review the policy and relevant rules applicable to PFICs, will review the most recent IRS PFIC guidance, and will discuss other areas of needed PFIC guidance.

PFIC POLICY DRIVERS

Congress has been concerned with the ability of U.S. persons to defer U.S. income tax through the use of foreign corporations and, by disposing of the shares of such corporations, convert the ordinary income of these foreign corporations to capital gains. In response to these concerns, Congress enacted, in part, the PFIC regime.

The PFIC regime addresses both the anti-deferral and character-conversion concerns expressed by Congress. In the case of the excess distribution regime, the PFIC rules address the anti-deferral concerns by requiring every U.S. person who owns stock in a PFIC to pay tax and an interest charge on the deemed deferred tax liability attributable to any distributions made, or any gain recognized, on such stock. Moreover, the excess distribution regime taxes return of capital as well. This interest charge has the effect of mitigating any possible U.S. tax benefits derived from deferring any income or appreciation in a PFIC and, in fact, may place a taxpayer in a less favorable tax position than if the taxpayer had paid the tax currently on the PFIC's annual income. Furthermore, the excess distribution regime addresses the character-conversion concerns of Congress by generally treating any gain from the disposition of PFIC stock as ordinary income.

PFIC DEFINED

In general, a foreign corporation (the ''Tested Foreign Corporation'') is a PFIC for a taxable year if: (1) 75% or more of its gross income is passive income (the ''PFIC Income Test''); or (2) at least 50% of its assets is held for the production of passive income (the ''PFIC Asset Test''). The PFIC Income Test is determined by taking into account all gross income of the Tested Foreign Corporation for its taxable year. The PFIC Asset Test is determined by taking into account the average quarterly value of the assets of the Tested Foreign Corporation, as measured on the last date of each quarter of the corporation's taxable year. The PFIC rules, however, alternatively require or permit a Tested Foreign Corporation to use the adjusted basis of its assets rather than their fair market value for purposes of the PFIC Asset Test.

''Passive income'' means, for these purposes, ''any income which is of a kind which would be foreign personal holding company income as defined in [§] 954(c).'' [1] Section 1297(b), however, excludes from the definition of ''passive income'' certain income earned in the active conduct of a banking business or insurance business, and foreign trade income of a Foreign Sales Corporation or Export Trade Corporation. Furthermore, additional exceptions to ''passive income'' may be available under §954(c). An asset will generally be characterized as passive if it has generated (or is reasonably expected to generate in the reasonably foreseeable future) ''passive income'' in the hands of the foreign corporation. However, it should be noted that working capital is treated as a passive asset.

For purposes of determining whether an entity meets either one of the PFIC Tests, three ''look-through'' rules are provided: §1297(b)(2)(C) (the ''Related-Person Look-Through Rule''); §1297(c) (the ''General Look-Through Rule''); and §1298(b)(8) (the ''Domestic Look-Through Rule'').[2]

There are three statutory exceptions to the definition of a PFIC: the §1298(b)(2) start-up exception, the §1298(b)(3) change-of-business exception, and the §1297(d) CFC/PFIC overlap exception. The §1298(b)(2) start-up exception applies only to the first taxable year in which a foreign corporation has gross income.

Under the change-of-business exception, a corporation will not be treated as a PFIC for any taxable year if: (1) neither such corporation nor any predecessor was a PFIC for any prior taxable year; and (2) it is established to the satisfaction of the Secretary that: (a) substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses; (b) such corporation will not be a PFIC for either of the first two taxable years following such taxable year; and (c) such corporation is not a PFIC for either of such two taxable years.

Under the CFC/PFIC overlap exception, a CFC will not be treated as a PFIC with respect to a 10% voting U.S. shareholder during the qualified portion of such

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[1] §1297(b)(1).

[2] For a comprehensive review of these look-through rules, see Ocasal and Markham, ''The PFIC Look-Through Rules: A New Level of Thinking,'' 35 *Tax Mgmt. Int'l J.* 59 (Feb. 2006).

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shareholder's holding period with respect to the stock in such corporation.[3] Another consequence of this rule is that a foreign corporation may be a PFIC with respect to some shareholders and not to others.

ALTERNATIVE PFIC TAXING REGIMES

A U.S. shareholder in a PFIC is subject to one of three alternative taxing regimes: the excess distribution regime, the Qualified Electing Fund (QEF) regime, or the §1296 Mark-to-Market (MTM) regime.

Excess Distribution Regime

As noted above, the excess distribution rules are designed to prevent a U.S. shareholder's accumulation of passive income in a foreign corporation in a manner that defers current U.S. income taxation on such income. To accomplish this purpose, §1291 imposes a tax and, where applicable, an interest charge on ''excess distributions'' to U.S. persons who own stock in a PFIC. In general, an excess distribution can occur upon an actual or deemed distribution by the PFIC to a U.S. shareholder or upon the U.S. shareholder recognizing gain on the disposition of PFIC stock. Further, indirect distributions or dispositions with respect to indirectly owned PFIC stock may also be subject to the excess distribution rules. The excess distribution rules are applied on a PFIC-by-PFIC, and shareholder-by-shareholder, basis.

In addition, once a foreign corporation qualifies as a PFIC with respect to a U.S. shareholder's interest at any time during the relevant holding period, such shareholder's failure to make a QEF or MTM election at the appropriate time will result in a default to the excess distribution regime for any subsequent actual or deemed distributions, or actual or deemed disposition of the PFIC stock, regardless of whether the PFIC status still applies for the year of such distribution or disposition.

QEF Regime

In order for a U.S. shareholder to elect the application of the QEF regime under §1295, the PFIC must agree to make available to the shareholder the information required to determine the amount of the QEF inclusion. The shareholder must include in gross income for a taxable year: (1) as ordinary income, the shareholder's pro rata share of the ordinary earnings of the QEF for such year; and (2) as long-term capital gains, the shareholder's pro rata share of the net capital gains of the QEF for such year. The U.S. shareholder does not take QEF losses into account, however. Inclusions are taken into account in the shareholder's taxable year in or with which the taxable year of the QEF ends.

Once made, a QEF election may be revoked by the taxpayer only with the consent of the IRS. A QEF election must be made for a taxable year on or before the due date, including extensions, for filing the return of the tax associated with the QEF election.

In order that U.S. investors may report their pro rata share of a PFIC's earnings, the PFIC must provide a PFIC Annual Information Statement to each electing shareholder. Additionally, the books and records of the PFIC must be available to all direct and indirect U.S. shareholders making a QEF election.

MTM Regime

Any U.S. shareholder that owns directly, or is treated as owning under the §1296 regulations, PFIC stock that qualifies as ''marketable stock,'' may make a MTM election. The term ''marketable stock'' means stock that is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission (SEC) or the national market system of a foreign country and is comparable to regulated investment company stock that is redeemable at its net asset value. An MTM election achieves the overall purpose of the PFIC regime, avoiding deferral or character conversion on any built-in gain or earned income of a PFIC, without requiring such PFIC to provide the electing shareholder an Annual Information Statement.

If a U.S. person makes an MTM election with respect to marketable stock in a PFIC, and owns the stock at the close of the taxable year, such person must mark the PFIC stock to market. If at the close of the taxable year the stock's fair market value exceeds its adjusted basis, the U.S. person includes that excess in gross income for such taxable year. If the fair market value is less than the adjusted basis, the U.S. person may deduct an amount equal to the lesser of: (1) the lost value; or (2) the ''unreversed inclusions.''

Where an MTM election applies, any amount included in a U.S. person's gross income under §1296 and any gain on the sale of marketable stock are treated as ordinary income. Any losses recognized are treated as ordinary losses.[4]

[3] Absent an election, a shareholder may still be a PFIC shareholder for the period prior to the time when the foreign corporation became a CFC.

[4] For a comprehensive review of these PFIC regimes, see 923 T.M., *PFICs*.

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RECENT IRS RULINGS PERTAINING TO PFICs

Section 1297(c) Look-Through Treatment on Dispositions of Subsidiary Stock

Neither the General Look-Through Rule, nor its legislative history, nor other congressional commentary discusses how gain on the disposition of stock in a corporation otherwise entitled to look-through treatment under §1297(c) (''Look-Through Subsidiary'') should be treated under the PFIC Income Test. The IRS has addressed this issue in three separate private letter rulings.

PLR 200015028

In PLR 200015028, the Service addressed treatment of gain from the disposition of the stock of a Tested Foreign Corporation's wholly owned Look-Through Subsidiary, substantially all of whose assets were used in an active trade or business, and concluded that the gain was not passive for PFIC purposes. In making its determination, the Service applied the change-of-business exception under §1298(b)(3) to treat gain on the taxable distribution of the shares of the Look-Through Subsidiary as active income. Because the Tested Foreign Corporation disposed of the stock, and not assets of an active trade or business, the Service must have assumed that the disposition of the stock was equivalent to the disposition of the Look-Through Subsidiary's active business for purposes of the exception. In effect, the Service applied look-through treatment to the gain from such disposition. Furthermore, the ruling suggests that, in applying look-through treatment, the amount of gain from the sale of Look-Through Stock for PFIC Income Test purposes is 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).'' [5]

PLR 200604020

In PLR 200604020, to determine whether a tested Foreign Corporation (C) qualified as a PFIC, gain from the sale of its 25%-owned foreign subsidiary was treated as gain that would result if C had sold its proportionate share of the subsidiary's assets. The Service also concluded that this rule applied as well to indirectly owned (at least 25% by value) lower-tier subsidiaries of C.

Under the facts of the ruling, C wholly owned D, a foreign holding company of several European operating companies. C sold all the stock of D. At the time of the sale, C did not qualify as a controlled foreign corporation. 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 under §965, and needed to know whether C qualified as a PFIC in the year of the sale (and thus as a PFIC in the year of the anticipated distribution under the ''once a PFIC, always a PFIC'' rule of §1298(b)(1) — given that A presumably had not made a QEF election with respect to C).

The Service interpreted §1297(c) to provide ''look-through'' treatment for gain on the sale of the stock C's 25%-owned subsidiary (Look-Through Subsidiary). Specifically, the Service stated that, 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%.''

PLR 200604020 addressed two key issues in the application of the General Look-Through Rule of §1297(c) for PFIC Income Test purposes with respect to the disposition of the stock of a Look-Through Subsidiary. First, the ruling effectively 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 the deemed disposition of its underlying assets. Second, the ruling provides that the active or passive character of such gain is determined based on the character of the underlying assets.

PLR 200813036

In PLR 200813036, Corporation A, a foreign corporation with U.S. shareholders, indirectly held a greater-than-25% interest in the value of Corporation B, a foreign corporation actively engaged in Business B. The direct shareholder of Corporation B, a wholly owned indirect subsidiary of Corporation A, was sold to an unrelated third party, along with certain loan amounts due, for cash. Corporation A planned to invest a portion of the cash from the sale in assets that could be used in Business X.

Citing first PLR 200604020, the Service ruled that, in applying the PFIC Income Test, the character (active or passive) of the gain attributable to the disposition of the Corporation 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. Then, citing PLR 20015028, the Service ruled

[5] For a discussion of the potential inapplicability of the §1298(b)(3) exception, see Ocasal and Markham, ''The PFIC Look-Through Rules: A New Level of Thinking,'' 35 *Tax Mgmt. Int'l J.* 59 (Feb. 2006).

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that, for purposes of §1298(b)(3), which provides an exception to PFIC status for a company that sells a business, the disposition of the Corporation B stock was treated as a disposition of an active trade or business by Corporation A, Corporation B's indirect owner. Finally, PLR 200813036 interpreted §1298(b)(3) as available to Corporation A for purposes of avoiding PFIC status in either the year of disposition or the year immediately after such disposition (but not both years). As such, the taxpayer-friendly ruling is an important ruling because the statute is silent as to the taxable year to which the exception may be applied.

Effect of Intermediary U.S. Partnership on QEF- and MTM-Electing Shareholders — PLR 200838003

In PLR 200838003, 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''). 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 November 30 in order to allow the Subsidiary PFICs additional time to provide accurate Annual Information Statements.

With respect to the Electing Shareholders, the Service ruled, subject to numerous 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.

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.

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 the 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.

PLR 200838003 is probably the most significant PFIC private letter ruling issued to date in terms of the scope of issues addressed and their favorable resolution. While this ruling addressed the core issues presented in the structure, other more subtle issues such as foreign tax credits, Subpart F interaction, and the application of other QEF exceptions remain to be resolved.[6]

Application of §1298(b)(5) to Trust Beneficiaries — PLR 200733024

PLR 200733024 provides guidance as to the application of §1298 to the liquidation of a foreign corporation some of the shares of which were held by a foreign trust with U.S. beneficiaries. The U.S. beneficiaries had an ascertainable interest in the trust, which held stock of the 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

[6] For additional discussion of PLR 200838003, see Ocasal et al, ''PwC Reviews Letter Ruling on PFIC Compliance,'' 2008 *TNT* 190-48 (9/30/08).

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

The more interesting question concerned the treatment of the U.S. beneficiaries on the liquidation of the foreign corporation. Section 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. 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.

Application of §1297(d) to PFIC Shares Held by a U.S. Partnership — PLR 200943004

In PLR 200943004, Corporation A owned Corporation B, which in turn owned Corporation C. All were foreign corporations. Corporation C owned an interest in Partnership X, a Country J partnership. Both Corporation C and Partnership X for U.S. income tax purposes owned, directly or indirectly, interests in U.S.-based Partnership Y, which owned all of the stock of Corporation F, a CFC and a PFIC (but for §1297(d)).

The Service ruled that 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. The ruling did not apply with respect to a U.S. person who beneficially owned an interest in Partnership Y directly or indirectly through a CFC as this fact pattern implicated the concerns reflected in Notice 2009-7.[7]

QEF Inclusions Treated as Qualifying Income for RIC and PTP Purposes — PLR 200728025

In PLR 200728025, X was a holding company formed to invest in fixed-income assets consisting primarily of commercial mortgage-backed securities, residential mortgage-backed securities, corporate securities, consumer and commercial asset-backed securities, loans, and trust preferred securities held by certain subsidiaries. Each subsidiary was treated as a CFC under §957(a) or as a PFIC under §1297(a). Each PFIC made a QEF election.

The Service ruled that 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.

Changes to Form 8621 Reporting Requirements

Before 2008, the instructions to Form 8621 provided that U.S. partners of a U.S. partnership, U.S. shareholders of an S corporation, and U.S. beneficiaries of a U.S. trust or estate were required to file a Form 8621 if the particular U.S. pass-through entity failed to file its Form 8621 or the U.S. person was required to recognize income under either §1291 or §1293. Thus, for example, where a U.S. partnership made a QEF election, each and every U.S. partner in such partnership had to file a separate Form 8621 despite the fact that this information was already reflected in their yearly partnership information return. This instruction to Form 8621 apparently had its origin in Prop. Regs. §1.1291-1(i). In response to comments made by practitioners, the IRS amended the instructions to Form 8621, beginning as of the 2008 taxable year, to minimize the necessary PFIC reporting

[7] Notice 2009-7 described as a transaction of interest the use of a domestic partnership as a Subpart F blocker. In the transaction described in the Notice, 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. CFC 3 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.

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requirements.[8] Note, however, that a similar comment relating to tax-exempt entities remains to be adopted.[9]

ADDITIONAL IRS PFIC GUIDANCE REQUESTED

In Notice 2009-43, discussed above, the IRS solicited recommendations of U.S. income tax items that should be included in its 2009–2010 Guidance Priority List, including items relating to the PFIC regime. Some of the most important PFIC issues that warrant immediate IRS guidance are discussed below.

Sections 1297(c), 1297(b)(2)(B), and 1298(b)(8) Look-Through Rules

As discussed above, three look-through rules apply in the determination of whether a Tested Foreign Corporation constitutes a PFIC. There are numerous issues relating to the application of these provisions and their coordination with each other, to PFIC exceptions, foreign personal holding company exceptions, and other Code provisions.[10]

Section 1291(f)'s PFIC Non-Recognition Override Rules

In the case of a transfer of stock in a PFIC where (but for §1291(f) itself) there is not full recognition of gain, §1291(f) provides that, to the extent provided in regulations, any excess of the fair market value of such PFIC stock over its adjusted basis will be treated as gain from the sale or exchange of PFIC stock and recognized notwithstanding any provision of law. Currently, only Prop. Regs. §1.1291-6 provides any guidance on §1291(f). However, it is unclear whether §1291(f) is self-executing and, if not, whether the proposed regulations are sufficient to preclude a taxpayer from claiming non-recognition treatment. The proposed regulations provide that when finalized, they are to be effective retroactively to April 11, 1992 but the long length of time since the proposal (over 16 years), makes it unlikely that this retroactive effective date will be maintained.

The 1988 Conference Report, consistent with the §1291 proposed regulations, makes clear the intent of Congress that, where PFIC stock is exchanged for PFIC stock in a non-recognition transaction, no gain should be recognized under §1291(f). Thus, this part of the proposed regulations has support in the legislative history. However, whether a taxpayer can rely on several other significant exceptions in the proposed §1291(f) regulations — e.g., one pertaining to tax-free contributions of PFIC stock to a U.S. corporation, partnership, or grantor trust — remains unclear.

Further, other proposed §1291(f) regulations appear either incomplete or inconsistent with the legislative history and purpose of the PFIC rules. For example, it appears inappropriate to treat the gift of appreciated PFIC stock by a taxpayer to a recognized tax-exempt charity as a taxable disposition under the proposed PFIC rules (contrary to the general rule that deems such transfers to be non-recognition transactions), particularly where the donor's permitted charitable deduction will equal or exceed the gain recognized under the PFIC rules. Section 1291(b)(3)(G) would appear to support by analogy continued non-recognition treatment for donative stock transfers.

Section 1291 Reporting and PFIC Taint Rules

Section 1291(e) contains, by cross-reference to former §1246(f) (as in effect before January 1, 2005), a general reporting requirement under which all 5%-or-more, by value, shareholders in a PFIC are required to also provide the IRS with certain information.

While it is unclear whether §1291(e) is self-executing and whether the instructions of the Form 8621 reflect implementation of §1291(e), §302 of the Foreign Account Tax Compliance Act would make clear that *every* shareholder of a PFIC, without regard to their percentage of direct or indirect interest in such PFIC, would be required to file an annual information return "containing such information as the Secretary may require."

In addition, the Foreign Account Tax Compliance Act would extend the statute of limitations on assessment and collections for taxpayers who fail to submit a complete PFIC shareholder's annual information return, or any information relating to a PFIC shareholder's election to treat a PFIC as a qualified electing fund under §1295(b). The bill would modify §6501(c)(8) to include PFIC information returns among those for which the assessment period remains open until three years after the required information is actually submitted. Thus, unless a PFIC shareholder would annually file a Form 8621 for each PFIC interest it holds, either directly or indirectly, the statute of limitations would remain open indefinitely with respect to unreported PFIC interests.

These proposed legislative changes continue to highlight the increasing need for an early assessment

[8] For additional discussion as to the reasoning underlying this change, see Ocasal and Markham, "Comment Letter Regarding PFIC Reporting by U.S. Interest Holders in U.S. Pass-Through Entities," 18 *J. of Int'l Tax'n* 11 (Nov. 2007).

[9] Letter from Robert W. McHugh, KPMG Peat Marwick, to Philip D. Morrison, U.S. Treasury Dept., and Steven R. Lainoff, IRS (Mar. 12, 1991), *reprinted in Tax Notes Today* (Apr. 23, 1991).

[10] The many issues presented are comprehensively discussed in Ocasal and Markham, "The PFIC Look-Through Rules: A New Level of Thinking," 35 *Tax Mgmt. Int'l J.* 59 (Feb. 2006).

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as to the U.S. tax characterization of foreign investments as PFICs, to promptly navigate through the maze of PFIC provisions, and to adequately address the many unresolved conflicts, questions, and self-executing nature of many of its provisions, both taxpayer-friendly and otherwise. For example, §302 of the Foreign Account Tax Compliance Act highlights the current cross-reference by §1291(e), in addition to former §1246(f), to former §1246(c) and (d). The cross-reference to former §1246(c), to the extent not inconsistent with §1291(f) (the PFIC rules for otherwise tax-free transactions), would appear to preserve the PFIC taint with respect to any shares in a foreign corporation received in exchange for PFIC shares where the basis in the shares received is measured by reference to the basis in the PFIC shares surrendered or transferred. This would be true whether such acquiring foreign corporation is a PFIC or not.

The cross-reference to former §1246(d) similarly would appear to treat the disposition of certain trusts and shares in a U.S. corporation as a pro rata disposition of any PFIC shares held by such trust or corporation. Thus, former §1246(d) would appear capable of subjecting the shares of even U.S. corporations to the PFIC regime, without regard to intent or share value! (A September 2008 New York City Bar Report on PFIC issues raised, among other issues, many questions as to the self-executing nature of §1291(e) and the need for clear guidance under this provision and its relationship with §1291(f).)

Section 1297(b)(2)(A)'s PFIC Banking Exception

Section 1297(b)(2)(A) excludes from the definition of ''passive income'' any income derived in the active conduct of banking by an institution licensed to do business as a bank in the United States (and, to the extent provided in regulations, by certain other business entities). Currently Prop. Regs. §1.1296-4 and Notice 89-81 provide some guidance on this exception. The Preamble to the proposed regulations provides that there were intended to liberalize some of the more strict requirements of the Notice. However, while the Notice clearly states that taxpayers may rely upon the PFIC banking proposed regulations until the regulations are finalized, the proposed regulations do not provide for similar reliance. This leaves the Notice as the only current interpretive guidance under §1297(b)(2)(A), despite the clear intent for the proposed regulations to be the current (and more lenient) interpretation as to the exception. Thus, there is a need for an IRS pronouncement that the proposed regulations may be relied upon until finalization of the current proposed regulations.

Section 954(h) and (i)

Foreign personal holding company income does not include, under §954(h), qualified banking or financing income of an eligible CFC nor, under §954(i), qualified insurance income of a qualifying insurance company (collectively, ''the Active Financing Exceptions''). Because §1297(b)(1) does not cross-reference either §954(h) or (i), there is a question as to whether the Active Financing Exceptions apply for PFIC purposes. Because both provisions specifically cross-reference §954(c) and both have their origins in a provision originally codified in §954(c), it may be inferred that the Active Financing Exceptions also apply for PFIC purposes. Section 954(h) and (i) should not be limited to CFCs only, but should apply to all Tested Foreign Corporations, as required by §1297(b)(1) (''passive income'' here means any income that would be foreign personal holding company income as defined in §954(c)).

Active Rental and Licensing Exceptions

Under §954(c)(2)(A), foreign personal holding company income does not include rents and royalties derived in the active conduct of a trade or business and received from unrelated persons. The §954 regulations greatly elaborate on the requirements of this exception. While it appears most of the requirements must be met at the corporation level, some requirements of the active rents/royalties exception should be modified so that the aggregate principles of §1297(c) are applied, like the U.S. consolidated group rules, by treating members of a controlled group as divisions of a single corporation. An aggregate approach would permit activities of the Tested Foreign Corporation and a related look-through subsidiary to be taken into account in determining: (1) whether the lessor or licensor has manufactured, produced, developed, created, or added substantial value to the leased property or licensed tangible; and (2) whether the lessor or licensor performs management, operational, marketing, or servicing functions and whether such functions are active and substantial. Moreover, under an aggregate approach for purposes of the substantiality test, active leasing expenses and active licensing expenses would include compensation rendered by the Tested Foreign Corporation and a related look-through subsidiary, and adjusted leasing profits and adjusted licensing profits would not be reduced by any amount paid by one of the entities to the other.

Consideration should also be given to eliminating the unrelated person requirement under §954(c)(2)(A) for purposes of applying the PFIC tests. The §904 regulations have eliminated the unrelated-person requirement for purposes of determining whether rents or royalties are ''passive income'' under the foreign tax credit rules. Because of the close similarity of the definition of ''passive income'' under §§904(d)(2)(A)

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and 1297(b)(1) and the fact that, before the Technical and Miscellaneous Revenue Act of 1988, §1297(b) specifically cross-referenced §904(d)(2)(A) in defining ''passive income'' for PFIC purposes, arguably the same policy rationale for eliminating the unrelated-person requirement under §904(d)(2)(A) also applies for eliminating the unrelated-person requirement of §954(c)(2)(A) for PFIC purposes.

Section 1297(b)(2)(B)'s PFIC Insurance Exception

To date, no regulations or other meaningful guidance has been issued addressing the requirements of the active insurance exception of §1297(b)(2)(B). Only the 1988 Senate Report states that the exception does not apply to income derived from financial reserves in excess of the reasonable needs of the insurance business. While it is clear that the PFIC insurance exception applies only to income derived by a business entity that is engaged in an insurance business and that would be subject to Subchapter L if it were a domestic company, the extent and scope of any other aspect of §1297(b)(2)(B) remains unclear. For example, it is unclear whether the ''predominant'' and ''active conduct'' terms of the exceptions have any independent meaning by themselves or should be generally read in a manner consistent with the §904 regulations defining financial service entities. If these terms have separate meanings, it is also unclear what quantitative and qualitative facts are required. Finally, it is unclear whether the active insurance exception is to be applied at the entity level or the Tested Foreign Corporation level, or in some hybrid manner. Clearly, additional guidance is needed to reduce the amount of uncertainty surrounding this exception.

PFIC Rules and Trusts & Estates

Ever since 1992, the §1291 proposed regulations have reserved on PFIC excess distribution rules as applied to trusts and estates. Extensive guidance is needed to coordinate the interaction of the relevant rules. In particular, the PFIC Excess Distribution regime needs to adequately take into account: (1) whether the PFIC rules should not apply to a U.S. trust's proportionate share of PFIC interest held for the benefit of foreign persons; (2) whether special allocations, by the trust instrument, of trust income attributable to PFIC stock should be taken into account in determining an indirect interest in PFIC stock by a beneficiary; (3) whether discretionary beneficiaries of a trust should be deemed to own any PFIC stock for any PFIC purposes in a taxable year in which the beneficiary does not receive any actual distributions from the trust; (4) whether the trust rules should apply to PFIC stock held by a foreign trust; (5) whether PFIC Excess Distributions (arising as either distribution or disposition) should factor the distribution deductions of §651 and §661 in computing the required PFIC interest charge of §1291(c); (6) whether the PFIC Excess Distribution should give rise to more distributable net income for purposes of computing distributable net income; and (7) whether PFIC Excess Distributions should be excluded from the throwback rules of §§666 and 667.[11]

PFIC Rules and Regulated Investment Companies (RICs)

The Investment Company Institute (ICI) requested that the IRS Guidance Priority List provide the following additional guidance regarding PFICs:

(1) Treat gains from dispositions of former PFIC stock as capital gains while losses are ordinary to the extent of prior unreversed inclusions;

(2) Provide RICs with automatic consent to terminate an MTM election during a non-PFIC year;

(3) Provide rules resolving ''post-October'' PFIC loss issues that are modeled after the rules governing a RIC's ''post-October'' foreign currency losses under the §852 regulations;

(4) Permit RICs to recognize any change in PFIC status of a foreign corporation for the RIC's taxable year within which the taxable year of the foreign corporation ends;

(5) Provide that the consequences to RICs of applying former Prop. Regs. §1.1291-8 will be respected, where relevant, for purposes of §1296;

(6) Permit RICs to determine the amount of QEF inclusions using audited financial statements that were prepared using U.S. Generally Accepted Accounting Principles or International Financial Reporting Standards; and

(7) Provide that all QEF inclusions subject to the above election will be treated as ordinary, but retain the capital character of disposition gains and losses.

CONCLUSION

While the recent IRS private letter rulings in the PFIC context are a very helpful first step in resolving

[11] For a full discussion on the PFIC issues relating to U.S. trusts and estates, *see* Letter from Newman T. Halvorson and Deanna J. Hamilton, Covington & Burling, to IRS (July 30, 1992), reprinted in *Tax Notes Today* (Aug. 13, 1992), and Letter from Newman T. Halvorson and Deanna J. Hamilton, Covington & Burling, to Thomas D. Fuller, IRS, and Ann Fisher, U.S. Treasury (Dec. 31, 1992), reprinted in *Tax Notes Today* (Jan. 28, 1993).

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uncertainty regarding some significant issues, many more PFIC items, as discussed above, remain unanswered or unaddressed. The government's recent approach of resolving these still-to-be-answered PFIC issues on a case-by-case basis may resolve many of those issues for both the taxpayer and the government, but more permanent guidance on which all taxpayers may rely is needed.

The private ruling process provides the government an opportunity to test its interpretation and application of the PFIC regime in the context of real facts without continued delay in providing guidance. However, the guidance-by-PLR approach, while helpful and welcome, does not permit a taxpayer other than the one who obtained the ruling to rely on such rulings as PLRs explicitly may not be used or cited as precedent. In addition, the government may be constrained by its 1992 proposed regulations because it generally does not rule in a manner that is inconsistent with its proposed regulations, even if it no longer supports the position therein. However, the authors would urge the government to make an exception to its unstated ruling policy and begin to explore the viability of certain aspects of its 1992 proposed regulations, as outlined above, in its PLR guidance approach.

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