



**REPORT OFFERING PROPOSED GUIDANCE REGARDING THE PASSIVE
FOREIGN INVESTMENT COMPANY RULES**

The Committee on Taxation of Business Entities

September 21, 2009

Table of Contents

	Page
I. INTRODUCTION	- 1 -
II. SUMMARY OF RECOMMENDATIONS	- 2 -
III. SUMMARY OF CURRENT LAW REGARDING PASSIVE FOREIGN INVESTMENT COMPANIES	- 7 -
A. Definition of a “Passive Foreign Investment Company”	- 7 -
B. The “Once a PFIC, Always a PFIC” Rule	- 9 -
C. Taxation of PFIC Shareholders under the Excess Distribution Regime	- 10 -
D. Indirect Ownership of PFIC Stock Through an Entity	- 13 -
E. Option Attribution	- 15 -
F. QEF Regime	- 15 -
G. Mark-to-Market Regime	- 18 -
H. The CFC Regime and the “CFC Trumps PFIC” Rule	- 19 -
I. Purging Elections	- 20 -
IV. PROPOSED GUIDANCE REGARDING THE QEF ELECTION	- 22 -
A. QEF Election for Options	- 22 -
B. Deemed QEF Election	- 24 -
C. Requirements for a Retroactive QEF Election	- 25 -
D. Financial Information Requirements for a Valid QEF Election	- 29 -
V. PROPOSED GUIDANCE REGARDING PFIC CLASSIFICATION	- 31 -
A. The Treatment of Cash and Non-Depreciable Assets as Passive Assets and the Start-up Exception	- 31 -
B. Guidance Regarding the Application of the Look-Through Rules with Respect to Partnerships and 25% Owned Subsidiaries	- 36 -
VI. PROPOSED GUIDANCE REGARDING THE STOCK ATTRIBUTION RULES ..	- 41 -
A. The Treatment of PFIC Shares Held Through a Foreign Trust	- 41 -
B. Proposed Guidance Regarding Tiered PFIC Structures	- 52 -
C. Option Attribution	- 69 -
VII. PROPOSED GUIDANCE REGARDING THE APPLICATION OF SECTION 1291(E)	- 70 -
A. Introduction	- 70 -
B. Summary of Relevant Provisions	- 70 -

Table of Contents
(continued)

	Page
C. Self-Executing Nature of Section 1291(e).....	- 74 -
VIII. OTHER PROPOSED GUIDANCE.....	- 76 -
A. Purging Elections.....	- 76 -
B. Guidance Regarding Section 1297(d).....	- 77 -
IX. CONCLUSION.....	- 78 -

This report, which is submitted on behalf of the New York City Bar by its Committee on Taxation of Business Entities, proposes certain guidance regarding the passive foreign investment company (“PFIC”) rules.¹

I. Introduction

This report sets forth our proposals for changes to be made to the Treasury Regulations governing PFICs. This report is issued in part in response to a request for comments published by the Internal Revenue Service (“IRS”) in the Federal Register on August 14, 2008.²

The PFIC rules were enacted by Congress to prevent taxpayers from avoiding or deferring (on an interest-free basis) U.S. federal income taxation on passive investments, or converting ordinary income to capital gains, by making those investments through foreign corporations.³ The PFIC rules, however, cast an extremely wide net, and many companies – even those engaged in active businesses – can easily be caught in the trap. Furthermore, the effects of the PFIC rules on taxpayers to which they apply have accurately been described as “draconian.”⁴ And while certain options are available to taxpayers to escape from the PFIC regime into other regimes that are less punitive, for reasons discussed in greater detail below, those options often do not work effectively. We believe that the proposals set forth in this report should be adopted by the Treasury Department and the IRS in the form of Treasury Regulations

¹ This report was prepared by the Committee on Taxation of Business Entities of the New York City Bar. The authors of the report are Zvi Hahn, Deborah J. Goldstein, Jason Kaplan, Andrew Walker, Michael Miller and Alan J. Tarr. Helpful comments were provided by Peter Blessing, Mark Stone, Mitch Weiss, John Barrie, David Franklin, Tzachi Schwartz, Rachel Ingwer and Stanley Barsky.

² See 73 Fed. Reg. 47645 (Aug. 14, 2008).

³ See Staff of J. Comm. on Tax’n, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, at 1023 (J. Comm. Print 1987) (“Blue Book”) (noting as a reason for the change that “Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation”).

⁴ See, e.g., New York State Bar Association Tax Section, *Report on Proposals for Guidance with respect to Passive Foreign Investment Companies*, at 2 (May 22, 2001) (“NYSBA Report”).

in order to remove traps for the unwary, to prevent the PFIC rules from applying in certain situations in which they were never intended to apply, and generally to rationalize the PFIC rules.

II. Summary of Recommendations

The principal proposals made in this report with respect to the PFIC rules, which, we believe, should and can be implemented by the issuance of Treasury Regulations, are summarized below:

Encouraging QEF Elections

- A holder of an option to purchase PFIC stock should be permitted to make a qualified electing fund (“QEF”) election with respect to any PFIC shares deemed to be owned by such person under the “option attribution” rule of Section 1298(a)(4).⁵ Alternatively, an exercising optionholder should be permitted to “reset” its holding period, thereby avoiding the “once a PFIC, always a PFIC” rule, by paying (with interest) the federal income tax that would have been imposed if it had made a QEF election with respect to the option for the first PFIC year.
- A shareholder of a PFIC should be deemed to have made a QEF election with respect to a PFIC if the shareholder can demonstrate that the PFIC has no earnings and profits for any taxable year included (in whole or in part) within his holding period. Such deemed election would remain in effect until the first taxable year (if any) in which the foreign corporation is a PFIC and has earnings and profits.

⁵ All section references are to the Internal Revenue Code of 1986, as amended (the “Code”), or the regulations promulgated or proposed thereunder (the “Treasury Regulations”), unless otherwise indicated.

At that time, the shareholder should be permitted to decide whether or not to make a “real” QEF election for the PFIC.

- The circumstances in which retroactive QEF elections are permitted should be liberalized. At a minimum, retroactive QEF elections should be permitted in all circumstances in which the first PFIC year and all subsequent years are open (provided that the taxpayer states that it has not knowingly decided not to make a QEF election for any such applicable taxable year). In addition, similar relief should be granted in circumstances in which the first PFIC year is closed, provided, however, that the shareholder would need to request a private letter ruling from the IRS and, as a condition to the receipt of such ruling, would need to enter into a closing agreement with the IRS and agree to pay an amount sufficient to eliminate any prejudice to the Treasury as a consequence of the shareholder’s inability to file amended returns for closed taxable years.
- Small PFIC shareholders who are unable to obtain annual PFIC information statements should be permitted to make QEF elections on the basis of certain financial information reasonably available to them, such as audited financial statements of the PFIC that are either (i) required to be provided to the U.S. Securities and Exchange Commission, or (ii) used for purposes of providing reports to creditors, shareholders, or for any other substantial non-tax purpose.

Test for PFIC

- Cash and other liquid assets held for the “reasonable needs” of an active business or for the development and subsequent carrying on of an active business, as well as land and other non-depreciable assets used in a trade or business, should not be

treated as passive assets for purposes of the asset test, and earnings on such assets should not be treated as passive income for purposes of the income test.

- For purposes of the asset test, it should be clarified whether the foreign corporation's percentage of passive assets should be determined by averaging the percentages that passive assets represent by the end of each quarter or by dividing the average of the quarterly values of the passive assets by the average of the quarterly values of the foreign corporation's overall assets. In addition, the regulations should provide rules for applying the asset test to a short taxable year.
- Whenever the subsidiary look-through rule applies:
 - ◆ The stock of a direct or indirect 25% subsidiary (as defined in Section V.B below) and dividends thereon should be disregarded for purposes of the asset and income tests. Similar treatment may be appropriate for loans made by an owner to its 25% subsidiary, to reflect the applicable legislative history (*See* discussion in Section V.B below),
 - ◆ Any other parent-subsidiary transactions (or transactions between 25% subsidiaries of the foreign corporation) should be disregarded for purposes of such tests to the extent of the parent's direct or indirect ownership in the applicable subsidiary, and
 - ◆ Any gain recognized upon the disposition of an equity interest in a 25% subsidiary should be characterized by reference to a deemed sale of the assets of the 25% subsidiary.

- Where the foreign corporation owns an interest in a partnership:
 - ◆ For purposes of the income test, income earned through the partnership (whether directly or indirectly through a look-through subsidiary) should be characterized as passive or non-passive based on rules similar to those applied for purposes of determining whether income is “subpart F income” under the CFC rules.
 - ◆ For purposes of the income test, gain on the sale of an interest in a 25% owned partnership should be classified as passive or non-passive by reference to a deemed sale of the partnership’s assets.
 - ◆ For purposes of the asset test, an interest in a 25% owned partnership should be governed by rules similar to those applicable to an interest in a 25% subsidiary. A smaller interest in a partnership should be classified based proportionally on either the character of the income (passive or non-passive) earned by the foreign corporation through the partnership as described above, or the character of the partnership’s assets generating such income.
 - ◆ Transactions between the foreign corporation (or attributed to it from a lower-tier look-through subsidiary) and a 25% owned partnership should be disregarded to the extent of the foreign corporation’s direct or indirect interest in the partnership.

Treatment of Trusts

- An excess distribution received by a foreign nongrantor trust should not be taxed to the U.S. beneficiaries to the extent it is accumulated within the foreign trust.

The excess distribution should become part of the foreign trust's distributable net income ("DNI") for the year and taxed to a U.S. beneficiary only when it is distributed to him, and in that case only to the extent of the lesser of (i) the distribution amount received or (ii) the trust's applicable DNI or undistributed net income ("UNI") in the year of receipt.

Tiered PFICs

- Treasury Regulations should clarify whether in a multi-tier PFIC structure the PFIC attribution rules apply from the top of the ownership chain down to the lower-tier PFICs or from the PFIC up the ownership chain.
- Distributions from a lower-tier PFIC to a non-U.S. intervening corporation should not be attributed to the U.S. investor and subject to the excess distribution rules if (i) the lower-tier PFIC has annually distributed all of its earnings or (ii) the distribution occurs during the first year in which the U.S. investor is treated as having an indirect interest in the lower-tier PFIC.
- Distributions from lower-tier PFICs should not be subject to the excess distribution rules to the extent such distributions do not reflect economic income items (for example, if such distributions are returns of capital).
- Dispositions of lower-tier PFIC stock should not give rise to excess distributions if the dispositions do not result in a dilution of the U.S. investor's ownership interest in the lower-tier PFIC. Similarly, "dilutions" resulting from the issuance of additional equity interests by the PFIC should not result in a taxable event to the U.S. indirect shareholder.

- If a U.S. investor has made a mark-to-market election with respect to its shares in a first-tier PFIC, the U.S. investor should not be subject to the excess distribution rules with respect to any lower-tier PFIC.
- A distribution on, or disposition of, PFIC stock owned (or deemed owned) by an upper-tier non-QEF PFIC should not be attributed to the U.S. investor.

Section 1291

- The principles of Section 1246(c) should not apply to PFIC stock permitted to be received without recognition of gain or loss under the proposed regulations pursuant to Section 1291(f).

Purging Elections

- Treasury Regulations should clarify that domestic partnerships and S corporations are treated as “shareholders” for the purpose of making purging elections, and that PFIC shares held by a domestic partnership that is a “U.S. shareholder” of a CFC are not treated as PFIC shares in the hands of a U.S. partner during the qualified period of the partnership’s holding period with respect to such shares.

III. Summary of Current Law Regarding Passive Foreign Investment Companies

A. Definition of a “Passive Foreign Investment Company”

Pursuant to the general definition set forth in Section 1297(a), a foreign corporation is treated as a PFIC for a taxable year (of the foreign corporation) if (i) at least 75% of its gross income for the taxable year is passive income (the “income test”) or (ii) the average percentage of assets held by such corporation during the taxable year that produce (or are held for the production of) passive income is at least 50% (the “asset test”).

Passive income generally means “foreign personal holding company income” as defined in Section 954(c),⁶ including, subject to certain exceptions, dividends, interest, rents, and royalties.

For purposes of applying the asset test, the average value of a foreign corporation’s assets for a taxable year generally is the average of the fair market values of its assets determined as of the end of each quarterly period during the taxable year of the corporation.⁷ Subject to significant exceptions, the asset test is applied based on the gross fair market values of the corporation’s assets (*i.e.*, without regard to liabilities).⁸ However, in the case of a non-publicly traded corporation that is a controlled foreign corporation (“CFC”), the asset test is applied based on the adjusted tax bases of the corporation’s assets.⁹ In the case of a non-publicly traded corporation that is not a CFC, gross fair market values are used, unless the corporation elects to use adjusted tax bases.¹⁰ In general, an asset is treated as passive if it has generated (or is

⁶ See Section 1297(b).

⁷ See Notice 88-22, 1988-1 C.B. 489, *modified by* Notice 89-81, 1989-2 C.B. 399 (“Notice 88-22”).

The application of the asset test under Notice 88-22 is, however, unclear. Specifically, it is unclear whether the average percentage of passive assets should be measured by reference to (i) the *average* of the *percentages* that the respective values of passive assets represent at the end of each quarter, or (ii) the *percentage* resulting from dividing the *average* of the respective values of passive assets at the end of each quarter by the average of the respective values of the total assets of the foreign company at the end of each quarter.

For example, assume that a foreign company has at the end of the first, second, third and fourth quarters passive assets valued (in millions) at \$10, \$10, \$90 and \$90, respectively, and total assets valued (in millions) at \$50, \$50, \$150 and \$150, respectively. Under the first computation method, the foreign company’s average percentage of passive assets would be 40% $((10/50+10/50+90/150+90/150)/4)$, hence *not* satisfying the asset test, while under the second computation method, the foreign company’s average percentage of passive assets would be 50% $([(10+10+90+90)/4]/[(50+50+150+150)/4])$, hence satisfying the asset test.

The computation method used to determine the average percentage of passive assets can therefore significantly affect the PFIC classification of the entity involved. Accordingly, Treasury Regulations should clarify which method should be used in applying the asset test.

Guidance is also needed as to how the asset test is applied in a short taxable year.

⁸ See Section 1297(e)(1).

⁹ See Section 1297(e)(2).

¹⁰ *Id.*

reasonably expected to generate in the reasonably foreseeable future) passive income.¹¹

Pursuant to Notice 88-22, cash and other assets that are readily convertible into cash produce passive income and are therefore treated as passive, even if they are part of the working capital of an active business.

For purposes of the income and asset tests, a “look-through” rule applies if a foreign corporation owns (directly or indirectly) at least 25%, measured by value, of the stock of another corporation.¹² The foreign corporation is treated as owning its proportionate share of the assets of the other corporation and as receiving directly its proportionate share of that corporation’s income.¹³

Pursuant to a limited exception provided under Section 1298(b)(2) (the “start-up exception”), a corporation is not treated as a PFIC for the first taxable year such corporation has gross income if (i) no predecessor of such corporation was a PFIC, (ii) it is established to the satisfaction of the IRS that such corporation will not be a PFIC for either of the first two taxable years following such first taxable year, and (iii) such corporation is in fact not a PFIC for either of the first two taxable years following such first taxable year.

B. The “Once a PFIC, Always a PFIC” Rule

The status of a foreign corporation as a PFIC or non-PFIC is, in the first instance, determined separately for each taxable year of the foreign corporation under the income and asset tests described above. However, pursuant to a special rule, commonly referred to as the “once a PFIC, always a PFIC” rule, a corporation that is treated as a PFIC for any taxable year included (in whole or in part) in the holding period of a particular shareholder will continue to be

¹¹ See Notice 88-22.

¹² See Section 1297(c).

¹³ *Id.*

treated as a PFIC with respect to such shareholder in subsequent taxable years unless the shareholder makes (i) a “QEF election” for the corporation’s “first PFIC year” (as described in Part III.F below) or (ii) one of several “purging elections” (as described in Part III.I below). Thus, for example, assuming that the above-described start-up exception does not apply, a corporation that is a PFIC during an initial start-up period, but thereafter becomes a non-PFIC, generally will continue to be treated as a PFIC as to any shareholder that owned stock of the foreign corporation during the initial start-up period in which it was a PFIC.

Given the harsh tax treatment that applies to PFIC shareholders under the excess distribution regime (as described in Part III.C below), the impact of the “once a PFIC, always a PFIC” rule cannot be overstated.

C. Taxation of PFIC Shareholders under the Excess Distribution Regime

A U.S. person that owns stock of a PFIC (either directly or pursuant to certain attribution rules described below) is taxed under special rules (referred to herein as the “excess distribution regime”) on any portion of a distribution with respect to its PFIC stock that constitutes an “excess distribution.”¹⁴ Gain recognized by a U.S. shareholder on a disposition of PFIC stock is treated as an “excess distribution” and is therefore taxed in the same manner.¹⁵

The total excess distribution with respect to a share of PFIC stock for any taxable year is the excess of the total amount of all distributions during the year with respect to the share over 125% of the average amount of the distributions with respect to the share during the preceding

¹⁴ See Section 1291(a)(1). The “nonexcess” portion of any direct or indirect distribution by a PFIC is taxed to the U.S. shareholder under general U.S. tax rules.

¹⁵ See Section 1291(a)(2). A U.S. shareholder generally recognizes gain on any direct or indirect disposition of PFIC stock, even in cases where the actual transaction qualifies for nonrecognition treatment under general U.S. tax rules. There are, however, certain exceptions, *e.g.*, exchanges of PFIC stock solely for stock of the same or another PFIC. See Prop. Treas. Regs. § 1.1291-6(c)(1).

three taxable years.¹⁶ Notably, a distribution may constitute an excess distribution even if the PFIC has no current or accumulated earnings and profits, *i.e.*, even if the distribution would otherwise constitute a tax-free return of capital described in Section 301(c)(2).

The portion of the distribution that is an excess distribution is allocated ratably to each day in the U.S. shareholder's holding period for the PFIC stock.¹⁷ The shareholder includes in ordinary income for the taxable year of the distribution the portions of the excess distribution allocated to the year of the distribution, to pre-1987 years and to post-1986 years during which the company was not a PFIC.¹⁸ Each portion of the excess distribution allocated to a year after 1986 but preceding the year of the distribution and during which the foreign corporation was a PFIC (a "post-1986 prior PFIC year") is taxed to the shareholder at the highest marginal tax rate in effect for such year.¹⁹ In addition, interest is charged on any increase in tax for any post-1986 prior PFIC year at the tax underpayment rate under Section 6621.²⁰ The increase in tax for post-1986 prior PFIC years and the interest charge are simply added to the taxpayer's tax liability for the year, and consequently they cannot be reduced or offset by any deductions for the taxable year to which they are allocable (or the taxable year in which the excess distribution occurs).²¹

Although it may not be immediately evident from the above discussions, the U.S. federal income tax consequences of the PFIC excess distribution regime may be draconian, as the following example illustrates.

¹⁶ See Section 1291(b).

¹⁷ See Section 1291(a)(1).

¹⁸ *Id.*

¹⁹ See Section 1291(a)(1)(C), (c).

²⁰ *Id.*

²¹ *Id.*

Assume, for example, that on January 1, 1989, Dan, a U.S. person, purchased for \$100 shares of a private foreign corporation that was a PFIC for such year. Dan was unaware of the corporation's PFIC status and therefore did not make a QEF election. On December 31, 2008, Dan sold the shares to a third party for \$20,100, realizing a gain of \$20,000. Assuming for the sake of convenience that the highest marginal tax rate in each of the applicable taxable years (*i.e.*, 1989-2008) was 35% and that the interest charge on tax underpayments was 8%, Dan's tax liability with respect to such gain under the PFIC excess distribution regime would be \$16,017, for an effective tax rate of over 80%!²²

Alternatively, if the interest charge on tax underpayments was 10% and the highest marginal tax rate in each of the applicable taxable years was 36%, Dan's tax liability under the

²² Total Gain - 20,000; Highest marginal tax rate - 35%; Interest on tax underpayments - 8%.

Taxable Year	Allocable Portion of Gain	Tax (before interest)	Interest	Total (tax plus interest)
1989	1,000	350	1,160.50	1,510.50
1990	1,000	350	1,048.61	1,398.61
1991	1,000	350	945.01	1,295.01
1992	1,000	350	849.08	1,199.08
1993	1,000	350	760.26	1,110.26
1994	1,000	350	678.02	1,028.02
1995	1,000	350	601.87	951.87
1996	1,000	350	531.36	881.36
1997	1,000	350	466.07	816.07
1998	1,000	350	405.62	755.62
1999	1,000	350	349.65	699.65
2000	1,000	350	297.83	647.83
2001	1,000	350	249.84	599.84
2002	1,000	350	205.41	555.41
2003	1,000	350	164.26	514.26
2004	1,000	350	126.17	476.17
2005	1,000	350	90.90	440.90
2006	1,000	350	58.24	408.24
2007	1,000	350	28.00	378.00
2008	1,000	350	-	350.00

Total Tax Liability

16,016.69

PFIC excess distribution regime would be \$20,619 - an amount that exceeds not only Dan's gain on the sale (for an effective tax rate of over 103%), but also the amount realized!²³

D. Indirect Ownership of PFIC Stock Through an Entity

U.S. persons that do not directly own stock in a PFIC may nevertheless be treated as shareholders of the PFIC for purposes of the excess distribution regime pursuant to certain stock attribution rules. Section 1298(a)(2) provides that stock held through a corporation will be attributed to a shareholder of such corporation to the extent of the shareholder's proportionate interest, by value, in the corporation, if either (i) the shareholder owns 50% or more in value of the stock of the corporation, or (ii) the corporation is a PFIC.²⁴ Under Section 1298(a)(3), stock

²³ Total Gain - 20,000; Highest marginal tax rate - 36%; Interest on tax underpayments - 10%.

Taxable Year	Allocable Portion of Gain	Tax (before interest)	Interest	Total (tax plus interest)
1989	1,000	360	1,841.73	2,201.73
1990	1,000	360	1,641.57	2,001.57
1991	1,000	360	1,459.61	1,819.61
1992	1,000	360	1,294.19	1,654.19
1993	1,000	360	1,143.81	1,503.81
1994	1,000	360	1,007.10	1,367.10
1995	1,000	360	882.82	1,242.82
1996	1,000	360	769.83	1,129.83
1997	1,000	360	667.12	1,027.12
1998	1,000	360	573.75	933.75
1999	1,000	360	488.86	848.86
2000	1,000	360	411.69	771.69
2001	1,000	360	341.54	701.54
2002	1,000	360	277.76	637.76
2003	1,000	360	219.78	579.78
2004	1,000	360	167.08	527.08
2005	1,000	360	119.16	479.16
2006	1,000	360	75.60	435.60
2007	1,000	360	36.00	396.00
2008	1,000	360	-	<u>360.00</u>
Total Tax Liability				20,619.00

²⁴ The corporation's status as a potential PFIC is determined without regard to the "CFC trumps PFIC" rule described in Part III.H below.

owned (directly or indirectly) by a partnership, estate, or trust will be considered to be owned “proportionately” by the partners or beneficiaries of such entity.²⁵

Section 1298(a)(1)(B) provides, however, that “except to the extent provided in regulations,” the attribution rules of Section 1298(a) “shall not apply to treat stock owned (or treated as owned under this subsection) by a United States person as owned by any other person.” No final or temporary regulations have been issued under Section 1298(a), but proposed regulations would expand attribution from U.S. persons.²⁶

U.S. persons that are considered to indirectly own PFIC stock through an entity may therefore be treated as receiving excess distributions from, or realizing gain with respect to, such PFIC. Section 1298(b)(5) provides that, under regulations, a U.S. person that indirectly owns PFIC stock will be considered to have received a distribution if the PFIC makes a distribution to the person that directly holds such PFIC stock. There are rules that prevent double-counting of distributions; thus, if an indirect shareholder of a PFIC is taxed on an indirect distribution, the shareholder will not be taxed again when the previously taxed amounts are distributed up an ownership chain.²⁷

Section 1298(b)(5) similarly provides that, “under regulations,” a U.S. person that indirectly owns PFIC stock will be considered to have disposed of such PFIC stock if any disposition by such U.S. person or the person directly owning stock of the PFIC results in such U.S. person no longer owning such PFIC stock. Proposed regulations would go further than the statute, by providing that an “indirect disposition” of PFIC stock by the indirect U.S. shareholder also includes “[a]ny other transaction as a result of which an indirect shareholder’s ownership of

²⁵ For purposes of this report, the term “partnership” means any entity that is treated as a partnership for U.S. federal income tax purposes.

²⁶ See Prop. Treas. Regs. § 1.1291-1(b)(8).

²⁷ See Section 1298(b)(5)(B); Prop. Treas. Regs. §§ 1.1291-3(e)(4)(iv),-2(f)(5).

a section 1291 fund [*i.e.*, a PFIC] is reduced or terminated.”²⁸ Basis adjustment rules prevent, to an insufficient extent as discussed below, double-counting of gain when a U.S. person owns an interest in a chain of PFICs.²⁹

E. Option Attribution

Section 1298(a)(4) provides that “[t]o the extent provided in regulations, if any person has an option to acquire stock, such stock shall be considered as owned by such person.” No final or temporary regulations have been issued under this provision, but proposed regulations would treat any U.S. person holding an option to purchase PFIC stock as a holder of PFIC stock for purposes of applying the excess distribution regime to a disposition of the option.³⁰ The proposed regulations would further provide that, solely for purposes of applying the PFIC rules, the holding period of PFIC stock acquired upon the exercise of an option includes the period during which the option was held.³¹ Notably, this special rule would differ from the normal rule whereby a taxpayer’s holding period for stock received upon the exercise of an option would not include the period during which the option was held.³²

F. QEF Regime

A direct or indirect shareholder of a PFIC can entirely avoid the excess distribution regime, if the shareholder is eligible to make a QEF election with respect to the PFIC, and it makes the QEF election for the first taxable year of the PFIC that is included (in whole or in part) within the shareholder’s holding period and in which such corporation is a PFIC (referred

²⁸ See Prop. Treas. Regs. § 1.1291-3(e)(2)(iii).

²⁹ See Prop. Treas. Regs. § 1.1291-3(e)(4)(iii).

³⁰ See Prop. Treas. Regs. § 1.1291-1(d).

³¹ See Prop. Treas. Regs. § 1.1291-1(h)(3).

³² See Section 1223(5).

to herein as the “first PFIC year”).³³ In that event, the PFIC is referred to as a “pedigreed QEF” with respect to such shareholder.

Whether or not the PFIC is a pedigreed QEF with respect to the electing shareholder is extremely important. Under Section 1298(b)(1), the “once a PFIC, always a PFIC” rule does not apply to a pedigreed QEF. It is for this reason that an electing shareholder can entirely avoid the excess distribution regime by making a QEF election for the first PFIC year. A QEF election may be made for a later year (in which case the foreign corporation may be referred to as a “nonpedigreed QEF”), but in that case the excess distribution regime will continue to apply.

Pursuant to Section 1293 (the “QEF regime”), an electing shareholder is taxed currently on its proportionate share of the PFIC’s ordinary earnings (as ordinary income) and net capital gain (as long-term capital gain) each year.³⁴ If the foreign corporation is a pedigreed QEF with respect to the shareholder, such “QEF inclusions” are required only for years in which the foreign corporation is a PFIC under the income test or the asset test of Section 1297(a).³⁵ If the foreign corporation is a nonpedigreed QEF with respect to the shareholder, then QEF inclusions generally are required each year, whether or not the foreign corporation is a PFIC under the income test or the asset test of Section 1297(a).³⁶ Amounts that have been taxed to the shareholder under the QEF regime increase the shareholder’s basis in the PFIC stock and can later be distributed tax-free.³⁷

³³ See Section 1298(b)(1); Prop. Treas. Regs. § 1.1291-1(b).

³⁴ See Section 1293(a). Other than net capital gain, other types of tax-favored income (*e.g.*, qualified dividend income) do not “flow through” and are simply included in ordinary earnings.

³⁵ See Prop. Treas. Regs. § 1.1295-1(c)(2).

³⁶ *Id.*

³⁷ See Section 1293(c).

A shareholder is eligible to make a QEF election only if the foreign corporation agrees to provide the shareholder with an annual information statement.³⁸ Among other things, the annual information statement generally must include: (i) a statement of the U.S. shareholder's pro rata shares of the PFIC's ordinary earnings and net capital gain,³⁹ and (ii) a statement that the PFIC will permit the shareholder to inspect and copy its books and records, in order to establish and verify that such shareholder's pro rata shares of the PFIC's ordinary earnings and net capital gains are computed based on U.S. tax principles.⁴⁰

In general, the QEF election for any taxable year must be made on or before the return filing due date (including extensions) for such year.⁴¹ Pursuant to the Treasury Regulations, however, a "retroactive" QEF election may be made in certain very limited circumstances. In particular, a retroactive election for a taxable year is permitted only if the shareholder: (a) "reasonably believed" the foreign corporation to be a non-PFIC and filed a protective statement on its return for such year;⁴² (b) has at all times owned (within the meaning of Section 958) directly, indirectly or constructively less than 2% of the vote and value of each class of stock of the foreign corporation and relied on certain specified types of disclosure statements to the effect that the foreign corporation reasonably believed it was not (or would not be) a PFIC;⁴³ or (c) receives consent from the IRS, in the form of a private letter ruling, by reason of having

³⁸ See Section 1295(a)(2); Treas. Regs. § 1.1295-1(g).

³⁹ Alternatively, the annual information statement may include (i) sufficient information to enable the shareholder to calculate such amounts, or (ii) a statement that the foreign corporation has permitted the shareholder to examine its books and records in order to permit the shareholder to calculate such amounts.

⁴⁰ In "rare and unusual circumstances", certain alternative documentation may be provided if the taxpayer obtains a private letter ruling. See Treas. Regs. § 1.1295-1(g)(2).

⁴¹ See Section 1295(b)(2); Treas. Regs. § 1.1295-1(f)(1).

⁴² See Treas. Regs. § 1.1295-3(b).

⁴³ See Treas. Regs. § 1.1295-3(e).

reasonably relied on the advice of a “qualified tax professional” (“QTP”) and satisfying certain other requirements.⁴⁴

Notably, a QEF election may not be made for an option to acquire PFIC stock. Thus, for example, if in year 1 a U.S. person acquires an option to buy PFIC stock and exercises the option in year 3, the U.S. person would not be permitted to make a QEF election until year 3, at which time the PFIC would become, if a QEF election is made, a nonpedigreed QEF because the QEF election was not made for the first PFIC year (unless a “purging election” is made, as discussed in Part III.I, below).

G. Mark-to-Market Regime

If a taxpayer owns “marketable stock” in a PFIC⁴⁵, the taxpayer can elect mark-to-market treatment under Section 1296. Under the mark-to-market regime, the taxpayer generally includes in its income at the end of each taxable year the difference, if any, between the value of the PFIC stock and its adjusted basis.⁴⁶ The income is treated as ordinary income for this purpose.⁴⁷ If the adjusted basis of the stock exceeds its value at the end of the year, the taxpayer is allowed a deduction (but only to the extent of “unreversed inclusions” previously taken into account under the mark-to-market regime). Any deduction allowed is treated as an ordinary loss. A taxpayer may generally make a mark-to-market election with respect to its share of PFIC stock owned through a foreign partnership, foreign trust or foreign estate.⁴⁸

⁴⁴ See Treas. Regs. § 1.1295-3(f). One additional requirement is that such consent must be requested *before* the IRS raises the PFIC issue on audit.

⁴⁵ See Section 1296(e) for the definition of the term “marketable stock”.

⁴⁶ See Section 1296(a).

⁴⁷ See Section 1296(c).

⁴⁸ See Section 1296(g)(1).

A taxpayer that owns stock of a PFIC indirectly through another foreign corporation generally may not make a mark-to-market election with respect to the PFIC stock, even if the first-tier foreign corporation is also a PFIC; however, if the first-tier foreign corporation is a CFC, it may make a mark-to-market election with respect to its stock in the PFIC.⁴⁹

H. The CFC Regime and the “CFC Trumps PFIC” Rule

A foreign corporation is a CFC if “United States shareholders” (as defined in Section 951(b), and hereinafter referred to as “U.S. shareholders”) own (directly, indirectly, or through application of certain constructive ownership rules) stock of the foreign corporation possessing more than 50% of the total voting power or total value of the foreign corporation’s stock.⁵⁰ A U.S. person is a “U.S. shareholder” within the meaning of Section 951(b) if such person owns (directly, indirectly, or through application of certain constructive ownership rules) stock of the foreign corporation possessing at least 10% of the total voting power of the foreign corporation’s stock. A U.S. shareholder that owns, directly or indirectly through foreign entities, stock of a CFC is generally required to include in income, on an annual basis, its pro-rata share of the CFC’s “subpart F income” (including the CFC’s “foreign personal holding company income”). U.S. shareholders are also taxed on certain investments by the CFC in U.S. property.⁵¹

Pursuant to a rule sometimes referred to as the “CFC trumps PFIC” rule, a CFC that is also a PFIC is generally not treated as a PFIC with respect to a shareholder of the CFC for the “qualified portion” of the shareholder’s holding period with respect to the CFC.⁵² The “qualified portion” of the shareholder’s holding period is that portion (i) during which the corporation is a

⁴⁹ See Section 1296(f).

⁵⁰ See Section 957(a).

⁵¹ See Section 951(a)(1).

⁵² See Section 1297(d)(1).

CFC; (ii) during which the shareholder is a U.S. shareholder of the CFC within the meaning of Section 951(b); and (iii) that is after December 31, 1997.⁵³

The “CFC trumps PFIC” rule, however, is itself trumped by the “once a PFIC, always a PFIC” rule. Suppose, for example, that Dan, a U.S. citizen, acquired a 90% interest in a foreign corporation, FC, on January 1, 1996, and that FC was at all times a PFIC under the income test or the asset test of Section 1297(a). In such circumstances, the qualified portion of Dan’s holding period would begin on January 1, 1998, and, but for the “once a PFIC, always a PFIC” rule, the “CFC trumps PFIC” rule would have caused FC to be treated as a non-PFIC with respect to Dan beginning on that day. Pursuant to the “once a PFIC, always a PFIC” rule, however, FC generally would continue to be treated as a PFIC with respect to Dan because FC was considered a PFIC in 1996 and 1997. Certain elections that may be made to purge the PFIC “taint” are addressed in Part III.I below.

I. Purging Elections

Certain elections may be made to avoid the excess distribution regime in different circumstances where a foreign corporation would cease being a PFIC, or would cease being treated as a PFIC, but for application of the “once a PFIC, always a PFIC” rule. In each case, the purging election involves a toll charge based on either a deemed sale or a deemed distribution from the PFIC.

1. Purging Elections Made in Conjunction with a QEF Election

a. Deemed Sale Election

A U.S. person that makes a QEF election after the first PFIC year may avoid application of the excess distribution regime by making a deemed sale election in conjunction with the QEF

⁵³ See Section 1297(d)(2).

election.⁵⁴ In such circumstances, the electing shareholder is treated as having sold its PFIC stock for fair market value and as having repurchased such stock for the same amount. Any gain recognized on the deemed sale is taxed under the excess distribution regime to the same extent as if there had been an actual sale.

The deemed sale election begins, for purposes of the PFIC rules, a new holding period for the shareholder's PFIC stock, and from that point on the PFIC is treated as a pedigreed QEF with respect to the shareholder.⁵⁵ Consequently, the "once a PFIC, always a PFIC" rule no longer applies.

b. Deemed Dividend Election

If the PFIC is also a CFC, a U.S. person that makes a QEF election after the first PFIC year may avoid application of the excess distribution regime by electing to include in income, as a dividend, certain post-1986 earnings and profits of the foreign corporation that are attributable to the PFIC stock owned by such U.S. person as of the first day of the first year to which the QEF election applies.⁵⁶ The amount of such deemed dividend is treated as an excess distribution to which the excess distribution regime applies. As with the deemed sale election, the deemed dividend election begins, for purposes of the PFIC rules, a new holding period for the shareholder's PFIC stock, and from that point on the PFIC is treated as a pedigreed QEF with respect to the shareholder.⁵⁷

⁵⁴ See Section 1291(d)(2)(A).

⁵⁵ See Treas. Regs. § 1.1291-10(g).

⁵⁶ See Section 1291(d)(2)(B).

⁵⁷ See Treas. Regs. § 1.1291-9(g).

2. Other Purging Elections

A U.S. person that owns stock of a foreign corporation that was previously a PFIC (at some time during such U.S. person's holding period), but no longer is a PFIC under the income test or the asset test of Section 1297(a), may avoid application of the "once a PFIC, always a PFIC" rule by making a deemed sale election or (if the foreign corporation is also a CFC) a deemed dividend election under essentially the same rules described above for deemed sale and deemed dividend elections made in conjunction with a QEF election.⁵⁸ A variation of each such election is also available in circumstances where the foreign corporation would, in the absence of the "once a PFIC, always a PFIC" rule, cease to be a PFIC as to the taxpayer by reason of the "CFC trumps PFIC" rule.⁵⁹

IV. Proposed Guidance Regarding The QEF Election

As discussed above, the consequences of the excess distribution regime can be extremely harsh, particularly because such regime may apply to genuinely active corporations that were not necessarily the intended target of the PFIC rules. As the Committee understands it, Congress contemplated that the principal mechanism for avoiding the excess distribution regime would be the ability to achieve "pedigreed QEF" status by making a QEF election for the first PFIC year. Accordingly, we believe that all reasonable efforts should be made to allow shareholders to avoid the excess distribution regime by electing to treat their PFICs as pedigreed QEFs. Towards that end, four specific suggestions are set forth below.

A. QEF Election for Options

As noted above, a U.S. person is not permitted to make a QEF election for an option to purchase shares of a PFIC, notwithstanding that, if Section 1298(a)(4) is self-executing, such

⁵⁸ See Section 1298(b)(1) (second sentence); Treas. Regs. § 1.1298-3.

⁵⁹ See Treas. Regs. §§ 1.1297-3(b), (c).

optionholder is considered to own PFIC stock.⁶⁰ Accordingly, the U.S. optionholder generally would be (i) subject to the excess distribution rules if it disposed of the option, and (ii) unable to avoid application of the excess distribution rules even if it made a QEF election immediately upon exercise of the option, unless it also made a potentially costly deemed-sale election.⁶¹

We are not aware of any provision of the Code or any policy reason that should compel this result. We therefore propose that the holder of an option to purchase PFIC stock be permitted to make a QEF election with respect to any PFIC shares deemed to be owned by such person under the “option attribution” rule of Section 1298(a)(4). Such an electing optionholder will then be taxed currently on the PFIC’s ordinary earnings and net capital gain allocable to the PFIC shares deemed to be owned by such person under the “option attribution” rule. (The tax treatment of the actual owner of such PFIC shares will not be affected, however, by the optionholder’s QEF election.) We recognize that this approach may cause some (or potentially all) of the PFIC’s income to be taxed to more than one electing shareholder, but it is difficult to see why this should be objectionable to the Treasury Department.

Alternatively, we propose that an exercising optionholder be permitted to “reset” its holding period, thereby avoiding the “once a PFIC, always a PFIC” rule, by paying (with interest) the federal income tax that would have been imposed if it had made a QEF election with respect to the option for the first PFIC year.

⁶⁰ As noted below, whether Section 1298(a)(4) is self-executing is an open issue.

⁶¹ If the foreign corporation is also a CFC, the shareholder may make a deemed dividend election. The deemed dividend election may, however, be far more costly than the tax that would have been imposed if the shareholder had been permitted to make a QEF election for the option. In the latter case, QEF inclusions would have been required only for years in which the foreign corporation satisfied the income test or the asset test of Section 1297(a), and in such years the electing shareholder would have been eligible for long-term capital gains rates on its share of any net capital gains earned by the PFIC. By contrast, in the case of the deemed dividend election, the entire dividend (including the earnings accumulated in years in which the foreign corporation was not a PFIC under the income test or the asset test of Section 1297(a)) would be taxable, and none of the dividend would qualify for long-term capital gains rates.

B. Deemed QEF Election

We propose that regulations be issued deeming a shareholder to have made a valid QEF election with respect to a PFIC if the shareholder can demonstrate that (i) the PFIC has no earnings and profits for the taxable year; and (ii) the PFIC has not had earnings and profits for any prior taxable year included (in whole or in part) within the shareholder's holding period.⁶² Such deemed election would remain in effect until the first taxable year (if any) in which the foreign corporation is a PFIC and has earnings and profits. At that time, the shareholder would be permitted to decide whether or not to make a "real" QEF election for the PFIC.⁶³

The deemed QEF election would provide a significant measure of relief in many circumstances where a foreign corporation that conducts an active business is a PFIC during an initial start-up period (but where the start-up exception does not apply), and where the shareholder fails (*e.g.*, due to a lack of sophisticated tax advice) to make the QEF election.

We propose that the deemed QEF election also apply to optionholders. Indeed, as a matter of policy, we are not aware of any reason why PFIC optionholders should be treated more unfavorably than PFIC shareholders. Furthermore, even if it is determined (contrary to our suggestion above) that optionholders should not be permitted to make QEF elections in other circumstances, we believe that allowing them to qualify for deemed QEF elections in these circumstances, thereby avoiding unnecessarily punitive application of the excess distribution regime, is appropriate.

⁶² A similar proposal was made by the New York State Bar Association in 2001, and the NYSBA Report includes an extensive discussion of such proposal.

⁶³ Although a QEF election normally cannot be revoked without IRS consent, we do not believe that the Treasury Department is precluded from consenting in advance to the revocation of such deemed QEF election.

C. Requirements for a Retroactive QEF Election

In our experience, most taxpayers, and many tax advisors who do not specialize in cross-border matters, are largely if not entirely unaware of the PFIC rules. Accordingly, we believe that “PFIC problems” are often discovered long after it is too late to make a QEF election for the first PFIC year. In such circumstances, there are essentially only two means by which the taxpayer may potentially be able to avoid the excess distribution regime.

First, as indicated above, a shareholder that makes a QEF election after the first PFIC year may make a deemed sale election or, if the foreign corporation is also a CFC, a deemed dividend election in conjunction with the QEF election. The amount of deemed gain or deemed dividend income recognized as a result of such purging election, however, is subject to the excess distribution regime, and the total tax and interest charge may be quite onerous.

Second, as indicated above, the Treasury Regulations currently permit a retroactive QEF election to be made in certain circumstances. These circumstances, however, are extremely limited. As noted above, a retroactive QEF election is permitted only if the shareholder: (i) “reasonably believed” the foreign corporation to be a non-PFIC and filed a protective statement on its return for such year; (ii) has at all times owned (within the meaning of Section 958) less than 2% of the vote and value of each class of stock of the foreign corporation and relied on certain specified types of disclosure statements to the effect that the foreign corporation reasonably believed it was not (or would not be) a PFIC; or (iii) receives a “special consent” from the IRS, in the form of a private letter ruling, by reason of having reasonably relied on the advice of a QTP and satisfying certain other requirements. Thus, for example, a taxpayer that knew nothing about (and, consequently, never considered) the PFIC rules, and that failed to consult a QTP, would not qualify.

Furthermore, as noted above, in order to secure the above-described “special consent” to make a retroactive QEF election, all individuals having knowledge or information about the events that led to the failure to make the QEF election, including the QTP, would need to provide affidavits describing such events. Presumably, many QTPs will be reluctant to provide the affidavit that is necessary to secure IRS consent.⁶⁴

Accordingly, we propose that the regulations be amended to liberalize the circumstances in which retroactive QEF elections are permitted. At a minimum, it would be desirable to permit retroactive QEF elections in all circumstances in which the first PFIC year and all subsequent years are open (provided that the taxpayer states that it did not knowingly decide not to make a QEF election for any of such taxable years). In such circumstances, there would be no prejudice to the Government, provided that, as a condition of such retroactive election, the taxpayer is required to file amended returns reporting all of the income arising from the QEF election (and, if necessary, the taxpayer consents to such extension of the statute of limitations period for each such year as the IRS may deem appropriate).

We also recommend that similar relief be granted in circumstances in which the first PFIC year is closed. We recognize that closed years present certain practical difficulties, but the existing regulations already contain a mechanism for ensuring that the Treasury’s interests will be protected. Consistent with the rules of Treas. Regs. § 1.1295-3(f), which governs the “special consent” rules described above, an electing shareholder would need to request a private letter ruling from the IRS and, as a condition to the receipt of such ruling, would need to enter into a closing agreement with the IRS. Among other things, such closing agreement would require the

⁶⁴ Among other considerations, such individuals may be concerned about how such “confession” may be used against them in malpractice litigation if the IRS declines to consent.

shareholder to pay an amount sufficient to eliminate any prejudice to the Treasury as a consequence of the shareholder's inability to file amended returns for closed taxable years.⁶⁵

A technical issue would arise in such circumstances, because the QEF election technically could not apply to the first PFIC year if such year is closed. Therefore, we propose that, for purposes of the PFIC rules, an electing shareholder would be granted a new holding period for its PFIC stock, beginning on the first day of the first taxable year to which the QEF election applies. As a result of such "reset" holding period, the QEF election would be in effect for the taxpayer's entire holding period and the foreign corporation would therefore be treated as a pedigreed QEF as to such shareholder.

In making these suggestions, we are mindful of the statutory constraints of Section 1295(b)(2), which provides as follows:

When made.--An election under this subsection may be made for any taxable year at any time on or before the due date (determined without regard to extensions) for filing the return of the tax imposed by this chapter for such taxable year. To the extent provided in regulations, such an election may be made later than as required in the preceding sentence where the taxpayer fails to make a timely election because the taxpayer reasonably believed that the company was not a passive foreign investment company.

We recognize that the second sentence above may potentially be read as authorizing the Treasury Department to issue regulations permitting retroactive elections only in circumstances where the taxpayer actually considered the PFIC issue and formed a reasonable belief that the

⁶⁵ See Treas. Regs. § 1.1295-3(f)(3)(ii).

foreign corporation was not a PFIC. The existing regulations, however, make clear that the Treasury Department does not take such a restrictive view of its authority. We note, for example, that the special consent procedure for a shareholder that reasonably relied on a QTP may be available even if the QTP never even mentioned the PFIC issue to the shareholder (*e.g.*, because the QTP missed the issue). Therefore, our proposal should not raise any new issues of statutory authority under Section 1295(b)(2).

We also recognize that our proposal would allow taxpayers several years (or potentially an unlimited amount of time) to make the QEF election and that, as a general rule, taxpayers ought not be given too long to “wait and see” whether a given election would turn out to be desirable or undesirable. In our view, however, the PFIC context is unique in ways that justify an admittedly drastic departure from the usual timing restrictions. First, most taxpayers, and a great many tax advisors who do not specialize in cross-border matters, are not familiar with the PFIC rules. Second, many foreign corporations that conduct active business and are therefore not the intended targets of those rules will nevertheless be classified as PFICs at some point in their existence and, absent a purging election, will thereafter remain PFICs under the “once a PFIC, always a PFIC” rule. Third, the impact of the excess distribution regime is extremely harsh. Fourth, the IRS’s interest would generally be protected because the taxpayer would be required to pay tax and interest with respect to the QEF inclusions following the effective date of the retroactive election.

As a result of the foregoing considerations, there is a great potential for many taxpayers to be subjected to an extremely punitive regime in circumstances that are unlikely to have been intended. On the other hand, the potential abuse arising from a shareholder’s ability to defer making the QEF election, even for many years, is relatively small. Accordingly, we believe that

a fair weighing of taxpayer and government interests militates strongly in favor of allowing PFIC shareholders to escape the excess distribution regime by making retroactive QEF elections. To the extent that tax-avoidance is a concern, the grant of relief could, if desired, be conditioned in certain circumstances (*e.g.*, where closed years are involved) upon the IRS being satisfied that the failure to make the QEF election earlier was the result of the taxpayer's ignorance, and not, for example, a strategic decision to be taxed under the excess distribution regime or to "wait and see" whether a QEF election is favorable.

D. Financial Information Requirements for a Valid QEF Election

As explained above, a shareholder generally may not make a QEF election unless the PFIC provides an annual information statement that, among other things, contains certain financial information regarding the PFIC and, moreover, allows the shareholder to inspect and copy the PFIC's books and records. The Committee understands that, in a great many circumstances, foreign corporations are unwilling to make such an undertaking for the benefit of their U.S. investors. Thus, under current law, many PFIC shareholders are, as a practical matter, simply ineligible to make the QEF election.

We therefore propose that Treasury Regulations be issued to permit certain PFIC shareholders who are unable to obtain annual information statements to make QEF elections on the basis of certain financial information reasonably available to them. The QEF election on the basis of such alternative financial information would be available only to shareholders that, after taking into account appropriate attribution rules, own less than some threshold percentage (*e.g.*, 10%) of the total voting power of the PFIC. With respect to the type of financial information that should support a QEF election for such shareholders, we propose that an audited financial statement of the PFIC should qualify if such audited financial statement is (i) required to be

provided to the U.S. Securities and Exchange Commission, or (ii) used for purposes of providing reports to creditors, shareholders, or for any other substantial non-tax purpose.⁶⁶ (We recognize that such financial statements will likely be prepared based on U.S. (or international) generally accepted accounting principles, rather than U.S. federal income tax principles, but, in the absence of precise information regarding earnings computed under U.S. tax principles, the utilization of such available information seems the lesser harm.)

We believe that the Treasury Department has the authority to issue such regulations. Although Section 1293 specifies that a U.S. person who makes a QEF election with respect to a PFIC must include his pro rata share of the PFIC's "ordinary earnings" for the year as ordinary income and "net capital gain" of the PFIC for the year as long-term capital gain and defines such amounts based on earnings and profits generally computed in accordance with U.S. federal income tax principles, Section 1295(b) specifically authorizes the Treasury to prescribe rules relating to determining ordinary income and net capital gain of a QEF. Moreover, both Sections 1295(b) and 1298(f) allow the Treasury to promulgate regulations to carry out the purpose of the PFIC rules.

⁶⁶ This standard is similar to the definitions of "applicable financial statement" as set forth in (i) Section 965(c)(1) (with respect to the temporary 85% dividends received deduction provided by Section 965 for certain extraordinary earnings received by a U.S. shareholder from a CFC, subject to a limitation based in part on the amount shown on an "applicable financial statement" as earnings permanently reinvested outside the United States); (ii) Treas. Regs. § 1.475(a)-4(h) (with respect to the valuation safe harbor election of Treas. Regs. § 1.475(a)-4, which permits a dealer in securities or commodities to use certain values on an "applicable financial statement" for purposes of Section 475); and (iii) Rev. Proc. 2004-34, 2004-1 C.B. 991 (which permits a limited deferral for an accrual method taxpayer that reports certain "advance payments" for services on an "applicable financial statement" in a year following the year of receipt). *See also* former Section 56(f)(3)(A) and Treas. Regs. § 1.56-1(c) (prescribing a similar definition for purposes of an alternative minimum tax adjustment applicable under prior law to a corporation with "adjusted net book income" (as set forth on an "applicable financial statement") in excess of the taxpayer's alternative minimum taxable income, as otherwise determined).

V. Proposed Guidance Regarding PFIC Classification

A. The Treatment of Cash and Non-Depreciable Assets as Passive Assets and the Start-up Exception

Under Notice 88-22, which is still the principal Treasury pronouncement interpreting several significant rules under the PFIC regime, cash and other liquid assets are treated as passive assets for purposes of the income test and the asset test (the “liquid asset rule”) even if such cash or liquid assets used in the business constitute working capital. In addition, Notice 88-22 states that non-passive assets are limited to “*depreciable* property used in a trade or business.”

This interpretation of the terms “passive income” and “passive asset” causes many active foreign ventures, such as foreign start-ups, service companies (which typically have relatively small amounts of non-cash business assets) and companies that raise capital (either through equity or debt) for acquisitions, construction of long-term projects or further business expansion, to be treated as PFICs, unjustifiably subjecting the shareholders to the onerous PFIC rules.

Specifically, new foreign ventures are frequently formed as foreign entities that are treated as corporations for U.S. federal tax purposes. Many such ventures, such as foreign start-ups, construction projects and other capital intensive ventures, generate little, if any, operating gross income during their first few years of operations. This is especially true of high-tech and bio-tech companies, which normally devote several years to research and development efforts before a product or intellectual property capable of generating any revenue is developed. While it seems clear, as a policy matter, that these types of entities should not be PFICs, under Notice 88-22, almost every such company that generates any income on its available cash will be treated as a PFIC under the income test.

Limited relief is available under Section 1298(b)(2), which provides that:

a corporation shall not be treated as a passive foreign investment company for the *first taxable year* such corporation has *gross income* (. . . referred to as the “start-up year”) if (A) no predecessor of such corporation was a passive foreign investment company, (B) it is established to the satisfaction of the Secretary that such corporation will not be a passive foreign investment company for either of the 1st 2 taxable years following the start-up year, and (C) such corporation is not a passive foreign investment company for either of the 1st 2 taxable years following the start-up year. (Emphasis added).

The start-up year exception under Section 1298(b)(2) is, however, very narrow and applies only for the first taxable year (even if a short taxable year) during which the foreign corporation has any gross income. Consequently, the start-up year exception often fails to provide effective relief in the following common situations:

(i) A foreign entity is formed shortly before the end of the calendar year and hence has a short first taxable year;

(ii) A foreign entity qualifies as a PFIC under the asset test for its first taxable year but does not have any gross income for such year (for example, if its cash is held in a non-interest bearing checking account);⁶⁷ and

(iii) A foreign entity does not generate significant operating *gross income* for its first several years of operations, which would include almost every foreign start-up or other company engaged in a construction project or other long-term project.⁶⁸

⁶⁷ Technically, such an entity would not have any gross income for such first taxable year and, hence, might not qualify for the start-up exception as it applies only for the first taxable year during which the entity has any gross income.

⁶⁸ A related problem is faced by foreign operating companies that have either low gross margin or negative gross margin on their inventory sales. Because the income test is applied on a gross income basis, if such entities earn even a small amount of passive investment income they might be deemed PFICs, as their gross

Similarly, as a result of Notice 88-22's characterization of cash as a passive asset regardless of its actual or intended use, foreign operating companies that raise cash, either as equity or debt, are often treated as PFICs under the asset test if they raise a significant amount of cash, relative to their other business assets, and do not use the cash quickly enough. Furthermore, this rule is particularly harsh in situations where the PFIC is also a non-public CFC, because in such cases the asset test is applied based on the adjusted tax bases of the company's assets, thereby preventing the inclusion of the value of the corporation's goodwill and going concern value in the asset test, because such assets generally have no tax basis.

We believe that the Treasury can to a great extent resolve the problems set forth above by issuing guidance treating cash and other investment assets held by a foreign corporation as working capital or for the other "reasonable needs" of the corporation's active business as non-passive assets, as discussed below.

We therefore reiterate the request made in the NYSBA Report approximately eight years ago that Treasury utilize its regulatory authority to revise the liquid asset rule set forth in Notice 88-22 to provide that:

(a) Cash and other liquid assets held for the "reasonable needs" of an active business or for the development and subsequent carrying on of an active business are not treated as passive assets for purposes of the asset test, and that earnings on such assets will not be treated as passive income for purposes of the income test; and

(b) Land and other non-depreciable assets that are used in a trade or business (*e.g.*, by a real estate developer) are treated as non-passive assets for purposes of the asset test, and that earnings on such assets are not treated as passive income for purposes of the income test.

income from sales of inventory (defined as revenue minus cost of goods sold) might be insufficient to avoid satisfying the income test (*i.e.*, might be less than 25% of the overall gross income of the company). *Cf.* Priv. Ltr. Rul. 9447016 (Aug. 19, 1994).

The “reasonable needs” of an active business, in and of itself, is not a clear test. The Treasury should therefore also specify (i) which types of business objectives are deemed to be within the scope of the reasonable needs of an “active business,” and (ii) how to quantify the amount of cash and liquid assets reasonably held for such qualified business objectives.

In this regard, it was proposed that the Treasury utilize, subject to certain modifications, the principles developed under the accumulated earnings tax rules of Sections 531 to 537 and the Treasury Regulations thereunder.⁶⁹ We agree that such principles can be used to determine the general scope of such term. Nevertheless, we recognize, as evidenced by the many cases decided under the accumulated earning tax rules, that it is difficult to promulgate general principles that clearly identify the boundaries of the “reasonable needs” of a business. We further recognize that the rules under the accumulated earning tax regime are complex and unclear in several respects. Accordingly, in view of the significant and onerous tax consequences of the PFIC rules, and, hence, of the status of a foreign entity as a PFIC, we suggest that Treasury provide several objective and simple “safe harbors” for such test, in order to provide clarity and certainty to taxpayers. For example, such safe harbors might provide that:

(I) For purposes of the asset test, cash and liquid assets will be deemed non-passive to the extent of a specified percentage of the actual expenses of the foreign entity during the current taxable year and/or one or more preceding (or subsequent) taxable years;

(II) For purposes of the asset test, cash and liquid assets will be deemed non-passive to the extent of the foreign company’s actual investments during the current year and/or a subsequent taxable year in property used or held for use in the foreign company’s active business;

⁶⁹ See NYSBA Report, at 26-41.

(III) For purposes of the asset test, cash and liquid assets will be deemed non-passive to the extent of a percentage of the company's gross income, revenue or other business assets over a testing period;⁷⁰

(IV) For purposes of the asset test, the proceeds of newly-raised capital or debt by a public or private company, and investments of such proceeds, will not be treated as passive assets for a specified period of time;⁷¹ and/or

(V) For purposes of the income test, to the extent any asset is deemed non-passive pursuant to any of the safe harbors set forth above, earnings with respect to such asset (properly apportioned to the extent that only a portion of such asset is deemed non-passive) will be deemed non-passive.

From an administrative perspective, we further believe that it would be advisable to develop a simple IRS form to be signed by an officer of a foreign company to confirm the foreign company's non-PFIC status, on which U.S. shareholders of the PFIC could rely, absent actual knowledge that the form is incorrect.⁷²

Finally, we wish to emphasize that we do not believe that the theoretical ability of U.S. taxpayers to make a QEF election and thereby avoid the PFIC excess distribution regime, at the expense of current inclusion of the PFIC's earning, is an appropriate or sufficient response to the overbroad reach of the liquid asset rule. Specifically, in order to make the QEF election the U.S.

⁷⁰ See, e.g., Treas. Regs. § 1.897-1(f)(3)(i), which, for purposes of determining whether a domestic corporation is treated as a "U.S. real property holding corporation", provides a safe harbor allowing a presumption that liquid assets are held for use in a trade or business in an amount up to 5% of the fair market value of other trade or business assets of the corporation.

⁷¹ See, e.g., the exception provided for "qualified temporary investment income" under Section 856(c)(5)(D) in the context of the definition of "real estate investment trust".

⁷² A certification by a company of its status for U.S. tax purposes has been employed in other contexts of the Code. For example, a U.S. corporation may certify that it is not a "U.S. real property holding corporation" for purposes of Sections 897 and 1445. A foreign seller and a buyer of interests in such company may then rely on such certification to avoid the Foreign Investment in Real Property Tax Act withholding rules, absent knowledge to the contrary. See Treas. Regs. §§ 1.1445-2(c)(3); 1.897-2(h).

taxpayer is required to annually obtain from the PFIC extensive information regarding the earnings and profits of the PFIC.⁷³ As discussed above, in many instances, particularly when the U.S. taxpayer is a minority shareholder or does not own the interest in the PFIC directly, it is impossible for the U.S. taxpayer to obtain the information necessary to make a QEF election. Furthermore, in many instances, especially when active foreign companies are involved, the U.S. taxpayer is unaware of the PFIC status of the foreign entity in which it owns a direct or indirect interest, and, hence, fails to make the QEF election. In such instances, the liquid asset rule will unjustifiably subject the U.S. taxpayer to the PFIC rules.

B. Guidance Regarding the Application of the Look-Through Rules with Respect to Partnerships and 25% Owned Subsidiaries

For purposes of determining whether a foreign corporation qualifies as a PFIC for any taxable year three look-through rules apply:

(i) The “subsidiary look-through rule” under Section 1297(c), which provides that assets and income of a directly or indirectly 25% or more owned lower-tier subsidiary (a “25% subsidiary”) are treated as owned by the foreign corporation being tested for PFIC status;

(ii) The “related person look-through rule” under Section 1297(b)(2)(C), which provides that dividends, interest, rents, and royalties received by a foreign corporation from a “related person”, as defined in Section 954(d)(3), and the assets generating such payments, are treated as non-passive to the extent such amounts are properly allocable to income of such related person that is not passive income; and

(iii) The “domestic subsidiary look-through rule” under Section 1298(b)(7), which provides that if (a) a foreign corporation is subject to the accumulated earnings tax imposed by Section 531 (or waives any benefit under any treaty which would otherwise prevent the

⁷³ See Treas. Regs. § 1.1295-1(g).

imposition of such tax), and (b) such foreign corporation owns at least 25% (by value) of the stock of a domestic corporation, then for purposes of determining whether such foreign corporation is a PFIC, any “qualified stock” held by such domestic corporation is treated as a non-passive asset and any amount included in gross income with respect to such stock is treated as non-passive income.⁷⁴

These look-through rules, however, leave several questions unanswered.

First, while it seems reasonably clear that the stock of a 25% subsidiary, and dividends thereon, should be disregarded in applying the asset test and income test to the parent corporation, it is less clear how to treat other assets and income resulting from transactions between such entities. For example, the treatment of a loan, a lease, or a license from the subsidiary to the parent corporation or *vice versa* and the treatment of income earned in respect of any such transaction are unclear. Similarly, it is unclear how other types of intra-group transactions and payments, such as intercompany sales of inventory, management fees and cost-sharing payments, are to be treated when the subsidiary look-through rule applies.

We believe that the Treasury should clarify in regulations that, whenever the subsidiary look-through rule applies:

(i) The stock of a direct or indirect 25% subsidiary and dividends thereon are disregarded for purposes of the asset and income tests (and the proportionate shares of the underlying assets and income of the subsidiary are taken into account in the owner’s asset and income calculations),⁷⁵

⁷⁴ For purposes of the domestic subsidiary look-through rule, the term “qualified stock” means any stock in a C corporation which is a domestic corporation and which is not a regulated investment company or real estate investment trust. *See* Section 1298(b)(7)(B).

⁷⁵ This approach was expressed in the Blue Book, *supra* note 3, at 1025, and in the Technical and Miscellaneous Revenue Act of 1988 House Report. *See* H.R. Rep. No. 100-795, at 268 (1988). *See also*

(ii) Similar treatment may be appropriate for loans made by an owner to its 25% subsidiary, to reflect the applicable legislative history.⁷⁶ Under that approach, for purposes of the asset and income tests, the loan presumably would be treated in the same manner as limited dividend preferred stock, to which it is analogous. We note, however, that if we were writing on a clean slate, we might tend to treat a loan in the manner described in clause (iii) below, on the theory that a distinction between debt and equity investment is appropriate and the proportion of look-through treatment should not exceed the percent of equity ownership.

(iii) Any other parent-subsidary transactions (or transactions between 25% subsidiaries of the foreign corporation) are disregarded for purposes of such tests to the extent of the parent's direct or indirect ownership in the applicable subsidiary,⁷⁷ and to the remaining

Rev. Rul. 87-90, 1987-2 C.B. 216 (confirming that the stock of the subsidiary is eliminated in applying the asset test to the parent). Basis adjustments might be considered to account for undistributed income.

⁷⁶ The legislative history (which does not distinguish between wholly-owned and at least 25%-owned subsidiaries) states that this approach should also apply to debt investments (and interest thereon) in a direct or indirect 25% subsidiary. *See* Blue Book, *supra* note 3, at 1025 (“Under this look-through rule, amounts such as interest and dividends received from foreign or domestic subsidiaries are to be eliminated from the recipient’s income in applying the Act’s income test and the shareholder’s stock investment is to be eliminated from its assets in applying the Act’s asset test. For example, a foreign holding company that receives dividends or interest from a subsidiary is not treated as receiving passive income unless the subsidiary derives passive income. A corporation is a “subsidiary” of an upper-tier corporation for these purposes if at least 25 percent of the value of the corporation’s stock is owned by the upper-tier corporation.”); H.R. Rep. No. 100-795, at 268 (1988) (addressing the subsidiary look-through rule under “Present Law” and stating that “amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder’s income in applying the income test and the stock or debt investment is eliminated from the shareholder’s assets in applying the asset test.”)

The effect of these statements is that a loan by an owner to its 25% (or greater) subsidiary is eliminated in full from the asset test and the interest is eliminated in full from the income test. Rationales for this treatment could include the following: (i) for the purpose of testing whether an entity is sufficiently active to avoid PFIC status, a non-portfolio threshold of 25% was considered to represent investment and control of sufficient magnitude to look through to the subsidiary’s assets and income for any loan, (ii) the commercial significance of whether amounts are advanced as debt or as preferred equity to an entity in which there is substantial ownership can be too thin to warrant a “cliff” distinction for PFIC testing purposes, (iii) unlike for purposes of determining income inclusions (as in the context of Subpart F, including Section 954(b)(5)), whether the payments on an instrument are deductible by the subsidiary or not should not be of significance for testing PFIC status, and (iv) substantial complexity is avoided in many normal commercial situations by reducing the need to apply the “related person look-through rule”.

⁷⁷ For example, if a lease is extended by a wholly-owned subsidiary of the foreign corporation to a 50% owned subsidiary of such foreign corporation, only 50% of the lease should be disregarded for purposes of the asset test and the income test.

extent are analyzed under the general rules (subject to the related person exception, if applicable), and

(iv) Any gain recognized upon the disposition of an equity interest in a 25% subsidiary is characterized by reference to a deemed sale of the assets of the 25% subsidiary (*i.e.*, the character, but not the amount, of such gain is determined by reference to the character of the gains that would have been realized by the 25% subsidiary if it had disposed of the assets attributed to such equity interest in a taxable transaction).⁷⁸

Second, (a) the treatment of income earned by a foreign corporation through a partnership, (b) the characterization of an interest in a partnership for purposes of the asset test, (c) the characterization of gain on the sale of partnership interests, and (d) the characterization of transactions between the foreign corporation (or a look-through subsidiary thereof) and such partnership are unclear.

⁷⁸ In this regard, the following should be noted:

(i) For purposes of the income test under the PFIC rules, the *amount* of gain recognized by the foreign corporation upon the sale of shares of a 25% subsidiary in theory should be adjusted to reflect prior inclusions by the foreign corporation of the 25% subsidiary's income for purposes of the income test (and reverse adjustments should be made to reflect distributions from the 25% subsidiary). This can be achieved by adopting rules similar to the basis adjustment rules under Treas. Regs. § 1.1502-32. See Christopher Ocasal and Charles S. Markham, *The PFIC Look-Through Rules: A New Level of Thinking*, 35 Tax Mgm't Int'l J. 59 (2006).

(ii) We recognize that in many cases there would be a discrepancy between the PFIC's "outside" basis in the shares of the 25% subsidiary and such subsidiary's "inside" basis in its assets. In such situations, unless principles similar to those promulgated under Sections 704(c) and 754 and the Treasury Regulations thereunder are employed for purposes of the income and asset tests, mechanical inclusion of a proportionate share of the 25% subsidiary's income and assets under the "subsidiary look-through rule" of Section 1297(c) might lead to distorted results. Such a disparity might similarly result in mischaracterization of gain realized upon a sale by a foreign corporation of shares of a 25% subsidiary. We nevertheless believe that for purposes of the income test, for the sake of simplicity, the character (but not the amount) of gain realized by a foreign corporation upon a sale of shares of a 25% subsidiary should be determined by reference to a deemed sale of the subsidiary's assets. Cf. Priv. Ltr. Rul. 200604020 (Jan. 27, 2006); Priv. Ltr. Rul. 200015028 (Jan. 12, 2000).

We believe that the Treasury should make the following clarifications under regulations regarding the treatment of a directly or indirectly owned partnership for purposes of the income test and the asset test:

(a) For purposes of the income test, income earned by a foreign corporation through a partnership (either directly or indirectly through a look-through subsidiary) should be characterized as passive or non-passive based on rules similar to those applied for purposes of determining whether the income is “subpart F income” under the CFC rules (*i.e.*, as if the income were earned directly by the foreign corporation).⁷⁹

(b) For purposes of the income test, gain on the sale of an interest in a partnership in which a foreign corporation owns, directly or indirectly, a 25% or greater interest (a “25% owned partnership”) should be classified as passive or non-passive by reference to a deemed sale of the partnership’s assets, proportionally; this rule would apply regardless of whether the foreign corporation is a CFC.⁸⁰ (In situations where the partnership agreement provides for special allocations of items of income, the gain should be characterized based on the characterization of the partnership’s assets giving rise to the income specially allocated to the applicable partnership interest.)

(c) For purposes of the asset test, an interest in a 25% owned partnership should be governed by rules similar to those applicable to an interest in a 25% subsidiary (*i.e.*, look through rules based on the aggregate approach). Any other interest in a partnership should be classified based proportionally on either the character of the income (passive or non-passive) earned by the

⁷⁹ See Treas. Regs. § 1.952-1(g); *see also* Treas. Regs. § 1.954-2(a)(5).

⁸⁰ Currently, for purposes of determining “foreign personal holding company income,” gain realized upon the disposition of a partnership interest is explicitly classified as passive under Section 954(c)(1)(B). Section 954(c)(4) provides, however, that in the case of a CFC that owns, directly, indirectly or constructively, a 25% or greater interest in a partnership’s capital or profits, a CFC’s sale of a partnership interest is treated as a sale of the CFC’s proportionate shares of the partnership’s underlying assets.

foreign corporation through the partnership as described above, or the character of the partnership's assets generating such income. In this regard, it should further be clarified that, for purposes of the asset test, the value of the interest in the partnership, rather than of the partnership's assets allocable to such interest, should be taken into account.

(d) Transactions between a foreign corporation (or attributed to it from a lower-tier look-through subsidiary) and a 25% owned partnership should be disregarded to the extent of the foreign corporation's direct or indirect interest in the partnership, and to the remaining extent should be analyzed under the general rules (subject to the related person exception, if applicable).

VI. Proposed Guidance Regarding the Stock Attribution Rules

A. The Treatment of PFIC Shares Held Through a Foreign Trust

1. Background

When applying the U.S. federal income tax rules in the case of a foreign nongrantor trust that has U.S. beneficiaries and owns the stock of a PFIC, two anti-deferral regimes must be considered: the PFIC rules and the Subchapter J rules. In general, both the PFIC rules and the Subchapter J rules are designed to prevent U.S. taxpayers from using foreign holding entities, *i.e.*, foreign corporations or foreign trusts, to defer the recognition of income. Thus, the PFIC rules impose a tax and interest charge on excess distributions received by a U.S. person in respect of PFIC stock. Similarly, the Subchapter J rules provide that a distribution of accumulated income to a U.S. beneficiary of a foreign nongrantor trust, determined based on UNI of the trust, is both taxable under the "throwback rules" and subject to an interest charge.⁸¹

⁸¹ In general, under the Subchapter J rules applicable to foreign trusts, each beneficiary is allocated that portion of the trust's DNI for the taxable year which is equal to the amount of income required to be distributed to him or her. *See* Sections 661 and 662. Amounts that are allocated from the foreign trust's DNI to a beneficiary have the same character in the hands of the beneficiary as they had in the hands of the

Neither the PFIC rules nor the Subchapter J rules coordinate the application of the two regimes in the case of a disposition of the stock of a PFIC by, or a distribution by a PFIC to, a foreign nongrantor trust with U.S. beneficiaries. Although the Treasury was granted authority under Section 1298(b)(5) to issue such rules in regulations, it has not exercised this authority. Proposed regulations under Section 1291 have expressly reserved this issue.⁸² The preamble to the 1992 proposed regulations (the “Preamble”) provides that:

Other than the guidance provided in Treas. Regs. § 1.1291-2(f)(6) (adjustments for trusts permitted to take the Section 642(c) deduction) and Treas. Regs. § 1.1291-6(d)(3) (Section 643(e)(3) election), the regulations do not provide explicit rules for determining the tax consequences to a trust or estate (or a beneficiary thereof) that directly or indirectly owns stock of a Section 1291 fund. Until such rules are issued, the shareholder must apply the PFIC rules and subchapter J in a reasonable manner that triggers or preserves the interest charge.⁸³

More recently, in TAM 200733024,⁸⁴ the IRS considered the application of Section 1298(b)(5) in the case of a foreign nongrantor trust that had both U.S. and foreign beneficiaries and held PFIC stock. Under the facts of the TAM, the foreign trust owned the PFIC stock for nine years. In year 9, the foreign trust liquidated the PFIC and distributed half of its assets to the

trust. *See* Section 662(b). In addition, a U.S. beneficiary of a foreign trust generally must also include in his or her gross income the amount of any distribution made by the trust out of UNI accumulated during prior taxable years. *See* Sections 666 and 667. Except to the extent of tax-exempt income, Section 667(a) provides that the character rule of Section 662(b) does not apply to distributions of UNI, which are taxable as ordinary income. In addition, a U.S. beneficiary receiving a distribution of UNI is generally subject to an interest charge computed over the period between the year in which the UNI was earned by the trust and the year of the distribution. *See* Section 668.

⁸² *See* Prop. Treas. Regs. § 1.1291-3(e)(5)(ii) in respect of indirect dispositions of PFIC stock and Prop. Treas. Regs. § 1.1291-2(f)(2)(ii) in respect of indirect distributions by a PFIC.

⁸³ *See* 1992-1 C.B. 1124, 1126.

⁸⁴ Tech. Adv. Mem. 200733024 (Aug. 17, 2007).

foreign beneficiaries. In year 10, the foreign trust distributed the rest of its assets to a U.S. trust, which was created for the benefit of the U.S. beneficiaries of the foreign trust. On these facts, the IRS determined that, under Sections 1298(a)(3) and 1298(b)(5), the U.S. beneficiaries of the foreign trust were treated as receiving an “excess distribution” from the PFIC when it commenced a liquidating distribution in year 9. Applying a facts and circumstances test similar to that used under subpart F, the IRS held that the U.S. beneficiaries of the foreign trust should be treated as receiving as an excess distribution 50% of the gain from the liquidating distribution from the PFIC to the foreign trust.

Various issues regarding the intersection of the PFIC rules with Subchapter J are raised by the Preamble and TAM 200733024, which constitute the only published pronouncements of the IRS in this regard. In analyzing the application of the PFIC regime to the case of PFIC stock owned by a foreign nongrantor trust with U.S. beneficiaries, two issues must be addressed. First, who should be treated as the owner of the PFIC stock under Section 1298(a)(3)? Second, what taxing rules should apply in determining the allocation of PFIC income among the beneficiaries of the foreign trust? Before discussing these issues, a summary of the application of the PFIC rules to a domestic trust that owns PFIC stock is set forth below as background.

2. Domestic Trusts

In general, the PFIC rules work relatively well in the case of a domestic trust that owns PFIC stock.

In the case of a simple trust, which is required to distribute to its beneficiaries all the trust accounting income it recognizes on an annual basis, the beneficiaries of the trust would be subject to the PFIC excess distribution tax. On the other hand, in the case of a complex trust, to the extent it does not distribute the total amount of an excess distribution, the PFIC rules apply at

the trust level rather than at the beneficiary level. There are, however, a number of technical issues that should be addressed in regulations.

For example, a trust distributing its income generally is entitled to deductions for amounts distributed under Sections 651 and 661 to the extent of the trust's DNI. The amount of an excess distribution received by the trust that is allocated to prior tax years, technically, is *not* included in the DNI. As a result, the trust cannot use the deduction attributable to amounts of distributed income to offset the amount of an excess distribution allocated to prior years. The proper solution to this problem is for the Treasury to promulgate PFIC regulations which adopt a pass-through approach in the case of a domestic trust that distributes the amount of an excess distribution in the year it receives such amount. Pursuant to such a rule, the U.S. beneficiary would be treated as receiving the excess distribution directly, and the trust would not be subject to the PFIC rules at the trust level.

3. Foreign Trusts

a. Ownership Attribution of PFIC Stock Owned by a Foreign Trust

Section 1298(a)(3) provides that “[s]tock owned, directly or indirectly, by or for a ... trust shall be considered as being owned proportionately by its ... beneficiaries.”⁸⁵ There is no regulation that defines the term “proportionately.” Reiterating the above-cited language of the Code, Prop. Treas. Regs. § 1.1291-1(b)(8)(iii)(C) provides only that “[i]f a ... trust ... directly or

⁸⁵ The PFIC legislative history provides as follows with respect to the ownership attribution rules that apply in the case of PFIC stock owned by a trust:

In attributing stock owned by a trust, it is intended that the general rules of subchapter J apply. That is, in the case of a grantor trust, any stock owned by the trust generally shall be attributed to the grantor of the trust, and any stock owned by a trust which is not a grantor trust shall be attributed to the beneficiaries of the trust.

See Blue Book, *supra* note 3, at 1032.

Therefore, in the case of a grantor trust, the grantor will be treated as the owner of the PFIC stock held by the trust and will be taxed on any excess distribution with respect to such stock.

indirectly owns stock, the beneficiaries of such ... trust will be considered to own a proportionate amount of such stock.” With respect to ownership issues, the Preamble to the proposed regulations states only that:⁸⁶

Comment is solicited whether different attribution rules, such as the indirect ownership rules in §25.2701-6 (relating to special valuation rules for purposes of estate and gift taxes), should be adopted for purposes of determining whether a beneficiary of a trust or estate is an indirect shareholder of a PFIC.

In addition to the methods for determining ownership contemplated by the Preamble, Prop. Treas. Regs. § 1.1291-1(b)(8)(i) provides that “the determination of a person’s indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership is controlling, taking into account the purpose of Section 1291. *Cf.* § 1.958-1(c)(2).”

We note that the Blue Book contains the following explanation of the purpose of the PFIC rules and the way they are to be interpreted:⁸⁷

Congress recognized that current taxation of U.S. investors in passive foreign investment companies could create difficulties for certain investors in cases where the U.S. investors did not have the ability to obtain relevant information relating to their share of the funds’ earnings and profits, did not have enough control to compel dividend distributions, or did not have sufficient liquidity to meet a current tax liability before actual income was realized from their investment.

⁸⁶ See 1992-1 C.B. 1124, 1125.

⁸⁷ Blue Book, *supra* note 3, at 1023.

The Code and Treasury Regulations contain three alternative sets of rules that can be considered as models for Treasury Regulations to be promulgated for purposes of attributing the ownership of PFIC stock held by a foreign trust to its beneficiaries: (i) the rules under Section 2701 (noted in the Preamble), (ii) a “facts and circumstances” test similar to the ownership attribution rules under Section 958 (under the proposed regulations and TAM 200733024), or (iii) the principles of Subchapter J (under the Blue Book).⁸⁸

The first ownership rule under Treas. Regs. § 25.2701-6 provides that the interest of a beneficiary of a trust will be determined as if the trustee exercised the maximum possible discretion under the trust instrument in favor of a particular beneficiary. This regulation was promulgated under Section 2701, which was designed to curb abusive intra-family transfers of interests in the estate freeze context. However, Treas. Regs. § 25.2701-1(b)(2)(i)(C) provides that Treas. Regs. § 25.2701-6 does not apply unless the beneficiary is the grantor of the trust or has sufficient power over the trust corpus to cause the inclusion of the trust corpus in his estate. Therefore, it is not appropriate to apply this rule broadly for purposes of attributing ownership of PFIC stock, because it may treat a discretionary beneficiary of a trust as owning PFIC stock even though he or she never has received a distribution from the trust and it is not expected that he or she will do so in the future.

The second ownership attribution rule under Treas. Regs. § 1.958-1(c)(2) provides that the determination of a person’s proportionate interest in a foreign corporation will be made on the basis of all the “facts and circumstances” in each case.⁸⁹ If the rules of Section 958(a) are

⁸⁸ Section 318 and Treas. Regs. § 20.2031-7 set forth a fourth possible ownership attribution rule, based on the actuarial interest of a beneficiary.

⁸⁹ The IRS also applied a facts and circumstances test in Priv. Ltr. Rul. 9024076 (Mar. 21, 1990) in the case of a discretionary trust which owned the shares of a foreign personal holding company. In Priv. Ltr. Rul. 9024076 the IRS relied on a pattern of distributions made by the trust over a number of years in attributing stock ownership to the beneficiaries of the trust.

applied to determine the amount of stock owned for purposes of Section 951(a) (the income inclusion rule of subpart F), a person's proportionate interest in the foreign corporation generally will be determined by reference to such person's interest in the income of such corporation.⁹⁰

However, due to fundamental differences between the PFIC regime and the CFC regime, we believe that the application of the ownership attribution rule of Section 958 is not appropriate in determining the ownership of PFIC stock for the reasons set forth below. First, the CFC rules apply only in the case of a foreign corporation which is controlled by U.S. shareholders and then only to U.S. shareholders that own, or are deemed to own, a 10% or greater voting interest in the CFC. The PFIC rules, by contrast, contain neither a control requirement nor a requirement of any minimal level of stock ownership by the U.S. shareholder.

Second, the U.S. shareholders of a CFC must include in their gross income amounts equal to the CFC's subpart F income on an annual basis. On the other hand, the PFIC regime is generally triggered only if the U.S. shareholders receive (or are deemed to receive) cash in the case of an excess distribution, which may occur years after the acquisition of the PFIC stock.⁹¹ These two elements of the CFC rules, *i.e.* the control and annual income inclusion, which are not present in the PFIC context, support the conclusion that different rules should apply to attribute

⁹⁰ The regulation under Section 958 contains an example that deals with a foreign trust created for the benefit of 3 U.S. individuals. *See* Treas. Regs. § 1.958-1(d)(2), Ex. 3. The Example provides that under the trust instrument (i) the trust income is required to be divided into 3 equal shares, (ii) each beneficiary's share of the income may either be accumulated for him or distributed to him in the trustee's discretion, and (iii) the trust is to terminate in 1970 (within 4 years after the Regulation was promulgated in 1966) when each beneficiary was entitled to receive the accumulated income applicable to his share and one-third of the corpus. Based on these facts, the Example concludes that, for purposes of subpart F, each beneficiary is treated as the owner of one-third of the shares of stock owned by the trust. Example 3 reaches this result in a limited fact pattern, in which each beneficiary had a fixed one-third interest in both the trust income and corpus and was entitled to receive such one-third share of income and corpus within a 4-year time period. Moreover, the trustee would abuse his discretion under the trust instrument if he failed to distribute to each beneficiary such beneficiary's share of the trust income and corpus. Therefore, the facts and circumstances in Example 3 present a very simple and limited case, which should not be used to support a general rule in the context of PFICs.

⁹¹ Different rules would apply where the U.S. shareholders made a QEF election. However, very often the U.S. beneficiaries of a foreign trust would not have the information required to make such an election.

ownership of PFIC stock. Specifically, because the U.S. beneficiaries of a foreign trust do not have control over PFIC stock and because the PFIC regime is triggered only upon the actual receipt of cash, it is not appropriate to apply the test under the Section 958 regulations in the year the excess distribution is received by the trust.

Third, the “facts and circumstances” relating to the interests of the U.S. beneficiaries in the trust may change between the day the excess distribution is received by the trust and the day the trust will make a distribution to its beneficiaries. For example, assume that a foreign nongrantor trust with two U.S. beneficiaries owns the stock of a PFIC. The foreign trust receives an excess distribution in year 2 with respect to its PFIC stock. In year 3, a new beneficiary is added to the trust. In year 4, the entire amount of excess distribution is distributed to the new beneficiary. Tax policy reasons support treating the new beneficiary as the owner of the PFIC stock held by the foreign trust. The issue becomes more complicated in the case of a discretionary trust, where it is unclear what interest each beneficiary has in the trust.

Finally, imposing current taxation on U.S. beneficiaries of a nongrantor foreign trust seems particularly inappropriate for two reasons. First, in contrast with the superficially similar situation of U.S. investors in a foreign partnership, U.S. beneficiaries of a foreign trust typically are “innocent bystanders” who did not choose to make an investment that could have highly undesirable tax consequences, who do not have control over the trust or its investments and who do not have control over when and if any of the trust’s assets will be distributed to them. Second, a nongrantor foreign trust with U.S. beneficiaries would generally have a foreign settlor,⁹² and, hence, the likelihood of the foreign trust having been intended as a device for avoiding the PFIC rules is generally likely to be relatively low.

⁹² Pursuant to Section 679, a foreign trust with a U.S. settlor and U.S. beneficiaries would typically be treated as a grantor trust.

Due to the problems with the approaches discussed above, we support the application of Subchapter J principles in determining indirect ownership of PFIC stock held by a foreign nongrantor trust. Under the principles of Subchapter J, in any particular year, only those beneficiaries who actually receive trust distributions should be deemed to own the PFIC stock giving rise to the excess distribution, and only those beneficiaries should be responsible for the interest charge on that year's excess distribution, to the extent of the trust distributions they each receive. This rule would require the tracing of excess distributions made by the PFIC to the foreign trust to the distributions made by the trust to its beneficiaries in the manner described in subsection I.A.3.b below. As further explained below, however, we believe that this rule would further the purposes of the PFIC rules and is consistent with the principles of Subchapter J. Moreover, this rule has been proposed by several commentators who have considered this issue, as noted below.

b. Allocation of Excess Distributions to U.S. Beneficiaries of a Foreign Trust

The indirect disposition and indirect distribution rules, which apply when a U.S. person is treated as owning the stock of a PFIC by reason of the ownership attribution rules of Section 1298(a), provide as follows:⁹³

Under regulations, in any case in which a United States person is treated as owning stock in a PFIC by reason of subsection (a) [the stock attribution rules]–

- (i) any disposition by the United States person or the person owning such stock which results in the United States person being treated as no longer owning such stock, or

⁹³ See Section 1298(b)(5).

(ii) any distribution of property in respect of such stock to the person holding such stock, shall be treated as a disposition by, or distribution to, the United States person with respect to the stock in the passive foreign investment company.

As a preliminary matter, there is a question as to whether the provisions of Section 1298(b)(5) are operative in the absence of regulations, particularly with respect to the case of a discretionary beneficiary of a foreign trust, where the application of the statute is not clear.⁹⁴ We recommend that the Treasury Department issue appropriate regulations to resolve the issue on a going-forward basis.

We propose that an excess distribution received by a foreign nongrantor trust not be taxed to the U.S. beneficiaries to the extent it was accumulated within the foreign trust. The excess distribution would become part of the foreign trust's DNI for the year. It would be taxed to the U.S. beneficiaries only when it is distributed to them. A distribution out of UNI loses its character as PFIC income under Section 667(a).⁹⁵ However, Treasury Regulations under the PFIC rules could in effect change this result on a going-forward basis by providing that a distribution out of UNI attributable to excess distributions retains its character as an excess

⁹⁴ The phrase "under regulations" arguably means that the provision is not self-operative, and does not apply prior to the promulgation of regulations. See, e.g., *Conn. Gen. Life Ins. Co. v. Comm'r*, 109 T.C. 100, 110-111 (1997), *aff'd*, 177 F.3d 136 (3d Cir. 1999), *cert. denied*, 528 U.S. 1003 (1999). Courts have held, however, that statutory provisions that include the phrase "under regulations" are not dependent on the issuance of regulations where the plain language of the statute is clear or where the statute includes a taxpayer-favorable provision. See, e.g., *Pittway Corp. v. U.S.*, 102 F.3d 932 (7th Cir. 1996) (holding that Section 4662(b)(1) could be applied in the absence of regulations because the plain meaning of what the statute intended is clear); *Francisco v. Comm'r*, 119 T.C. 317 (2002), *aff'd*, 370 F.3d 1228 (D.C. Cir. 2004) (holding that the legislative history of Section 931, which provides a taxpayer favorable exclusion, would take effect independently of the issuance of regulations); *Int'l Multifoods Corp. v. Comm'r*, 108 T.C. 579 (1997) (holding that the IRS could not deny taxpayers the benefits of Section 865(j)(1) by failing to adopt regulations).

⁹⁵ See *supra* note 81.

distribution. In addition, it also would be necessary to coordinate the application of the PFIC interest charge with the Section 668 interest charge, to prevent double taxation of the same income and to coordinate the imposition of the interest charge.⁹⁶

Several commentators have agreed with the conclusion that, in the absence of Treasury Regulations that require a different result, it is reasonable to allocate PFIC gain in accordance with the income characterization rules applicable to distributions under Subchapter J of the Code.⁹⁷

Consistent with our proposed ownership attribution rules that would treat a U.S. beneficiary of a foreign trust as owning the PFIC stock only to the extent that the trust distributes to such beneficiary any excess distribution the trust receives from the PFIC, we recommend that a beneficiary of a foreign nongrantor trust be taxed only in the year in which he receives any excess distribution from the trust, and only to the extent of the lesser of (i) such amount received or (ii) the trust's applicable DNI or UNI in the year of receipt.

We have considered the argument that the application of the Subchapter J rules may lead to abuse. For example, a trustee might be given discretion under the trust instrument to elect to make distributions solely to foreign beneficiaries in the years in which amounts subject to PFIC

⁹⁶ Such a coordination rule might provide, for example, that the PFIC interest charge will apply from the date the foreign trust acquired the PFIC stock until the date of the excess distribution, and the interest charge under "throwback rules" of Section 668 will apply from the date of the excess distribution until the date the amount of the excess distribution is distributed to the beneficiary. See Michael J. Miller, *Anti-Deferral and Anti-Tax Avoidance: IRS Addresses Disposition of PFIC Shares by a Foreign Trust with U.S. Beneficiaries*, 34 Int'l Tax J. 5 (May-June 2008) ("Miller, *Anti-Deferral and Anti-Tax Avoidance*").

⁹⁷ See, e.g., Newman T. Halvorson, Jr. and Deanna J. Hamilton, *Comments on Application of the PFIC Rules to Trusts*, 93 TNT 20-52 (Dec. 21, 1992); Newman T. Halvorson, Jr. and Deanna J. Hamilton, *Comments on Proposed Passive Foreign Investment Company Regulations*, 92 TNT 165-67 (July 30, 1992); Thomas St.G. Bissell, 944 T.M., *Aliens Who Invest in the United States Through a Low-Tax Jurisdiction*, at A-68 (2003); M. Read Moore, *Indirect Ownership of CFC and PFIC Shares by U.S. Beneficiaries of Foreign Trusts*, 108 J. Tax'n 105 (Feb. 2008); M. Read Moore, *Thinking Outside the Box: U.S. Federal Income Tax Issues for Trusts and Estates That Own Shares in Foreign Corporations*, reprinted in ALI-ABA, *International Trusts and Estates Planning* (2008); Don Kozusko, *PFICs and CFCs Held by Trusts: Recent Developments* (May 2008). See also Henry Christiansen III, *International Estate Planning* § 4.10[4][a][iii] (2d ed. 2008). Compare Miller, *Anti-Deferral and Anti-Tax Avoidance*, supra note 96.

tax are received by the foreign trust. In order to prevent such abuse, the Treasury can consider applying the separate share rules of Section 663(c) and rules similar to the principles of Section 704(b), which provide that special income allocations by a partnership are ineffective unless they have substantial economic effect or they are in accordance with the partners' real interests in the partnership.⁹⁸

B. Proposed Guidance Regarding Tiered PFIC Structures

In this section, we discuss various problems that arise when a U.S. investor indirectly owns an interest in a PFIC (a “lower-tier PFIC”) through one or more entities (an “intervening entity” or an “intervening corporation”). The first part of this section addresses certain interpretative issues involved in applying the PFIC attribution rules to determine whether a U.S. investor is considered an indirect shareholder of a lower-tier PFIC. The second part of this section addresses a number of problems that arise in applying the PFIC regime to indirect shareholders of lower-tier PFICs.

1. Issues Concerning the PFIC Attribution Rules

Look-through rules apply with respect to a U.S. investor's interest in a tiered ownership structure. Under Section 1298(a)(3), stock that is owned, directly or indirectly, by a partnership, trust or estate is treated as being owned proportionately by such entity's partners or beneficiaries. A similar attribution rule applies under Section 1298(a)(2)(B) when the intervening entity is a PFIC or would have been a PFIC but for the “CFC trumps PFIC” rule. If the intervening corporation is not a PFIC or a CFC, however, Section 1298(a)(2)(A) provides that this attribution rule is only applicable with respect to those “persons” that own, directly or indirectly, at least 50% of the stock (by value) of the intervening corporation.

⁹⁸ See Treas. Regs. § 1.704-1(b)(2)(ii).

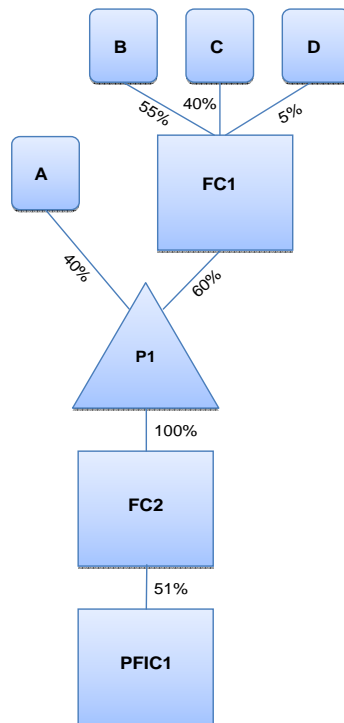
These attribution rules are applied sequentially “to the extent the effect” is to treat the stock of the lower-tier PFIC as being owned by a “United States person.”⁹⁹ However, stock that is owned directly or indirectly by a United States person is not reattributed to any other person *except to the extent provided in the regulations*. Although no final regulations have been issued, the proposed regulations would expand the scope of this provision to attribute to a U.S. person PFIC stock owned by a U.S. corporation if the U.S. person owns, directly or indirectly, 50% or more of the stock (by value) of such U.S. corporation.¹⁰⁰

In practice, the application of the PFIC attribution rules raises a number of interpretive issues. The following example illustrates the need for guidance in this area: Assume U.S. individual A owns 40% of P1, a partnership. The remaining 60% of P1 is owned by FC1, a foreign corporation that is not a PFIC. FC1 is owned 55% by U.S. individual B, 40% by U.S. individual C and 5% by U.S. individual D. P1 owns 100% of FC2, a foreign corporation that is not a PFIC, and FC2 owns 51% of a PFIC, PFIC1.

The group’s ownership structure chart is as follows:

⁹⁹ See Section 1298(a)(1)(A).

¹⁰⁰ See Prop. Treas. Regs. § 1.1291-1(b)(8)(ii)(C). There is no apparent need for this attribution rule. If a U.S. corporation is treated as having an interest in a PFIC, the U.S. corporation will be subject to the PFIC rules.



In applying the PFIC attribution rules, it is necessary at the outset to determine whether these rules apply from the bottom up or from the top down. Surprisingly, this basic issue is not addressed in the statute or regulations, and the IRS has not issued any guidance in this area. As discussed below, resolution of this issue could have a determinative effect on which, if any, of the individuals, A, B, C and D, is subject to the PFIC regime.

2. The PFIC Attribution Rules – Needed Clarification

Were we to start with PFIC1 in the above example, and work our way up the ownership chain, A and B would be treated as having an indirect interest in PFIC1, at least if P1 is a foreign partnership. This is because P1 owns at least 50% of the value of FC2, a foreign corporation that is not classified as a PFIC, and is therefore treated under Section 1298(a)(2)(A) as owning its

proportionate share (by value) of FC2's interest in PFIC1. P1's proportionate share of PFIC1, 51% in this example, is then reattributed to P1's partners under Section 1298(a)(3). Hence, A is treated as owning a 20.4% interest in PFIC1 (40% x 51%), and B is treated as owning a 16.83% interest in PFIC1 (55% x 60% x 51%). Since neither C nor D owns at least 50% (by value) of FC1, and FC1 is not a PFIC and would not be a PFIC were it not a CFC, neither C nor D is treated as owning an indirect interest in PFIC1 under Section 1298(a)(2).

Under a top down approach, none of the individuals, A, B, C or D, will be treated as owning an indirect interest in PFIC1. This is because none of these individuals owns, directly or indirectly, at least 50% of P1 and, as a result, none of the individuals is treated as owning at least 50% (by value) of FC2.

There are a number of factors that support the application of the PFIC attribution rules from the top of the ownership chain down to the lower-tier PFIC, including the following:

- (i) The bottom up approach is less workable, as a practical matter, as U.S. investors often do not know, and cannot determine, their proportionate ownership interests several layers down the ownership chain.
- (ii) A U.S. investor's interest in a lower-tier PFIC will change whenever additional shares are issued or shares are sold or redeemed in the lower-tier PFIC or any of the intervening entities. Tracking these ownership shifts, starting with the bottom of the ownership structure, could be particularly burdensome, if not impossible.
- (iii) If Section 1298(a)(3) reflects a decision by Congress to treat a partnership as an aggregate of its partners, the top down approach is more appropriate because, unlike the bottom up approach, the top down approach would produce the same results as if the partners directly owned the partnership's direct and indirect PFIC

interests.¹⁰¹ For example, with the bottom up approach, A and B in the above example are treated as having a 20.4% and 16.83% interest in PFIC1, respectively. However, if A and B were direct shareholders in FC2, neither A nor B would have an interest in PFIC1. With the top down approach, the result would generally be the same.

Support for a bottom up approach, however, can be found in Section 1298(a)(2) and Section 1298(a)(3), which treat the partners and certain shareholders of an intervening entity as owning their proportionate share of the partnership's or the corporation's direct or indirect PFIC interests. Under these provisions, the ownership interest of the intervening entity must first be determined and then attributed up to the intervening entity's partners or shareholders.

It is also unclear whether the same result would occur if P1 is a U.S. partnership. Specifically, except to the extent provided in regulations, Section 1298(a)(1)(B) turns off the PFIC attribution rules once the PFIC stock has been attributed to a "United States person." Given the absence of any final regulations under this provision, and the fact that a U.S. partnership is a United States person,¹⁰² it would appear that P1's indirect interest in PFIC1 should not be reattributed to "any other person" under Section 1298(a)(1)(B). Such a reading of the statute, while apparently mandated by Section 1298(a)(1)(B), is arguably inconsistent with Section 1298(a)(3), which provides that the stock owned by a partnership is treated as being owned proportionately by the partnership's partners.

In light of the foregoing, we request that Treasury issue regulations clarifying:

(i) Whether the stock attribution rules should be applied based on a top down or bottom up approach or otherwise; and

¹⁰¹ Cf. Treas. Regs. § 1.702-1(a)(8)(ii) (applying an aggregate approach for partners that are CFCs).

¹⁰² See Section 7701(a)(30)(B).

(ii) Whether Section 1298(a)(1)(B) applies to prevent attribution from a U.S. partnership under Section 1298(a)(3).

3. Issues Concerning Tiered PFIC Structures¹⁰³

A U.S. investor may be subject to the excess distribution rules as a result of its indirect interest in one or more lower-tier PFICs. In this regard, the proposed PFIC regulations contain certain provisions that are intended to apply the excess distribution regime in the context of indirect distributions on, and dispositions of, lower-tier PFIC stock.¹⁰⁴ We believe that certain provisions of the proposed regulations conflict with the relevant provisions of the Code or result in an overly broad and unintended application of the PFIC excess distribution rules. The specifics of these issues are discussed below, followed by a summary of our recommendations.

a. The Proposed Regulations Result in an Overly Broad Application of the Indirect Distribution Rules

The legislative history of Section 1291 indicates that Congress intended that the IRS would issue regulations “in appropriate cases” to ensure that a U.S. investor’s indirect interest in a lower-tier PFIC remains subject to the excess distribution rules.¹⁰⁵ According to the Conference Committee Report on the Technical and Miscellaneous Revenue Act of 1988, Congress intended that the excess distribution rules would apply at the lower-tier PFIC level “to prevent the avoidance of the imposition of interest.”¹⁰⁶ As an example, the Conference Committee Report states that a distribution from a lower-tier PFIC should not be treated as

¹⁰³ Unless otherwise indicated, the discussion in this section assumes that the U.S. investor owns a direct interest in an intervening entity; after applying the PFIC attribution rules, the U.S. investor is treated as owning an indirect interest in the lower-tier PFIC; and the U.S. investor has not made a QEF or a mark-to-market election with respect to its indirect interest in the lower-tier PFIC.

¹⁰⁴ See Prop. Treas. Regs. §§ 1.1291-2(f); -3(e). Until these regulations are finalized, U.S. investors must apply “reasonable interpretations” of the statute and legislative history and must employ “reasonable methods” to preserve the interest charge on the deferred income component of a lower-tier PFIC’s excess distributions. See Prop. Treas. Regs. § 1.1291-1(j)(1).

¹⁰⁵ See Blue Book, *supra* note 3, at 1032 (1986).

¹⁰⁶ See H.R. Conf. Rep. No. 100-1104, at 11 (1988).

having been paid to the U.S. investor if the intervening corporation is a PFIC, the lower-tier PFIC is a wholly-owned subsidiary of the intervening corporation and the lower-tier PFIC has annually distributed all of its income to the intervening corporation. In that case, the Conference Committee Report concludes, the U.S. investor should not be treated as having received its proportionate share of the underlying distribution unless the distribution is somehow made available to the U.S. investor.¹⁰⁷

The proposed regulations, however, incorporate only the limited exception of the example that is set forth in the Conference Committee Report.¹⁰⁸ All other distributions and dispositions that are made with respect to stock in the lower-tier PFIC are, according to the proposed regulations, treated as if the U.S. investor received its proportionate share of the lower-tier PFIC distribution.¹⁰⁹

We believe, however, that there are a number of other instances in which a distribution on, or disposition of, lower-tier PFIC stock should not be attributed to an indirect U.S. investor:

- (i) There will be no deferral of income, and thus no avoidance of the interest charge on the deferred tax amount, if the lower-tier PFIC's income has been distributed annually, regardless of whether the lower-tier PFIC is a wholly-owned subsidiary of the distributee or the distributee is itself a PFIC. If the distributee is neither a PFIC nor a CFC, the distribution may result in the deferral of income; however,

¹⁰⁷ *Id.*

¹⁰⁸ See Prop. Treas. Regs. § 1.1291-2(f)(4). A similar exception applies when the lower-tier PFIC is a wholly owned subsidiary of a PFIC (the "first-tier PFIC"), the lower-tier PFIC has annually distributed all of its earnings and profits, and the first-tier PFIC disposes of some or all of its stock in the lower-tier PFIC. See Prop. Treas. Regs. § 1.1291-3(e)(6).

¹⁰⁹ Perhaps recognizing that this exception is under-inclusive, the proposed Treasury Regulations include a placeholder for "other exceptions" to the indirect excess distribution rules. See Prop. Treas. Regs. § 1.1291-2(f)(4)(ii), -3(e)(6)(ii).

such a deferral would be the result of the distributee's business activities, assets, income, and ownership structure.¹¹⁰

- (ii) A distribution on, or disposition of, PFIC stock owned (or deemed owned) by an upper-tier non-QEF PFIC should not cause the avoidance of the PFIC excess distribution regime, as the excess distribution regime would still apply at the upper-tier PFIC level.
- (iii) A distribution by a lower-tier PFIC during the first year in which the U.S. investor's holding period in the lower-tier PFIC begins is not treated as an excess distribution.¹¹¹ Although such first year distributions will not result in an excess distribution, the proposed regulations seem to indicate that these distributions are nevertheless treated as having been received by, and thus potentially taxable to, the U.S. investor.¹¹²
- (iv) The lower-tier PFIC's earnings would not avoid the economic effect of the interest charge on the deferred tax liability if the intervening corporation is a PFIC in respect of which a mark-to-market election was made. In that case, all of the lower-tier PFIC's income, whether distributed or not, would be recognized each year when the intervening corporation's stock was marked to market.¹¹³

¹¹⁰ Such distributions would not be subject to the excess distribution rules if an election were made to treat the lower-tier PFIC as either a disregarded entity or a partnership for federal income tax purposes. It is therefore not evident why the excess distribution rules should apply when the same economic result would occur without making such an election -- that is, when the lower-tier PFIC distributes all of its income annually each year in which the U.S. investor indirectly owns stock in the lower-tier PFIC.

¹¹¹ See Section 1291(b)(2)(B).

¹¹² See Prop. Treas. Regs. § 1.1291-2(f)(1)(ii), which illustrates that an indirect distribution in the first year is not an excess distribution but is nevertheless treated as having been distributed to the U.S. investor.

¹¹³ For a more complete discussion of this issue, see VI.B.3.c below.

None of these distributions result in the avoidance of the interest charge on excess distributions, nor are any of these distributions actually received by the U.S. investor. The U.S. investor should not be treated as having received its proportionate share of these distributions. We therefore recommend that the IRS issue regulations clarifying that the above-mentioned distributions from a lower-tier PFIC will not be treated as having been distributed to the U.S. investor under Section 1291.

b. The Proposed Regulations Result in an Overly Broad and Burdensome Application of the Indirect Stock Disposition Rules

Dispositions of stock in a lower-tier PFIC, as well as dispositions of stock in an intervening corporation, are treated, to the extent provided in regulations, as if the U.S. investor disposed of its proportionate share in the lower-tier PFIC.¹¹⁴ Assuming the U.S. investor has not made a QEF election or a mark-to-market election with respect to its indirect interest in the lower-tier PFIC, the U.S. investor's proportionate share of the actual or deemed gain resulting from the indirect disposition of the lower-tier PFIC stock will be treated under the proposed regulations as an excess distribution.¹¹⁵ The proposed regulations provide that a U.S. investor will be treated as having indirectly disposed of an interest in the lower-tier PFIC (i) when the U.S. investor disposes of some or all of its interest in an intervening entity, and (ii) in any other transaction, in either case provided that the U.S. investor's interest in the lower-tier PFIC is reduced as a result of such disposition or other transaction.¹¹⁶

The issuance by a lower-tier PFIC of additional shares to new investors results in a dilution of the intervening entity's interest in the lower-tier PFIC, and thus an indirect dilution of

¹¹⁴ See Section 1298(b)(5)(A).

¹¹⁵ See *id.*; Section 1291(a); Prop. Treas. Regs. § 1.1291-3(e).

¹¹⁶ See Prop. Treas. Regs. § 1.1291-3(e)(2).

the U.S. investor's indirect interest in the lower-tier PFIC. Under the proposed regulations, the dilution of the U.S. investor's interest in the lower-tier PFIC will be treated as if the U.S. investor realized its proportionate share of the gain the intervening entity "would have realized" had it sold that portion of its interest that was diluted as a result of the lower-tier PFIC's offering (the "diluted interest"). As a practical matter, complying with this requirement would be impossible, particularly when the U.S. investor has an insignificant ownership interest in the lower-tier PFIC or when the investors are routinely trading in and out of the lower-tier PFIC. In addition, attributing the gain to the U.S. investor in this instance is illogical because the U.S. investor's percentage dilution generally will not result in dilution of the value of its indirect interest in the PFIC by reason of the additional cash infusion. Hence, the U.S. investor's ownership interest in the lower-tier PFIC will economically remain unchanged when the lower-tier PFIC issues additional shares.

We recommend that the IRS issue regulations that, consistent with Section 1298(b)(5), would treat the U.S. investor as having realized its proportionate share of the intervening entity's gain only when, as a result of a disposition of shares by the U.S. investor or the intervening entity, the U.S. investor is treated as having a reduced ownership interest in the lower-tier PFIC.

c. The Mark-To-Market Rules Could Result in the Economic Equivalent of Double Taxation of the Lower-Tier PFIC's Earnings

When stock in a PFIC is considered "marketable,"¹¹⁷ a U.S. investor may prevent the application of the excess distribution rules by electing to be subject to the mark-to-market rules of Section 1296. The mark-to-market rules effectively provide for current taxation, at ordinary

¹¹⁷ In general, PFIC stock is considered marketable if it is regularly traded on a qualified exchange, which includes national securities exchanges registered with the Securities and Exchange Commission and certain regulated foreign exchanges. See Section 1296(e).

income tax rates, of the annual appreciation (or, subject to certain limitations, depreciation) in the value of the PFIC stock.¹¹⁸

A mark-to-market election can be made for marketable stock in a PFIC that is owned indirectly through certain foreign entities (*e.g.*, foreign partnerships, foreign trusts, or foreign estates).¹¹⁹ However, a mark-to-market election generally cannot be made for marketable stock in a lower-tier PFIC that is owned indirectly through a foreign corporation, including another PFIC.¹²⁰ As a result, a U.S. investor may be subject to the excess distribution rules with respect to its indirect interest in a lower-tier PFIC, even if the intervening corporation is a PFIC and the U.S. investor has made a mark-to-market election with respect to its direct ownership interest in the intervening corporation.

Application of the excess distribution rules to a U.S. investor's interest in a lower-tier PFIC may result in multiple applications of the PFIC regime. To illustrate this problem, assume that, in year 1, a U.S. investor contributes \$10 million to a first-tier PFIC in exchange for 10% of its common stock, and that unrelated foreign investors contribute \$90 million for the remaining common stock of such PFIC. Immediately thereafter, the first-tier PFIC (i) contributes \$50 million to a lower-tier PFIC in exchange for 100% of its common stock and (ii) purchases a second asset (the "Asset") with the remaining \$50 million. During year 1, the lower-tier PFIC

¹¹⁸ Under the mark-to-market rules, at the close of a taxable year, the electing U.S. investor includes in its gross income any excess of the fair market value of the PFIC stock over the U.S. investor's adjusted tax basis in the stock. *See* Section 1296(a)(1). The U.S. investor is also generally allowed to deduct any excess in its adjusted tax basis in the PFIC stock over its fair market value. *See* Section 1296(a)(2). However, the deduction is limited to any net gains (reduced by prior deductions) that the U.S. investor included in income for such PFIC stock in prior taxable years ("unreversed inclusions"). *See* Section 1296(a)(2) and (d). A U.S. investor's adjusted basis in the marketable PFIC stock is increased by the amount of inclusions, and decreased by the amount of deductions, that are taken into account under the mark-to-market rules. *See* Section 1296(b)(1).

¹¹⁹ *See* Section 1296(g)(1).

¹²⁰ If, however, the U.S. investor holds marketable stock in a PFIC indirectly through a CFC, the CFC can make a mark-to-market election for the lower-tier PFIC. *See* Section 1296(f).

has investment earnings of \$50 million, none of which is distributed, and, in addition, the Asset appreciates and is worth \$100 million by the close of the first year. No further earnings, appreciation or depreciation occurs. In year 2, the first-tier PFIC sells all of its stock in the second-tier PFIC for its fair market value of \$100 million. In year 3, the U.S. investor sells its stock in the first-tier PFIC for \$20 million (10% of the \$200 million value). The shares of the first-tier PFIC are publicly traded and subject to the mark-to-market rules, while the lower-tier PFIC is subject to the default excess distribution rules.¹²¹

In year 1, the \$10 million of appreciation in the first-tier PFIC stock (10% of the \$50 million in the lower-tier PFIC's earnings and of the \$50 million appreciation of the Asset) will be reported by the U.S. investor as ordinary income, and the basis in the U.S. investor's stock will be increased by an equal amount. In year 2, when the first-tier PFIC sells its stock in the lower-tier PFIC, the U.S. investor will report the underlying gain of \$5 million (\$20 million proceeds - \$10 million cash contributed - \$5 million income (10% of \$50 million)) as an excess distribution, and the U.S. investor's basis in the first-tier PFIC will be increased again -- this time by \$5 million to \$25 million.¹²² Lastly, in year 3, when the U.S. investor sells its stock in the first-tier PFIC, the U.S. investor will incur a loss of \$5 million (\$20 million proceeds - \$25 million basis). This \$5 million loss should be treated as an unreversed inclusion and should therefore be available as an ordinary deduction in year 3.¹²³

¹²¹ As discussed above, the excess distribution rules do not apply when the lower-tier PFIC is a wholly owned subsidiary of the first-tier PFIC and the lower-tier PFIC annually distributes all of its earnings and profits. *See* Prop. Treas. Reg. § 1.1291-2(f)(4), -3(e)(6). An economically similar result occurs when a mark-to-market election is made with respect to the first-tier PFIC stock and the lower-tier PFIC is a wholly owned subsidiary of the first-tier PFIC. However, since the mark-to-market provisions of Section 1296 were enacted after the proposed regulations under Section 1291 were promulgated, it is not surprising that an exception covering the circumstances discussed in this section is not included in the proposed regulations.

¹²² *See* Prop. Treas. Regs. § 1.1291-3(e)(4)(iii).

¹²³ *See* Section 1296(c)(1)(B)(ii); Treas. Regs. § 1.1296-1(c)(3).

In this case, there is no character mismatch. However, the result is still problematic because, in year 2, the U.S. investor was subject to tax on \$5 million of deemed income which was duplicative of income previously reported. The U.S. investor can only recover the resulting tax cost if it is able to utilize the \$5 million loss to offset other income. In addition, although the U.S. investor has paid tax on this phantom income, and has not enjoyed any income deferral, the investor is nonetheless subject to an interest charge in year 2.

The result is exacerbated in cases where depreciation in the value of the first-tier PFIC stock depletes the U.S. investor's unreversed inclusions. For example, assume that the U.S. investor in the above example had retained its interest in the first-tier PFIC for the duration of year 3, and that during year 3 the fair market value of the Asset declines from \$100 million to zero. In that event, the U.S. investor will be entitled to deduct this \$10 million (10% x \$100 million) loss in value as an ordinary deduction in year 3. Correspondingly, the U.S. investor will reduce its basis in the first-tier PFIC stock by \$10 million, resulting in an adjusted basis of \$15 million. If in year 4 the U.S. investor sells its interest in the first-tier PFIC for its fair market value of \$10 million (10% x \$100 million value), the U.S. investor will still incur a loss of \$5 million (\$10 million proceeds - \$15 million basis). However, this \$5 million loss will not constitute ordinary loss because the \$10 million deduction taken in year 3 has offset all previous inclusions.

As a result, the \$5 million loss in year 4 would be treated as a capital loss. In this scenario, in addition to the timing and interest charges discussed above, there is also a character mismatch in that the \$5 million inclusion in year 2 (under the excess distribution rules) was treated as ordinary income. A U.S. corporate investor will not be able to recoup this capital loss unless it has available capital gains to offset. An individual investor may offset up to \$3,000 of

ordinary income against the capital loss.¹²⁴ However, any excess of the capital loss over that amount will not be fully recovered under the current rate structure, even if sufficient capital gain is available, because the prior income will have been taxed at higher ordinary income tax rates while the capital loss will have been used to offset gains potentially taxable at the lower capital gains rates.¹²⁵ Rather than a “double” tax, this is, more accurately, a tax on income that has never been earned.¹²⁶

To alleviate this potential unjustified tax, we recommend that, at a minimum, if a U.S. investor has made a mark-to-market election with respect to its direct interest in the intervening PFIC, such investor should not be subject to the excess distribution rules with respect to any lower-tier PFICs.

d. Other Instances in Which a Tiered PFIC Structure Could Result in Taxation Without Any Corresponding Economic Accession of Wealth

Under a literal reading of Section 1291(a)(1)(B), excess distributions need only be made “with respect to stock” in the PFIC. The IRS is authorized to issue regulations under Section 1298(a)(1)(B) and Section 1298(f), which directs that the Secretary “shall prescribe such regulations as may be necessary to carry out the purposes of” the PFIC rules. On this basis, the IRS has taken the position that excess distributions are not limited to the distributing PFIC’s earnings and profits, but rather may also include a return of the investor’s capital.¹²⁷ This of

¹²⁴ See Section 1211(b).

¹²⁵ See Sections 1296(c)(1) and 1(h).

¹²⁶ As discussed in section VI.B.3.d below, a similar issue arises under the basis adjustment rules with respect to excess distributions generally.

¹²⁷ See 57 Fed. Reg. 11025 (Apr. 1, 1992) (preamble to the proposed regulations).

course raises serious constitutional questions, as a return of capital clearly does not reflect an accession of wealth and thus “gross income” under the Sixteenth Amendment or Section 61.¹²⁸

The preamble to the proposed regulations takes the view that, while a PFIC’s earnings and profits are “generally irrelevant” for purposes of the excess distribution rules, the U.S. investor can “avoid the interest charge and other disadvantages under Section 1291 by making a QEF election.”¹²⁹ While it is true that a QEF election or a mark-to-market election may mitigate many of the problems discussed above, including the potential taxation of a U.S. investor’s capital investment in the PFIC, as a practical matter these elections are often not available to U.S. investors (as discussed above).¹³⁰

It may be argued that, notwithstanding the QEF and mark-to-market elections, the basis adjustment rules provide the U.S. investor with adequate relief against the issues discussed in this section. As illustrated above, however, this is not necessarily the case when the intervening corporation is subject to the mark-to-market rules. The basis adjustment rules also may not provide adequate relief when neither the QEF nor the mark-to-market rules are applicable. For example, assume the U.S. investor acquires its interest in the intervening corporation for \$100 million when the intervening company has a built-in gain of \$20 million in its interest in the lower-tier PFIC; the intervening corporation sells its interest in the lower-tier PFIC for a gain, of which the U.S. investor’s proportionate share is \$20 million; and then the U.S. investor subsequently sells its interest in the intervening corporation for \$100 million. Although the U.S. investor broke even on the sale of its stock in the intervening corporation, having sold the stock

¹²⁸ See, e.g., *Doyle v. Mitchell Bros. Co.*, 247 U.S. 179, 185 (1918); *Harrill v. Comm’r*, T.C. Memo 1964-221.

¹²⁹ See 57 Fed. Reg. 11025 (Apr. 1, 1992) (preamble to the proposed regulations).

¹³⁰ In addition, the mark-to-market election is generally not an option when the PFIC stock is not traded on a public exchange and, as discussed above, the mark-to-market election generally may not be made when the U.S. investor is treated as having an interest in the lower-tier PFIC indirectly through a foreign corporation.

for the initial purchase price, the U.S. investor is nevertheless taxed on the underlying \$20 million built-in gain that was present when the U.S. investor acquired its interest in the intervening corporation.

When the intervening corporation disposes of its stock in the lower-tier PFIC, the U.S. investor is treated as having received a \$20 million excess distribution, which is taxed as ordinary income and subject to the interest charge on the deferred income component. The U.S. investor will increase its basis in the stock of the intervening corporation by this \$20 million and will, therefore, potentially recognize a \$20 million tax benefit when it sells its interest in the intervening corporation for \$100 million. As a result of the basis adjustment, the U.S. investor recognizes a loss equal to the previously taxed gain. However, since the loss will be treated as a capital loss, which may not be used by a corporate U.S. investor to offset its ordinary income, the basis adjustment will not provide adequate relief from double taxation if the U.S. investor does not have sufficient offsetting capital gains. In addition, even if the loss was fully deductible (or the basis adjustment resulted in a reduction of gain upon the disposition of the U.S. investor's interest in the intervening corporation), the basis adjustment will not compensate the U.S. investor for having to recognize the income in one year and the offsetting loss (or gain reduction) in a subsequent year.

4. Recommendations

As discussed in this section, applying the PFIC rules in the context of tiered PFIC structures raises a number of challenging issues. The attribution rules are unclear and sometimes lead to arbitrary results depending upon the ownership structure involved. The proposed regulations concerning the excess distribution rules are overly broad and, in certain circumstances, result in unintended consequences. And the excess distribution rules could result in the current taxation of items that do not reflect economic income when a mark-to-market

election has been made or more generally when the excess distribution rules apply with respect to a lower-tier PFIC.

To alleviate these adverse consequences, we propose that regulations be issued under Section 1298(a)(1)(B) and Section 1298(f) consistent with the following recommendations:

(i) Treasury Regulations should clarify whether in a multi-tier PFIC structure the PFIC attribution rules should be applied from the top of the ownership chain down to the lower-tier PFICs (which approach may have several advantages as discussed above) or otherwise.

(ii) Distributions from a lower-tier PFIC to a non-U.S. intervening corporation should not be attributed to the U.S. investor and subject to the excess distribution rules if (a) the lower-tier PFIC has annually distributed all of its earnings, or (b) the distribution occurs during the first year in which the U.S. investor is treated as having an indirect interest in the lower-tier PFIC.

(iii) Distributions from lower-tier PFICs should not be subject to the excess distribution rules to the extent such distributions reflect items that are not economic income, such as (a) returns of capital, or (b) disparities between (I) the U.S. investor's basis in the intervening corporation, and (II) the U.S. investor's proportionate share of the intervening corporation's basis in the lower-tier PFIC, each at the time the U.S. investor acquired its indirect interest in the lower-tier PFIC.¹³¹

(iv) Dispositions of lower-tier PFIC stock should not be treated as excess distributions if the dispositions do not result in a dilution of the U.S. investor's ownership interest in the lower-tier PFIC (subject to appropriate adjustments to basis and holding period to preserve the potential PFIC consequences, as necessary). Similarly, "dilutions" resulting from the issuance of

¹³¹ Such a disparity does not reflect any economic gain inherent in the U.S. investor's interest and, therefore, should not be subject to the adverse consequences of the excess distribution rules. This category should be further expanded to include other types of distributions from lower-tier PFICs that do not represent an economic gain to the indirect U.S. investor.

additional equity interests by the lower-tier PFIC should not result in a taxable event to the indirect U.S. investor.

(v) If a U.S. investor has made a mark-to-market election with respect to its shares in a first-tier PFIC, the U.S. investor should not be subject to the excess distribution rules with respect to any lower-tier PFIC.

(vi) A distribution on, or disposition of, PFIC stock owned (or deemed owned) by an upper-tier non-QEF PFIC should not be attributed to the U.S. investor.

C. Option Attribution

As noted above, Section 1298(a)(4) provides that “[t]o the extent provided in regulations, if any person has an option to purchase stock, such stock shall be considered as owned by such person.” No final or temporary regulations have been issued under this provision, but certain proposed regulations would treat any U.S. person holding an option to purchase PFIC stock as the holder of such PFIC stock for purposes of applying the excess distribution regime to a disposition of the option.¹³²

As a threshold matter, there is a question as to whether the option attribution rule of Section 1298(a)(4) applies in the absence of final or temporary regulations. We do not comment on this issue other than to recommend that the Treasury Department issue such regulations as it deems appropriate to resolve the issue on a going-forward basis.

We propose that regulations be issued to exempt compensatory options from option attribution.¹³³ The use of options as a legitimate compensation device is widespread, and, of course, tied to the holder’s obligation to provide services to the company. In our view, the

¹³² See Prop. Treas. Regs. § 1.1291-1(d).

¹³³ A similar proposal was made by the New York State Bar Association in 2001, and the NYSBA Report includes an extensive discussion of such proposal.

acquisition of an option by a service provider, as compensation for services, has little to do with the type of passive investment that the PFIC rules were designed to address. Moreover, we do not see any policy justification for treating employees of PFICs less favorably than employees of U.S. corporations (or foreign corporations that are not PFICs). Finally, we note that, in other contexts where the Treasury Department has been given the authority to treat options as stock, it has excluded standard compensatory options from such treatment.¹³⁴

VII. Proposed Guidance Regarding the Application of Section 1291(e)

A. Introduction

Section 1291(e) applies to PFICs certain rules that were applicable to foreign investment companies (“FIC”s) under former Section 1246(c). Former Section 1246(c) treated, to the extent provided under regulations (which have never been issued), non-FIC stock with a substituted basis received in a nonrecognition exchange for FIC stock as FIC stock. Applying that principle, non-PFIC stock received for PFIC stock in a nonrecognition transaction would be treated as PFIC stock (the “Substituted Taint Rule”).¹³⁵ However, there is substantial uncertainty whether Section 1291(e) is “self executing,” that is, whether it is operative absent regulations, and to what extent such regulations should adopt the former Section 1246(c) principles for PFICs.

B. Summary of Relevant Provisions

Section 1291(e) provides that rules similar to the rules of former Section 1246(c) through (f) as in effect prior to their repeal in 2004 shall apply “except to the extent inconsistent” with regulations under Section 1291(f). Section 1291(f), in turn, provides that “to the extent provided

¹³⁴ See Treas. Regs. §§ 1.382-4(d)(7)(iii); 1.1361-1(l)(4)(iii)(B)(2); 1.1504-4(d)(2)(v).

¹³⁵ The Substituted Taint Rule is applicable only to PFICs subject to the “excess distribution” regime under Section 1291. See Priv. Ltr. Rul. 9625059 (June 21, 1996). In the balance of the discussion on this topic below, “PFIC” refers only to passive foreign investment companies whose shares are subject to the excess distribution regime.

in regulations,” provisions under otherwise applicable law that permit nonrecognition of gain on the transfer of PFIC stock do not apply. The only regulations under Section 1291(f) are proposed and expressly reserve on their relationship to the former Section 1246 rules.¹³⁶

The proposed regulations under Section 1291(f), as a general rule, provide that when PFIC stock is disposed of, directly or indirectly, in a transaction that otherwise would qualify for nonrecognition, gain (but not loss) must be recognized. Accordingly, otherwise applicable nonrecognition provisions are overridden in the case of PFICs unless a specific exception in the proposed regulations applies. Among other specific exceptions, the proposed regulations provide that gain is not recognized if a U.S. shareholder receives in an applicable exchange an interest in another person that owns directly or indirectly stock of the transferred PFIC or of another PFIC, but only to the extent (by value) that the investor continues to be treated under the PFIC attribution rules as owning after the transfer at least as great an interest in the PFIC as the indirect shareholder owned directly before the transfer (the “Indirect PFIC Ownership Exception”).¹³⁷

In general, a U.S. investor does not recognize gain on a direct or indirect disposition of stock of a PFIC that results from a nonrecognition transfer where the transferee is a U.S. person, provided that (i) the transfer does not result in an increase in tax basis of the stock to the actual owner; (ii) the transferee’s holding period is at least as long as the transferor’s holding period; and (iii) the aggregate ownership of the U.S. investor and the transferee after the transfer is the same as or greater than the U.S. investor’s proportionate ownership before the transfer (the “U.S. Transferee Exception”).¹³⁸

¹³⁶ See Prop. Treas. Regs. § 1.1291-7.

¹³⁷ See Prop. Treas. Regs. § 1.1291-6(c)(1).

¹³⁸ See Prop. Treas. Regs. § 1.1291-6(c)(2)(i).

These specific exceptions generally are intended to reach sensible results. If nonrecognition would enable a U.S. shareholder of a PFIC to “cleanse” all or part of the gain otherwise subject to the excess distribution regime of PFIC taint, gain is recognized and the excess distribution regime applies to that gain. However, if the effect of the nonrecognition transaction is to preserve fully the PFIC taint (either in the hands of the transferring U.S. shareholder or another U.S. person), nonrecognition is allowed. Application of the Substituted Taint Rule, however, may eliminate the benefit of nonrecognition in situations where the proposed regulations intend to allow nonrecognition. Numerous inconsistencies may arise, only certain of which are illustrated below.

Consider, for example, a U.S. shareholder that owns PFIC stock with a tax basis of \$50 and value of \$100. The U.S. shareholder contributes the PFIC stock to a wholly-owned foreign subsidiary that is not a PFIC that has \$900 of other assets used in its active business. The transferee corporation takes a carryover basis in the PFIC stock.

Under the PFIC attribution rules the U.S. shareholder will be considered as continuing to own indirectly the transferred PFIC stock and a disposition of that stock by the transferee corporation or an indirect disposition (*e.g.*, a disposition of transferee corporation stock that reduces or eliminates the U.S. shareholder’s indirect interest in the PFIC) will result in gain recognition subject to the excess distribution regime. Because the PFIC taint is preserved in this situation, the proposed regulations permit nonrecognition.¹³⁹ However, if the Substituted Taint Rule applies under Section 1291(e), the effect is to treat the transferee corporation stock received in the exchange as PFIC stock with a holding period based on the PFIC holding period.

¹³⁹ Any Section 367 issues are ignored in the interests of simplicity.

Effectively, this could subject gain attributable to non-passive assets to the excess distribution regime -- for example, assume the value of the PFIC stock subsequently declines to \$50 but this is more than offset by appreciation in the other assets of the transferee. A sale of the stock in the transferee corporation would attract tax under the excess distribution regime. The same gain also could be subject to the excess distribution tax more than once. If the U.S. shareholder sells just the “tainted” transferee corporation shares it received in the exchange, technically this is not an indirect disposition (because the remaining stock it holds ensures continued attribution of the underlying PFIC). Therefore, technically it appears that the transferee’s basis in the PFIC is not adjusted.¹⁴⁰ A later sale by the transferee corporation of the PFIC therefore could trigger a second indirect disposition and excess distribution tax on the same gain.

Similar anomalies may arise if the Substituted Taint Rule applies to a transaction entitled to the U.S. Transferee Exception (*e.g.*, if the transferee in the example above were instead a U.S. corporation). In that case too, the result may be to subject gain on a disposition of U.S. transferee stock attributable to U.S. business assets (taxable in the United States) to additional tax under the excess distribution regime. The result could be confiscatory.

These potential inconsistencies, and lack of clarity about whether Section 1291(e) is self-executing, could even work to the Treasury’s disadvantage. Consider a variation on the example above in which the U.S. shareholder owns less than 50% of the transferee foreign corporation and transfers the PFIC shares in exchange for transferee corporation stock in a Section 351 exchange.¹⁴¹ In that case, under the proposed PFIC regulation immediate gain recognition

¹⁴⁰ See Treas. Regs. § 1.1291-3(e)(4)(iii) (adjusting an actual owner’s basis in the PFIC for gain recognized by the U.S. shareholder but only in the case of an indirect disposition).

¹⁴¹ Assume there are other transferors who as members of the Section 351 control group transfer other property so that the control group will own a controlling interest in the transferee corporation.

should result because the PFIC would not be attributed to the U.S. shareholder and the Indirect PFIC Ownership Exception would not apply. However, the U.S. shareholder could fail to report gain, and argue, if challenged, that since Section 1291(e) treats the transferee stock as PFIC stock, the nonrecognition treatment of the exchange should be respected under the PFIC for PFIC exception of Treas. Regs. § 1.1291-6(c)(1)(i).

The examples above illustrate only certain of the many ways in which the 1246 taint rule may reach results fundamentally inconsistent with the proposed regulations under Section 1291(f).

C. Self-Executing Nature of Section 1291(e)

At first blush, it might seem that Section 1291(e) is self-executing. It states flatly that rules similar to the rules of former Section 1246(c) through (f) as in effect prior to their repeal in 2004 *shall* apply, “except to the extent inconsistent” with regulations under Section 1291(f).¹⁴² However, the “rules similar” language at least implies that regulatory clarification is required to conform the principles of Section 1246(c) to PFICs.¹⁴³

It might be argued therefore that Section 1291(e) cannot be given effect absent regulations under Section 1291(f). Specifically, it is impossible to determine how Section 1291(e) should operate in the absence of such regulations because one cannot discern whether or

¹⁴² Literally the section referenced by Section 1291(e) -- Section 1246(c) (containing the Substituted Taint Rule) -- itself provides that its rules apply “to the extent provided in regulations,” and no such regulations were ever promulgated. It therefore might further be argued that Section 1291(e) is not self-executing (to the extent referencing the principles of Section 1246(c)) because it references a provision that itself required regulations to be operative.

¹⁴³ See *Estate of Neumann v. Comm’r*, 106 T.C. 216 (1996); *H. Enterprises Int’l, Inc. v. Commissioner*, 105 T.C. 71 (1995). See generally Phillip Gall, *Phantom Tax Regulations: The Curse of Spurned Delegations*, 56 Tax Law. 413 (2003). Criticism, perhaps well founded, of the approach adopted in the case law is beyond the scope of this report. See, e.g., Amandeep S. Grewal, *Substance Over Form? Phantom Regulations and the Internal Revenue Code*, 7 Hous. Bus. & Tax L. J. 42 (2006).

not the Substituted Taint Rule would reach inconsistent results.¹⁴⁴ To hold otherwise, one might argue, would require a court first to construct “phantom” Section 1291(f) regulations in order next to develop judicial regulations under Section 1291(e) that are consistent.¹⁴⁵

If Section 1291(f) is self-executing, it would be appropriate to determine whether the Substituted Taint Rule reaches results that are inconsistent with the proposed regulations (which a court should apply in lieu of inventing phantom regulations of its own, particularly because of the retroactive proposed effective date). For reasons illustrated above, we believe there is apparent inconsistency between the proposed regulations and the Substituted Taint Rule. Therefore, even if Section 1291(e) is self-executing, on its face it is not applicable insofar as it relates to Section 1246(c) and the Substituted Taint Rule because of this inconsistency.¹⁴⁶

We recommend clarification that the Substituted Taint Rule does not apply to PFIC stock permitted to be received without recognition of gain or loss under the proposed regulations pursuant to Section 1291(f).

¹⁴⁴ Cf. New York State Bar Association Tax Section, *Report on Legislative Grants of Regulatory Authority*, at 5 (Nov. 3, 2006) (explaining that certain grants taking the form of “how” delegations, such as Section 706(d)(1), require application of methods specifically authorized by regulations and practically cannot be self-executing).

¹⁴⁵ Of course, if Section 1291(f) is not self-executing, the IRS could argue that absent final regulations under Section 1291(f) there can be no inconsistency -- generally applicable nonrecognition rules apply as would the Substituted Taint Rule of Section 1291(e).

One might attempt to avoid this dilemma, however, by treating the proposed regulations under Section 1291(f) as effective for this purpose (in other words, by considering Section 1291(f) to be self-executing and assuming that the court would import the proposed regulations as the relevant self-executing rules). The IRS appears to have taken this position in certain private letter rulings. *See, e.g.*, Priv. Ltr. Rul. 9007014 (Feb. 16, 1990); Priv. Ltr. Rul. 8946048 (Nov. 17, 1989); Priv. Ltr. Rul. 8916037 (Apr. 21, 1989).

¹⁴⁶ Conversely, if Section 1291(f) is not self-executing, then effectively Section 1291(e) cannot be either, because a court would be precluded from developing the phantom regulations under Section 1291(f) necessary to determine the appropriate “phantom regulations” under Section 1291(e).

VIII. Other Proposed Guidance

A. Purging Elections

Treas. Regs. §§ 1.1291-9(a), 1.1291-10(a), 1.1297-3(a) and 1.1298-3(a), which set forth the rules for making a deemed sale purging election and a deemed dividend purging election, respectively, provide that such an election should be made by a “shareholder” within the meaning of Treas. Regs. § 1.1291-9(j)(3) and Prop. Treas. Regs. § 1.1291-1(b)(7).

However, Prop. Treas. Regs. § 1.1291-1(b)(7) provides that “[a] shareholder is a U.S. person that directly owns stock . . . of a PFIC, or that is an indirect shareholder For purposes of these regulations, *a partnership or S corporation is treated as a shareholder of a PFIC only for purposes of the information reporting requirements of §§1.1291-1(i), 1.1291-2(f)(2)(ii), 1.1291-3(e)(5)(iii), and 1.1291-6(g).*” (Emphasis added).

A literal reading of such proposed Treasury Regulations suggests that such purging elections cannot be made by a foreign or domestic partnership or other pass-through entity, but rather must be made by the ultimate partners or beneficiaries of such entities.

We believe that in the case of a domestic partnership or an S corporation, it is unduly burdensome (for both the taxpayers and the IRS) to require that purging elections be made by each of the U.S. owners of such entities. Indeed, for purposes of making a QEF election, where U.S. persons own PFIC stock indirectly through a domestic partnership, only the domestic partnership is eligible to make a QEF election with respect to the PFIC.¹⁴⁷ We therefore suggest that the Treasury Regulations be clarified to permit domestic partnerships and S corporations to be treated as shareholders for the purpose of making purging elections.

¹⁴⁷ See Treas. Regs. §§ 1.1295-1(d)(2)(i)(A); -1(j) (definition of “Shareholder”).

B. Guidance Regarding Section 1297(d)

Section 1297(d)(1) provides that “[a] corporation shall not be treated with respect to a shareholder as a passive foreign investment company during the qualified portion of such shareholder’s holding period with respect to stock in such corporation.” For this purpose, “the term ‘qualified portion’ means the portion of the shareholder’s holding period – (A) which is after December 31, 1997, and (B) during which the shareholder is a *United States shareholder* (as defined in section 951(b)) of the corporation and the corporation is a controlled foreign corporation.”¹⁴⁸

The relief under Section 1297(d)(1) clearly applies only to “U.S. shareholders” (as defined in Section 951(b)), which term includes a domestic partnership that owns, directly or by attribution, at least 10% of the voting power of a CFC.

However, contrary to the general rule under Section 1298(a)(1) that prevents attribution from a “U.S. person” to any other person, the Proposed Regulations would seem to require the attribution of PFIC stock to a partner in a domestic partnership.¹⁴⁹

Consequently, where a foreign corporation is both a PFIC and a CFC and a domestic partnership is a “United States shareholder” with respect to such corporation, partners in the partnership that are not, in their own right, “U.S. 10%-shareholders” with respect to such corporation arguably might not qualify for the CFC/PFIC overlap rule under Section 1297(d), might therefore continue to be subject to the PFIC rule as indirect shareholders, if the proposed regulations were finalized in their current form. This seems to be an unintended result (arising from the fact that the “CFC trumps PFIC” rule was not in existence when the proposed

¹⁴⁸ See Section 1297(d)(2) (emphasis added).

¹⁴⁹ See Prop. Treas. Regs. § 1.1291-1(c)(7).

regulations were issued) because the domestic partnership will be required to include the subpart F income of the foreign corporation and will pass such income on to its U.S. partners.

We suggest that the final regulations be clarified to provide that PFIC shares held by a domestic partnership that is a “U.S. shareholder” of a CFC will not be treated as PFIC shares in the hands of a U.S. partner during the qualified period of the partnership with respect to such shares.

IX. Conclusion

The Committee has set forth its recommendations to make the PFIC rules work more effectively and the reasons therefore. We believe these changes can be implemented by Treasury Regulations, and would be pleased to discuss them with the IRS.

* * * * *