INTERNATIONAL DEVELOPMENTS

Taxation of Passive Foreign Investment Companies: Current Rules, Problems and Possible Solutions

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The United States has for many years taxed certain U.S. shareholders of closely held or controlled foreign corporations deriving principally passive or related-party income on their pro rata share of the corporation's earnings whether or not distributed. These rules are commonly referred to as “anti-deferral provisions” and are contained in the Code. The primary anti-deferral provisions for corporations are the controlled foreign corporation (CFC) rules and the passive foreign investment company (PFIC) rules.[1]

The principal benefit associated with the use of foreign corporations is the deferral of U.S. taxes on the foreign source income of a foreign corporation until it is repatriated to a U.S.

[1] Prior to 1/1/06, there was a third set of rules known as the foreign personal holding company (FPHC) rules. However, Congress felt that because income that would have been taxable under the FPHC rules may also have been taxable under the rules governing CFCs or the PFIC rules, there existed unnecessary and confusing overlap. Accordingly, Congress eliminated the FPHC rules in 2004.

shareholder in the form of a dividend distribution.[2] Given the potentially unlimited duration of the deferral privilege, Congress was concerned that certain kinds of income could escape U.S. taxation forever because there would never be a need to repatriate the income. Moreover, if U.S. shareholders sold stock in the foreign corporation to raise cash in the United States instead of taking dividends, they could potentially convert the foreign corporation's ordinary income to capital gains subject to preferential tax rates. Congress enacted the CFC rules in 1962 to currently tax U.S. owners of certain foreign corporations on their pro rata share of certain types of income earned by the foreign corporation--generally speaking, income that could be easily shifted from the U.S. to an offshore tax haven, thereby obtaining "tax deferral."[3]

The CFC rules were designed to apply on the basis of majority U.S. ownership (or at least 10% U.S. ownership on an individual basis), but Congress eventually came to feel that this limitation left a loophole that allowed U.S. taxpayers to enjoy the benefit of deferral by taking minority ownership positions in non-U.S. ("foreign") mutual funds expected to accumulate earnings rather than make annual distributions of income. Congress enacted the PFIC provisions as part of the Tax Reform Act of 1986 to reduce the ability of U.S. persons to defer tax in this way and thereby to equalize the treatment of foreign and U.S. investment vehicles.

Although the PFIC rules originally targeted U.S. persons' investments in offshore mutual funds, the scope of the rules as enacted is broad and can capture a vast universe of investments in offshore companies and investment vehicles. The rules can apply to any U.S. persons that own an interest in an offshore subsidiary whose assets or income is generally passive. As noted above, there is no minimum level of stock ownership required by a U.S.

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[2] See S. Rep't No. 1881, at 87-88 (1962), reprinted in 1962-3 CB 707, 794; H. Rep't No. 1447 (1962), reprinted in 1962-3 CB 405, 462.

[3] H.R. Report No. 1447 (2 out of 5), 87th Cong., 2nd Sess., 1962-3 CB 405 (3/16/62).

person to be subject to the PFIC rules and therefore even foreign public companies can be considered PFICs for U.S. tax purposes. Thus, even a small percentage of ownership can result in severe tax and reporting consequences. Both the CFC and PFIC rules look not only to direct ownership, where shares of foreign corporations are owned outright by a U.S. person, but also to indirect ownership through foreign corporations, partnerships, trusts, and estates and take into account certain attributed ownership from certain related persons (although attributed or "constructive" share ownership does not generally lead to income inclusion).

This column is designed to provide a general overview of the substantive rules regarding the taxation of interests in PFICs, including the excess distribution regime, the qualified electing fund regime, and the mark-to-market regime. In addition to the substantive rules, there are significant record-keeping and reporting burdens placed on U.S. shareholders of a foreign corporation that is a CFC or PFIC. The record keeping and reporting obligations are not discussed in this paper, but the authors would like to note briefly that with regard to PFICs, each U.S. shareholder of a PFIC must file a Form 8621, "Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund," to report distributions from or sales of interests in a PFIC, or to make certain elections. There may be additional filing requirements depending on transactions occurring between the U.S. shareholder and the foreign company (e.g., Form 926, "Return of a US Transferor of Property to a Foreign Corporation," to report transfers of property to the foreign corporation).

Following a general discussion of the substantive rules, this column identifies certain areas of challenges in the current rules and proposes some preliminary thoughts on potential ways to improve the current rules.

Definition of a PFIC

A foreign corporation is treated as a PFIC for a tax year if: (1) at least 75% of the corporation's gross income for the year is passive or investment-type income ("income test"), or (2) at least 50% of the average fair market value of its assets during the year are assets that produce or are held for the production of passive income ("asset test").[4] For purposes of these tests, passive income generally includes any income item meeting the definition of "foreign personal holding company income" as defined in Section 954(c), which generally includes, among others, dividends, interest, and net gains from the sale of stock or interests in a trust, partnership, or REMIC.[5] There is a "look-through" rule that treats the assets and income of a second-tier subsidiary as being directly owned by the foreign corporation being evaluated for PFIC status, but it applies only to corporations that are directly or indirectly 25% or more owned by the corporation being evaluated.[6] Thus, all of the income earned by a holding or investment company will most likely be passive income, and the company will qualify as a PFIC.

A PFIC can be organized as a corporation or unit trust but generally is taxed the same in either event. PFICs are generally marketed by large foreign financial institutions, including banks and money managers. For example, UBS, Credit Suisse, Pictet, HSBC, Barclays, Mercury Asset Management, Global Asset Management, and so forth, market PFICs. Major European and Asian papers, including the International Herald Tribune and Financial Times, frequently carry daily or weekly lists of such funds, quoting their current "net asset values." They are also marketed and quoted on the internet. PFICs are usually operated as open-ended investment funds and do not generally distribute current income by way of dividends or other

[4] Section 1297(a).
[5] Section 1297(b)(1).
[6] Section 1297(c).

distributions. An investor usually realizes his or her gains and losses by having shares or "units" redeemed by the fund.

There is no U.S. shareholder control requirement under the PFIC regime; if a U.S. person holds even a de minimus amount of PFIC shares, it potentially will be subject to tax under the PFIC rules. In addition, while the test for determining PFIC status is based upon the income or assets in a given tax year, once a shareholder's investment in a foreign corporation has been characterized as a PFIC, it generally will be treated as a PFIC with respect to that shareholder in future years. This is known as the “PFIC taint” or the "once a PFIC, always a PFIC" rule. There are coordination rules that determine how to tax income subject to both the PFIC and CFC rules. Generally, where a foreign corporation qualifies both as a CFC and PFIC with respect to the same U.S. shareholder after 1997, such foreign corporation is treated solely as a CFC and subject to tax under the subpart F income rules. For this rule to apply, however, the U.S. shareholder must generally make an election
to “purge” the PFIC taint (see discussion below).

PFIC ownership rules

The PFIC regime applies to U.S. taxpayers who directly or indirectly own shares of a PFIC. Indirect ownership rules apply when a foreign trust owns the shares. Shares in a PFIC owned by a trust will be considered as owned proportionately by the beneficiaries of the trust. The U.S. Treasury Department has issued regulations that, though they are in proposed form, are still applicable today.[7] The regulations provide that indirect ownership depends on the facts and circumstances in each case, with the substance rather than the form of ownership

[7] Prop. Reg. 1.1291-1(b)(8)(iii)(C).

controlling. The proposed regulations, however, do not address how to apply the proportionate ownership rules to trusts and their beneficiaries.

PFIC shares directly owned by foreign entities are further attributed to U.S. persons who beneficially own the stock.[8] They apply only when their effect is to treat a U.S. person as the owner of PFIC stock.[9] The attribution rules, however, do not apply to treat stock owned by a U.S. person as owned by another person, except as provided in regulations.[10] If a single person owns, directly or indirectly, 50% or more in value of the stock of a corporation, such person is treated as owning the stock owned directly or indirectly by or for the corporation, in proportion to the value of the stock owned in such corporation.[11] On the other hand, if a person is a minority interest holder in a foreign corporation, the stock owned by the foreign corporation is not treated as owned by him or her unless the intervening corporation is, itself, a PFIC. In that case, the person is treated as owning his or her proportionate share of the stock held by the intervening PFIC.[12]

Options to purchase stock of a PFIC are covered under special rules.[13] These rules provide that an option to acquire stock may be treated as ownership of stock for purposes of the PFIC rules. Proposed regulations provide that, for purposes of the Section 1291 excess distribution regime, an option is considered to be stock.[14] Proposed regulations further provide that the holding period of stock acquired *upon exercise* of an option includes the period the

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[8] Section 1298(a).
[9] Section 1298(a)(1)(A).
[10] Section 1298(a)(1)(B).
[11] Section 1298(a)(2).
[12] Section 1298(1)(2)(B).
[13] Section 1298(a)(4).
[14] Prop. Reg. 1.1291-1(d).

option was held.[15] Thus, it can be concluded that the option to purchase PFIC stock should be treated as actual ownership of stock for the purposes of PFIC analysis.

U.S. federal income taxation of PFIC ownership

If a foreign company meets the requirements of the PFIC income or asset test, the company will be considered a PFIC with respect to each U.S. shareholder in the company. The PFIC regime is essentially a penalty provision. No favorable outcomes or planning opportunities arise once a shareholder falls within these rules.

The general penalty imposed for owning PFIC stock is that certain "excess distributions" from a PFIC, including gains from the sale of PFIC stock, are thrown back ratably over the shareholder's holding period for the stock and subject to tax at the shareholder's highest ordinary income tax rate in each throwback year, rather than the 15% preferential tax rate on qualified dividends and long-term capital gains.[16] The excess distribution rules are designed, in general, to prevent the accumulation of passive income in a foreign corporation in a manner that defers current U.S. taxation on the U.S. investor's portion of such income.

All gain recognized on the disposition of PFIC stock is treated as an "excess distribution." By contrast, some, all, or none of an actual distribution from a PFIC may be treated as an excess distribution. An actual distribution is an excess distribution only to the extent the total of actual distributions during a tax year received by the investor exceeds 125% of the average of actual distributions received in the three preceding tax years.[17] Once the total amount of the excess distribution has been determined, it is allocated ratably to all days in the

[15] Prop. Reg. 1.1291-1(h)(3).
[16] Section 1291(a)(2).
[17] Section 1291(b). Deemed distributions or dispositions with respect to indirectly held PFIC stock may also be subject to the excess distribution rules.

investor's holding period for the stock.[18] Amounts allocated to the pre-PFIC period and the current-year period are totaled and included in the U.S. investor's income as ordinary income.[19] The amounts allocated to the prior-year PFIC period are subject to the highest rate of tax for the year to which allocated, and each of the resulting amounts of tax draws an interest charge as if it were an underpayment of taxes for the year in question. Importantly, amounts allocated to the prior-year PFIC period are never included in the investor's income. Rather, the tax and interest determined under these rules (the "deferred tax amount"), is added to the investor's tax liability, without regard to other tax characteristics of the investor. Thus, the deferred tax amount is a payable tax liability, even though the investor otherwise had a current year loss, or had NOL carryovers.[20]

The tax on “excess distributions” may be avoided if the U.S. shareholder makes certain elections to “purge” the prior PFIC taint. The two principal “purging” elections are the qualified electing fund (QEF) election and the “mark-to-market” election, which are further discussed below.[21]

Taxation of 'qualified electing fund'

Under the QEF election, the U.S. person effectively elects to include in income each year its pro rata share of the PFIC's ordinary earnings and net capital gains.

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[18] This potentially can result in an allocation to three distinct periods--(1) the "pre-PFIC period," i.e., days in the investor's holding period prior to the first day of the first tax year of the foreign corporation in which it was a PFIC; (2) the "current-year period," i.e., days in the investor's tax year in which the excess distribution occurs; and (3) the "prior-year PFIC period," i.e., days in the investor's prior tax years during which the foreign corporation was a PFIC.

[19] Section 1291(a)(1)(B).

[20] The only credit permitted against the deferred tax amount is the special foreign tax credit granted under Section 1291(g).

[21] A PFIC that is not subject to the QEF election or is an "unpedigreed QEF” is known as a “Section 1291 fund." Reg. 1.1291-2(j)(2)(iii).

For each tax year in which the QEF election applies and the PFIC is treated as a QEF, the shareholder must complete Part II of Form 8621 and attach the form to its timely filed tax return. To facilitate this, the PFIC is required to supply each shareholder with a “PFIC Annual Information Statement” (“Annual Statement”). This statement must contain certain information, including the shareholder's pro rata share of the PFIC's ordinary earnings and profits and net capital gain for that tax year or sufficient information for those calculations to be made.

Where a PFIC is a closely held private entity, it may be possible for the U.S. shareholders to cause the PFIC to comply with the Annual Statement requirements. In the Annual Statement, however, the company must state that "it will permit the taxpayer to inspect and copy the permanent books and accounts, records, and such other documents as may be maintained by the PFIC that are necessary to establish that the PFIC ordinary earnings and net capital gain, as provided in section 1293(e) of the Internal Revenue Code, are computed in accordance with U.S. tax principles." In the real world, it may be unrealistic or unpractical to expect the PFIC to make adequate disclosures to support a QEF election since a foreign public company with no U.S. ties will not have any incentive to grant the IRS such access or convert their financial statements to U.S. tax principles.

To maximize the benefit, the QEF election should be filed by the due date of the shareholder's return for the year (including extensions) for the first tax year in which the election will apply.[22] If a “purging” election is not made applicable from the first year that a U.S. shareholder holds stock in the PFIC, the shareholder may be subject to tax under both the “excess distribution” regime and current taxation. In certain limited situations, a shareholder may make a retroactive QEF election (making the election for a tax year after the election due

[22] A PFIC for which the election is made for the first year of a U.S. owner's holding period is considered a pedigreed QEF. See Prop. Reg. 1.1291-1.

date) but only if: (i) the shareholder has preserved its right to make such an election under the protective statement regime, or (ii) the shareholder obtains the permission of the IRS under the consent regime.[23]

Mark-to-market election

A U.S. shareholder of a PFIC who is unable to use the QEF rules may nonetheless avoid taxation for excess distributions by accepting current taxation under the mark-to-market election.[24] A U.S. shareholder of a PFIC can make a mark-to-market election with respect to the stock of the PFIC if the stock is “marketable.” For stock to qualify as "marketable stock," the stock must regularly be traded on a national securities exchange that is registered with the U.S. Securities and Exchange Commission, or a national market system established under section 11A of the Securities and Exchange Act of 1934, or a foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located.

Under the mark-to-market election, the U.S. shareholder includes in income each year an amount equal to the excess, if any, of the fair market value of the PFIC stock as of the close of the tax year over the shareholder's adjusted basis in the stock. Losses, however, are restricted to the amount of current year or accumulated gains.

Amounts included in income under this election, as well as gain on the actual sale or other disposition of the PFIC stock, are treated as ordinary income.[25] If a shareholder makes the mark-to-market election with respect to a PFIC that is a nonqualified fund (i.e., a fund for which a QEF election has not been made) after the beginning of the taxpayer's holding period

[23] Reg. 1.1297-3T.
[24] Section 1296.
[25] Section 1296(a).

with respect to that stock, a coordination rule applies to ensure that the shareholder does not avoid the interest charge with respect to amounts attributable to periods before the mark-to-market election. Except for this coordination rule, the rules of Section 1291 do not apply to the shareholder of the PFIC if a mark-to-market election is in effect for the shareholder's tax year.

In 2010, the IRS offered an alternative tax computation initiative for taxpayers participating in the offshore voluntary disclosure program, in order to address problems many participants in the program faced due to lack of records necessary to determine their tax liability for the unreported years 2003-2008. Under the initiative, PFIC valuation can be done on a basis consistent with the mark-to-market method but without reconstruction of the historical data, and some special rates and limitations apply.[26]

Problems with the current PFIC rules

The current rules regarding taxation of PFICs are highly problematic, starting with the absence of concrete guidance in many aspects of the rules--;i.e., most portions of the PFIC regulations remain in proposed form since the late 1990s! Moreover, the current rules are excessively punitive, requiring significant reporting requirements and costs and, as such, may not be economically feasible or practical. Instead of leveling the playing field between domestic and foreign passive investments, the current PFIC rules penalize the latter significantly.

While its purpose was only to eliminate tax advantage, the PFIC tax treatment currently serves as a punitive tax on PFIC holders. Under the “interest charge” regime, the “deferred tax amount” is taxed as ordinary income, and the dividend or capital gain component is not taxed at the dividend/capital gain rates. Under the “QEF” regime, the pro rata share of the PFIC's net

[26] See the Offshore Voluntary Disclosure Initiative: Passive Foreign Income Company Investment Computations, September 2010, available at: http://www.irs.gov/newsroom/article/0,,id..=228621,00.html.

capital gain is taxed as capital gain, while the pro rata share in the PFIC's ordinary income is taxed as ordinary income. Under the mark-to-market regime, all of the PFIC appreciation is included in the taxpayer's ordinary income. Additionally, as noted above, other deductions and carryover losses, other than foreign tax credits, are not taken into consideration when the "deferred tax amount" is added to the taxpayer's tax liability.

The discrepancy between the tax treatment of U.S. passive investments (under reduced capital gain and qualified dividend tax rates) and non-U.S. ones contradicts the intention of Congress, which was to level the playing field between U.S. and foreign investments. Congress enacted the PFIC rules in 1986 due to a concern "that U.S. persons who invest in passive assets through a foreign investment company obtain a substantial tax advantage vis-à-vis U.S. investors in domestic investment companies because they avoid current taxation and are able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income."[27] Today, since the tax rates on qualified dividends and long-term capital gains are identical, there is no tax disparity between distributions taxed as qualified dividends and long-term capital gains. Thus, the PFIC rules no longer serve to "level the playing field" but instead unduly limit a U.S. person's choices in investments.

The adverse "side-effect" of the current rules is further emphasized by the fact that the current definition of a "PFIC" is overly broad and can capture businesses intended to be engaged in an active trade or business. More specifically, the application of the asset *or* the income test in determining when a foreign corporation should be treated as a PFIC will often result in the classification of an "active" business as a PFIC. Thus, for example, an active

[27] S. Rep. N. 313, 99th Cong., 2d Sess. 393-394 (1986).

foreign corporation that has a bad year with low income or losses from the active enterprise may nonetheless generate enough passive income (such as from a dividend from a portfolio investment) that will cause it to be a PFIC. Additionally, sales and services companies and start-up companies are prone to meet the asset test since they typically do not have significant assets other than working capital, which is passive. The "once a PFIC, always a PFIC" rule further aggravates the adverse side-effect of the current rules.

Thus, there appears to be a need to more squarely define PFICs to be consistent with the intended purpose of preventing tax deferral and leveling the playing field. Perhaps one option might be to require that *both* the income and the asset tests be met before a corporation can be classified as a PFIC (i.e., requiring a certain threshold of passive income *and* passive assets). Another option might be to expand the exceptions to the definition of a PFIC to create safe harbors for active businesses and start-up companies that might get caught under the current PFIC definitions.

The existing "safe harbors" are also problematic. The QEF regime generally is not appropriate to the situation of many U.S. taxpayers. It requires both that a taxpayer make a timely affirmative election to have the regime apply to a particular investment and that the PFIC itself provide a taxpayer with certain financial information. Moreover, in the case of many U.S. taxpayers with accounts in offshore jurisdictions, the decisions to invest in PFIC stock are generally made not by the taxpayers themselves but rather by foreign investment managers, who often do not understand the consequences of the PFIC regime for their customers and do not advise the taxpayers of the possible availability or benefit of making a QEF election. Further, because shares of foreign investment companies generally are not intended to be offered to U.S. persons, such PFICs generally do not keep the financial

information required by U.S. taxpayers making a QEF election and certainly did not provide it to such shareholders. (Foreign investment funds are loathe to become enmeshed in possible violations of U.S. securities laws.)

Difficulties in obtaining information and reconstructing historical data might be relevant not only for the very small investments in PFICs, discussed above, but also to various investors in different settings. The potential difficulties of obtaining information have been recognized by Congress. The Senate Report provides that, "[t]he committee recognizes, however, that the extension of current taxation treatment to U.S. investors in passive foreign investment companies (PFICs) could create difficulties for such investors in cases where the U.S. investors do not have ongoing access to the PFICs' records relating to their earnings and profits… for these reasons, the committee considered it appropriate to adopt a taxing mechanism which allows U.S. investors… to compute their income from the PFIC based upon certain reasonable assumptions…"[28] And, yet, the only viable alternative to the QEF regime is the mark-to-market regime, which has limited application--i.e., the mark-to-market election is conditioned on the PFIC's stock being marketable. Thus, taxpayers with minority interests in non-marketable securities do not have the option of electing current taxation on the investment's earnings on an annual basis.

Finally, the absence of a de minimis rule for minority holdings of a PFIC is also problematic. As noted above, the PFIC regime applies from the first dollar and without any percentage interest requirement. The problem is that many U.S. taxpayers do not choose to acquire interests in PFICs; rather, the decision to enter into such investments is often made by the taxpayer's foreign advisor who may be completely unaware of the potential adverse U.S. tax

[28] See *id*., at 394.

consequences to the investor. Nevertheless, even a U.S. taxpayer with a 0.1% interest in a PFIC is exposed to the full compliance costs associated with PFICs. The application of the complicated PFIC rules, which is beyond the expertise and knowledge of many tax professionals, may not be suitable and justifiable for small investments. Thus, small investors often end up being penalized for their “inadvertent” investments in PFICs.