

Passive Foreign Investment Company Rules Are Complex and Unforgiving

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The passive foreign investment company (PFIC) provisions provide planning opportunities for companies operating abroad through controlled foreign corporations (CFC). Techniques are available to ensure that an operating CFC is not subject to PFIC anti-deferral rules. The authors suggest legislative remedies to prevent unintended results under the PFIC rules.

The Service has released Proposed¹ and Temporary Regulations² on Passive Foreign Investment Companies (PFICs). These are the first substantive proposals under Sections 1291–1297, enacted in 1986 to limit deferral of tax by U.S. investors in offshore funds. This deferral permitted long-term investors to increase their after-tax return from offshore funds, as compared to domestic funds. Offshore funds were generally set up in tax havens so there would be no local tax at the entity level or on distributions. So long as the fund was not more than 50 percent owned by over 5 percent U.S. shareholders, U.S. investors were not subject to U.S. tax until they received dividends from the funds. While many of the funds were set up in Bermuda, due to easy access to world banking systems, secrecy was usually not a significant issue. The funds were often widely traded, so the investor stayed liquid.

Congressional intent was directed primarily at these offshore funds.³ While the committees did not limit the changes to investment funds, their entire discussion centered around perceived abuses related to such funds. The 1986 rules partially coordinate PFIC provisions with Subpart F

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¹ INTL-941-86, INTL-656-87, INTL-704-87 (Mar. 31, 1992).

² TD 8404 (Mar. 31, 1992).

³ See H. Rep. No. 99-426, 99th Cong., 2d Sess., at 408–412, and S. Rep. No. 99-313, 99th Cong., 2d Sess. at 393–395.

(Sections 951–964) and Foreign Personal Holding Company (FPHC, Sections 540–545) rules. Certain unintended consequences still remain, as recognized in proposed legislation.⁴ None of the proposals, however, fully cure the problems with PFIC rules, and do not prevent PFIC status for entities that Congress did not intend to cover under the PFIC rules.

Congress has recognized the need for tax simplification in the PFIC area, and is considering it as part of the Revenue Act of 1992. A discussion of these proposed legislative changes is beyond the scope of this article, and some of the changes may raise additional problem areas. In any event, the interest-charge rules discussed in this article would continue to apply to foreign subsidiaries that qualified as PFICs at any time since 1986 or after the date the new legislative proposals, if passed, take effect.

Background

A PFIC is *any* foreign corporation that meets either of the following tests of Section 1296(a):

1. Passive income exceeds 75 percent of gross income; or
2. The value of assets (including cash) that produce or could produce passive income exceeds 50 percent of total assets.

Examples of foreign corporations that are PFICs include:

1. A subsidiary that has \$10 million of sales, \$9.9 million of cost of sales, and \$400,000 of interest income.
2. An inactive subsidiary with \$100 of interest income and no other income.
3. An inactive corporation with \$100 cash and no other assets.
4. A subsidiary that has \$500,000 of interest-bearing notes receivable from sales, and \$450,000 of inventory, with no other assets.
5. A defunct corporation that has worthless receivables and obsolete, worthless inventory (basis \$1 million), and \$50,000 of financial assets. (PFIC status in this case may be avoided by electing to make the 50 percent asset determination based on tax basis rather than market value.)⁵

Passive income for this purpose includes only income which would be foreign personal holding company (FPHC) income as defined under

⁴ The Tax Simplification Act of 1991, recently revived with little change as H.R. 4210 and S. 2325.

⁵ The election is revocable only with consent.

the Subpart F rules.⁶ Such income normally includes dividends, interest, rents, and royalties. Dividends and interest from a same-country related party,⁷ rents and royalties on same-country property from a related party,⁸ and active business rents and royalties,⁹ however, are not passive income under these rules. Additional exclusions apply to certain banking, insurance, and export finance income.¹⁰ While gross income does not include tax-exempt interest,¹¹ there is no exemption for distributions from such income.

There is no minimum U.S. shareholding required to be a PFIC. Indeed, a foreign corporation can be a PFIC without having any U.S. shareholders, though there is no practical effect under existing law until there are U.S. shareholders. If a U.S. person purchases shares in a foreign corporation that is a PFIC and retains those shares while the corporation continues to be a PFIC, the corporation will be a PFIC as to that shareholder. Arguably, this status may be retained even if the corporation ceases to have the defining attributes of a PFIC at the time the U.S. person acquires the shares, so long as it met the definition of a PFIC during *its* year. Thus, for example, if a U.S. shareholder acquired PFIC shares on the last day of the year, the corporation will be a PFIC with respect to that shareholder (unless the start-up exception discussed below is met).¹²

In the context of an offshore mutual fund, these rules make sense. Shareholders in the offshore fund face anti-deferral rules that treat them the same as investors in domestic funds. For investors in operating companies, however, the rules can cause unintended, and possibly undetected, PFIC status.

A foreign corporation (a holding corporation) that owns at least 25 percent by value of the stock of another foreign corporation can either fall into or be saved from PFIC status as a result of its shareholdings in other companies. Such a holding corporation is, under Section 1296(c), attributed with direct ownership of its proportionate share of the affiliate's assets and receives a proportionate share of the affiliates's income. Thus, a first-tier Dutch subsidiary with its own Dutch operating subsidiaries

⁶ I.R.C. § 1296(b). See I.R.C. § 954(c) and Reg. § 1.954-2T for the definition of foreign personal holding company income.

⁷ Reg. § 1.954-2T(b)(3).

⁸ Reg. § 1.954-2T(b)(4).

⁹ Reg. § 1.954-2T(b)(5).

¹⁰ Reg. § 1.954-2T(b)(2), I.R.C. § 1296(b)(2).

¹¹ I.R.C. § 103.

¹² See I.R.C. §§ 1296(a), 1297(b)(1).

may avoid PFIC status due to this “look through” to the assets and income of these lower tier subsidiaries.

Once a corporation becomes a PFIC with respect to a shareholder, it will continue to be a PFIC with respect to that shareholder until either of two elections (discussed below) purges the PFIC taint.¹³

Effects of PFIC Status

PFIC rules have no direct impact on the foreign corporation. They only affect U.S. shareholders. Shareholders of a PFIC have deferred tax on their share of earnings and appreciation of the PFIC. When they recognize those earnings or appreciation through distributions or sale of the shares of the PFIC, under Section 1291(c) they must pay the tax so deferred plus an interest charge on the deferral for years after 1986. This interest charge is computed at the Section 6621 interest rate for underpayments on “excess distributions” after 1986.

An excess distribution is the gain on disposition of shares plus that part of any distribution in excess of 125 percent of the average distribution for the prior three years. “Distribution” is not explicitly defined. It should include any amount of money or property ceded to a shareholder in connection with the shareholding relationship. The Proposed Regulations confirm this.¹⁴ Thus, a return of capital or a redemption is a distribution, and potentially also an excess distribution.¹⁵

The excess distribution is carved out of regular taxable income (to the extent otherwise included therein) and taxed separately. First it is allocated ratably over the days the shareholder held the stock. Tax is then computed on this allocated excess distribution at the maximum rates in effect for the taxable year to which it was so allocated. A foreign tax credit (FTC) is allowed only against this separate tax, in a manner similar to Section 902. No carryover or carryback is allowed except with respect to the excess distribution.¹⁶

Current year tax is increased by the deferred tax plus interest. This interest charge is computed as if the deferred tax were an underpayment for prior years to which the excess is attributed. Interest on underpayments (including PFIC deferred tax) can exceed the tax. Excess distributions

¹³ I.R.C. § 1297(b)(1).

¹⁴ See also Prop. Reg. § 1.1291-2(b)(1).

¹⁵ Under Prop. Reg. § 1.1291-2(b)(1), certain redemption distributions are, under I.R.C. § 302(d), treated as received in exchange for stock. Such distributions will be treated as excess distributions only to the extent of gain.

¹⁶ I.R.C. § 1291(g); Prop. Reg. § 1.1291-5(b)(2), 1.1291-5(c)(2).

attributable to periods before 1986 are not counted in making this calculation, and remain in taxable income.

Thus, the principal effect of PFIC status is to change the timing of recognition of income and to impose an interest charge on deemed underpayments for prior years. The shareholder is in the same economic position as if he had received uniform, taxable distributions from the PFIC. Again, this statutory scheme makes sense in the context of the foreign mutual fund.

Once a foreign corporation is a PFIC, this deferred tax and interest regime (the "PFIC tax regime") applies to any excess distributions, regardless of whether the underlying earnings arose in years the PFIC test was met. Thus, for the U.S. investor, it's a case of "once a PFIC, always a PFIC."¹⁷

Avoiding the Interest Charge: The QEF Election

The PFIC interest charge is imposed on the tax deferred on all excess distributions. There are only three ways to avoid this PFIC interest charge: (1) avoid PFIC status or excess distributions, (2) elect treatment as a qualifying electing fund (QEF), or (3) pay foreign taxes at the PFIC level at rates in excess of the shareholder's top marginal rate, thus fully offsetting the PFIC tax with foreign tax credit. A shareholder of a PFIC may elect to treat the PFIC as a QEF and currently include its pro rata share of the PFIC's realized earnings and gains in income in years in which the PFIC test is met. A QEF election, if made in the first PFIC year, generally will not require including operating earnings in the shareholder's income except in years where either PFIC test is met.¹⁸ The QEF election, once made, is revocable only with Service consent.¹⁹

The QEF election works as Congress intended for a foreign mutual fund, putting shareholders in nearly the same position as if they had invested in a regulated investment company (RIC) under Section 852, which generally must distribute its entire income each year. A RIC is taxed only at the shareholder level, provided it distributes at least 90 percent of its ordinary income each year. Shareholders of a RIC are taxed on distributions from ordinary income plus their share of capital gains. The character of tax exempt interest flows through to the shareholders.

The QEF election, which applies only to the shareholder making

¹⁷ See I.R.C. § 1297(b)(1): "Stock held by a taxpayer shall be treated as stock in a passive foreign investment company if, at any time during the holding period of the taxpayer" the corporation was a PFIC.

¹⁸ Prop. Reg. § 1.1293-1(a)

¹⁹ I.R.C. § 1295(b)(1).

the election,²⁰ has the effect of removing the interest charge if the election has been in effect for every PFIC year.²¹ If, however, the election is missed the first year, the interest charge will apply at least in part unless a “mark-to-market” or “deemed sale” election is made.

Purging PFIC Taint

Using either the mark-to-market or deemed sale elections, the shareholder may purge PFIC taint by recognizing gain (and paying tax under the PFIC tax regime) as if the shares were sold for fair market value on the first day of the taxable year.²² This may require payment of substantial tax and interest, and will likely require an appraisal to determine fair market value. Upon making the election, basis is adjusted upwards for gain recognized, and the holding period begins again.²³ This cure may be worse than the disease on a current basis, but may prevent more serious future problems. Early detection of PFIC status may greatly reduce the cost of this election.

An alternative and less harsh election is available for shareholders of CFCs. The shareholder may purge PFIC taint by including in income as an excess distribution his pro rata share of post-1986 earnings and profits (E&P). This excess distribution is ratably allocated only to post-1986 days. It is also treated as distributed under Section 1248 for determining previously taxed amounts under Section 959.²⁴ Further, deemed paid foreign tax credits are available as with other excess distributions.²⁵

No distinction is made between E&P of PFIC and non-PFIC years. All post-86 E&P is included. This could be harsh treatment where the parent has severe current limitations on foreign tax credits, or where the CFC's foreign taxes are less than the U.S. rate. The authors believe that the law should be revised to provide that only PFIC-year E&P is an excess distribution on making the CFC deemed dividend election.

This CFC deemed dividend election, however, does not require the

²⁰ Prop. Reg. § 1.1295-1(b)(1).

²¹ I.R.C. § 1291(d)(1) states, in part, “[the interest charge] shall not apply . . . if such company is a qualified electing fund with respect to the taxpayer for each of its taxable years [after 1986] . . . which includes any portion of the taxpayer's holding period.”

²² I.R.C. § 1291(d)(2)(A), for companies continuing to be PFICs that make a QEF election, and § 1297(b)(1) for companies ceasing to be a PFIC without the QEF election.

²³ I.R.C. § 1291(d)(2)(C).

²⁴ I.R.C. § 1291(d)(2)(B). This amount is subject to adjustment under yet to be prescribed regulations.

²⁵ I.R.C. § 1291(g).

immediate recognition of unrealized appreciation of the CFC. This could be of great benefit, at perhaps little cost, to shareholders of a CFC with small earnings but substantial growth in value.

The QEF election and the two gain-recognition elections must be made by the extended due date of the shareholders' tax return.²⁶

Tax Deferral Election

Another election is available under current law that can limit interest charge exposure with no current tax cost. A shareholder may elect QEF status and also elect to defer actual payment of the tax. An interest charge is imposed on the deferred tax payment in the same manner as the PFIC tax regime. This election does not apply to QEF earnings also includable under Subpart F or the FPHC provisions.

The advantage of this election is that it will trigger tax and interest only on recognized income or gain, not on unrecognized appreciation in assets. On eventual recognition, such as by sale of the shares, no interest charge will be due.

Problem Areas

The following discussion focuses on situations where PFIC provisions can cause problems due to their complexity and application to a wider range of entities than perhaps Congress intended:

Inadvertent PFIC Status

The gross income test is based on gross income, not revenues. Gross income is sales plus other income less cost of goods sold. This test can lead to PFIC status for a manufacturing subsidiary or sales subsidiary. Under proper cost accounting and Section 263A, most manufacturing costs must be capitalized to inventory, leading to higher cost of sales when the products are sold. In a down year when price cutting is needed to stay afloat (common in many industries), a company may have a negative gross income from sales. In such years, prudent cash management will result in meeting the existing 75 percent of gross income test, since all non-passive gross income will be a loss. If the company is a foreign corporation, it then becomes a PFIC. This PFIC taint remains until purged. Thus, future distributions or sale of the shares invoke the PFIC tax regime.

This purely gross income test can thus result in manufacturing or sales subsidiaries being PFICs. This result was certainly not intended.

²⁶ I.R.C. § 1295(b)(2).

Treasury is currently considering additional corrective legislation,²⁷ but the corrections have not yet been incorporated into current legislative proposals.

The planning opportunity is to detect PFIC status on a timely basis and make the QEF election. Since the QEF election lasts forever, passing through profits but not losses, it should only be made when necessary. Further, if corrective legislation is passed, what happens to those prudent companies that elected QEF status for operating subsidiaries?

Example 1. Bigco, a U.S. corporation, owns 100 percent of Odometer GmbH., a German car manufacturer. In 1988, due to foreign competition, Odometer must cut its prices below full absorption cost, and incurs a \$1 billion negative gross margin. It earns \$1 million interest in cash management activities. Odometer is a PFIC despite the overall loss.

Several inventory costing strategies can avoid this problem for a manufacturing subsidiary. Strike costs are not required to be capitalized under Section 263A. This and other cost accounting decisions, however, should be carefully considered in light of Proposed Regulations that obviate the need for Section 263A adjustments.²⁸ Further, changes of practice in this area should be reviewed for possible changes in method of accounting.

The authors recommend that a gross receipts requirement be added to the gross income test of Section 1296(a)(1). The new clause could read as follows: “(1) 75 percent or more of the gross income and 10 percent or more of the gross receipts of such corporation for the taxable year are passive income.”²⁹ This would preclude PFIC status for most manufacturing or sales companies. Other possible improvements include making the new definition of a PFIC retroactive to years after 1986 at the shareholder’s election, and providing a high-tax exception to the PFIC income definition in coordination with Subpart F.

Missed Elections

The harshness of PFIC treatment and of the methods of removing PFIC taint point out the hazards of failing to timely detect PFIC status. If a company suddenly becomes a PFIC, it is imperative to make the QEF election to avoid the deferred tax/interest charge regime. In Example 2, below, if the QEF election had been made the first year, there would be

²⁷ According to the authors’ conversations with IRS officials.

²⁸ Prop. Reg. § 1.1964-1(c)(ii)(B).

²⁹ The authors believe that few operating companies would exceed this 10 percent limit.

no deferred tax or interest charge, and tax would be only \$340,000 (34 percent assumed tax rate times \$1 million gain). The cost of failing to detect PFIC status is over \$731,000 (assuming 10 percent interest). Since the PFIC is also a CFC, however, the Section 1291(d)(2)(B) election can be made at minimal cost in the year of the sale (if the tax adviser detects the problem) and the interest charge will be avoided.

PFIC elections, including the QEF, mark-to-market, and CFC elections, must be made by the extended due date of the shareholder's tax return.³⁰ No provision exists for later election. Thus, an error in preparing a tax return wherein PFIC status was not detected and QEF status not elected is not curable.

Fortunately, there may be relief available in future Regulations for missed elections, within limits. Section 1295(b)(2) provides that, to the extent provided in (not yet released) Regulations, a QEF election may be made later than the original return due date, where the taxpayer fails to make a timely election because the taxpayer reasonably believed that the company was not a PFIC. There must be some reasonable basis to believe the corporation was not a PFIC. Mere inadvertence does not seem to qualify. The authors believe that elections should be allowed on amended returns.

Pro Rata Allocation

Upon an excess distribution, including when PFIC stock is sold, any income or gain is automatically considered earned pro rata.³¹ The actual pattern of earnings or appreciation is ignored. Actual earnings don't count, merely the ratable allocation of earnings or gain. This can result in distortions where there has been no deferral of tax under regular tax principles but only unrealized appreciation. This is the case even if the appreciation all occurred at the end of the holding period. While Congress clearly intended this result for portfolio investments (it is similar to the mark-to-market concepts of Section 1256), the authors believe that the result in other cases was not intended and should be changed. It is, however, beyond the Service's power to fix this problem in Regulations.

Example 2. LandCo, a German corporate subsidiary of a U.S. corporation, owned land held for development and \$100 cash in an interest bearing bank account. For 20 years after 1986, its only income was bank interest (\$5 per year), which was distributed. On day 1 of year 21, with a basis of

³⁰ I.R.C. § 1295(b); Reg. §§ 1.1291-9T(c), 1.1291-10T(c).

³¹ I.R.C. § 1291(a)(1)(a) requires allocation "ratably to each day in the taxpayer's holding period."

\$1 million, development efforts having failed, the shareholder sells LandCo for \$2 million, the appreciated value of the land. There has been no deferral of income under U.S. tax principles, but the PFIC rules still apply.

In this example, the tax and interest would exceed the gain. In such a case, the shareholder would be better off selling the land for \$1 million!

Mandatory Gain Recognition

The Service can override by Regulation any nonrecognition provision in relation to PFICs.³² Unfortunately, the proposed Regulations are not sparing in the application of this rule. Gain must be recognized in most cases. This could have disastrous consequences on an inadvertent PFIC, requiring recognition of unrealized appreciation in restructurings otherwise tax free.³³

The authors believe the sense of the proposed nonrecognition rules should be reversed to keep the current provision allowing nonrecognition except as provided in Regulations, with required recognition only in certain specified cases.

Inadvertent Disposition

Pledging shares of a PFIC as security for a loan is considered a disposition at the date of pledge. The consideration is the lesser of market value or the obligation underlying the pledge, with gain treated as an excess distribution.³⁴ Contrast this treatment to that accorded a CFC: a pledge of CFC stock is considered an investment in U.S. property, and thus a deemed dividend, only if outstanding at year end. Further, under the CFC rules, a pledge of CFC shares does not trigger deemed dividend treatment unless it is a pledge of more than two thirds of the stock and is accompanied by negative covenants.³⁵

The authors have experienced a significant incidence of banks requiring companies to pledge all assets, including shares of subsidiaries, before granting a loan.³⁶ Often, banks also require cross guarantees and pledging of subsidiary assets. For both PFICs and CFCs the results are often inclusions of all the previously deferred earnings. The consequences

³² I.R.C. § 1291(f); Prop. Reg. § 1.1291-6.

³³ For example, foreign to foreign reorganizations or liquidations, now tax free under I.R.C. § 367(b), trigger gain under Prop. Reg. § 1.1291-6(a)(2). See Prop. Reg. § 1.1291-6(c) for numerous exceptions beyond the scope of this article.

³⁴ I.R.C. § 1297(b)(6); Prop. Reg. § 1.1291-3(d).

³⁵ Reg. § 1.956-2(c)(2).

³⁶ The authors recognize the appropriateness of treating loans taken against the value of a CFC as deemed dividends. See I.R.C. § 956.

can be especially onerous for shareholders of a PFIC, since this results in excess distribution treatment for amounts that otherwise might have been distributed (either currently or over time) without the PFIC tax and interest, under the 125-percent rule.

Tax advisers can often educate banks to the tax problems of such pledges and guarantees, with the result that a bank will seek other collateral more palatable to the taxpayer. With CFCs, even if the loan documents are signed before the tax effects are apparent, corrective action can still avoid the problem if taken before year end.³⁷ Further, the bank may be convinced to waive any negative covenants with regard to CFC assets. With a PFIC, however, the mere act of pledging causes the deemed sale. Thus, once documents are in place, tax will be imposed. In our opinion, the anti-pledging test should pertain only at year's end, as for CFCs.

FSCs as PFICs

A Foreign Sales Corporation (FSC) can be a PFIC. No Section or regulatory provision exempts a FSC from the PFIC definition. Such omission of exemption was apparently an oversight in drafting, as indicated by corrective proposals advanced by Treasury.³⁸ A commission FSC normally distributes its income and has few passive assets. Buy-sell FSCs have substantial non-passive assets. Neither has much passive income, and thus neither would likely be a PFIC. An FSC that rents assets, however, will be a PFIC if it has inadequate non-passive income and assets.

Prior to the PFIC rules, a rental FSC received the following treatment:

1. The FSC was subject to Section 482 pricing, since it had economic substance (ownership of assets).³⁹ As such, all income was not subject to U.S. tax at the FSC level if the assets were outside the U.S.⁴⁰
2. The non-exempt portion was FPHC income, includable in the shareholder's income currently under Subpart F and was not again taxed when distributed.⁴¹

³⁷ For the effects of rescission during or after the tax year, see Rev. Rul. 80-58, 1981-1 C.B. 181, and *Penn v. Comm'r*, 115 F.2d 167 (4th Cir. 1940).

³⁸ Note 4, *supra*.

³⁹ See, e.g., Reg. § 1.482-2(c)(2).

⁴⁰ I.R.C. § 921(d)(1).

⁴¹ I.R.C. §§ 954(c), 959.

3. The FSC's exempt income was subject to the dividends received deduction (DRD) when distributed.⁴²

This treatment is destroyed with the QEF election. QEF inclusions are not dividends subject to the DRD. They are taxed only once, however, by operation of Sections 959 and 1295.

A rental FSC faces two major PFIC problems:

1. If the shareholder elects to treat the FSC as a QEF, all FSC benefits will be lost. Qualified electing fund earnings and gains on dispositions are not eligible for the 100 percent dividends received deduction (DRD) normally granted to FSC dividends.
2. If the shareholder does not elect QEF treatment, all distributions will be subject to the deferred tax and interest treatment. This cancels the benefit of the DRD.⁴³

Under Proposed Regulations,⁴⁴ a distribution in liquidation or redemption is a disposition rather than a distribution. Thus, a complete liquidation will be equivalent to a sale. Where the FSC/PFIC has only one corporate shareholder, a redemption is always a dividend.⁴⁵ Failing to elect QEF status could have costly results if the underlying assets are sold and the FSC partially liquidated as the entire distribution of proceeds could be an excess distribution. One way to limit PFIC problems for a rental FSC is to make the QEF election and make a large return of capital distribution the first year, thus establishing a pattern of large distributions for the 125-percent rule. This, however, results in complete loss of FSC benefits.

A properly constituted discretionary commission FSC does not run afoul of PFIC rules, since its sole income is non-passive.⁴⁶ A commission FSC can be used in conjunction with a rental arrangement, so ownership of the rental assets is not required.

⁴² I.R.C. § 245(c).

⁴³ Again, the distributions are not treated as dividends. Under the PFIC tax regime, the dividends are excluded from current income but are subject to a separately computed tax, as discussed above. Current distribution of earnings solves this problem *only* if the distributions meet the 125 percent rule *and* the shareholder's marginal tax rate is the maximum tax rate for that type of taxpayer.

⁴⁴ Prop. Reg. §§ 1.1291-2(b)(1), 1.1291-3(b)(1).

⁴⁵ See, e.g., Davis, 397 US 301 (1970).

⁴⁶ All FSCs should be paid commissions at the discretion of the related suppliers, subject to Section 925. Such a FSC is not only simpler to maintain, it avoids a host of other problems.

Local Currency Determination

The determination of whether there has been an excess distribution is normally made in U.S. dollars.⁴⁷ If all distributions are in another currency, however, then the determination is made in that currency.⁴⁸ If this is a currency where inflation exceeds about 11 percent per year, level dollar distributions cause excess distributions. This rule applies “if the distributions are received in a foreign currency.”⁴⁹

Annualization

Under Section 1291(b)(3)(C), on which no Regulations have been issued, if the taxpayer does not hold the stock during the entire taxable year, distributions received during the year are to be annualized to determine how much is “excess.” This could result in serious distortions if a shareholder disposes of his stock early in the year after receiving an annual distribution.

Start-Up and Change-of-Business Rules

A foreign corporation avoids PFIC status its first tax year.⁵⁰ If a foreign corporation stays dormant with cash or an intercompany receivable as its principal assets for the following year, however, it is a PFIC. Such companies will likely be PFICs with respect to a shareholder who holds company stock beyond this permitted period. Such companies should be purged before being used. This purging requires a QEF election that is irrevocable and perhaps undesirable.

The start-up rule is based on fiscal years. PFIC status can be avoided for the first taxable year, not for the first twelve months. For example, assume a calendar year corporation is formed December 30th, year one, and stays dormant for eleven months. The corporation is funded December 1st, year two, and realizes its first sales income the following month, in year three. If the company had \$1 of interest income on idle cash in year two, it will forever be a PFIC: The year of first sales was its third year, and it had only passive income its second year. The same problem could befall a manufacturing subsidiary with similar timing of formation that was building a plant during its “second” year.

Where a foreign corporation changes or disposes of its business,

⁴⁷ Prop. Reg. § 1.1291-2(d)(4)(i).

⁴⁸ Prop. Reg. § 1.1291-2(d)(4)(ii).

⁴⁹ I.R.C. § 1291(b)(3)(D), emphasis added, clarified by Prop. Reg. § 1.1291-2(d)(4)(ii) to read “made in a single currency (other than the U.S. dollar).”

⁵⁰ I.R.C. § 1297(b)(2).

under Section 1297(b)(3) it may qualify under an exception to PFIC status during a transition year. To qualify, however, the foreign corporation must never have been a PFIC and must not be a PFIC in either of the two years following the change-of-business year. If the corporation was an inadvertent PFIC, this exception is unavailable. On the sale of a business, if distribution of the proceeds is delayed until the next tax year, the second half of the test may be failed, and the corporation may be a PFIC the year following the sale.

The start-up and change-of-business rules should be revised to provide that the permitted passive income period runs to the end of the year following the year of start-up or sale of a business.

125 Percent of What Distribution?

In computing excess distributions, only prior distributions not subject to the PFIC deferred tax regime are included in the base for the three-year average.⁵¹ This anti-avoidance measure was adopted in 1988 to prevent shareholders from taking a one-time hit to increase the distribution base. It effectively caps distribution growth at an annual 12 percent—the percentage which, compounded over three years, yields an increase to 125 percent of the three-year average.

“Distribution” is not defined in the PFIC sections. The Proposed Regulations define a distribution as “any actual or constructive transfer of money or property,” with certain exceptions.⁵² This provides a useful way to plan around the rules for a new company: Simply contribute extra cash, and then withdraw the cash after a short period.⁵³ Since the excess distribution rule does not apply to the first year, this strategy may provide a high base upon which to base the 125 percent calculation. Local foreign law may, however, prevent this technique or result in an additional capital tax on the extra contribution.

Deemed Distributions Are Excess Distributions

Making the CFC deemed dividend election causes an excess distribution. Under the new Temporary Regulations, the CFC deemed dividend is taxed as an excess distribution in full.⁵⁴ This results in the application of the PFIC tax regime even where there was a sufficient pattern of

⁵¹ I.R.C. § 1291(b)(2)(A).

⁵² Prop. Reg. § 1.1291-2(b)(1), which does not define “property.” Distributions qualifying as nontaxable distributions of the stock of the corporation under I.R.C. § 305(a) or § 355(a) will not be treated as distributions for these rules.

⁵³ Query, at what point does this run afoul of the step-transaction doctrine?

⁵⁴ Temp Reg. § 1.1291-9T(a)(1).

distributions to absorb an actual distribution in the same amount. This can be avoided in some cases by making an actual distribution to wipe out E&P before making the CFC deemed dividend election. The deemed dividend is limited to positive E&P, and is effective even if zero in amount.⁵⁵

Example 3. Peach Corp. is a CFC with earnings of \$100 per year. It has distributed \$90 each year. In 1996 it becomes an inadvertent PFIC when it had ending retained post-1986 E&P of \$100. If Peach Corp.'s parent detects the problem and makes the deemed dividend election on its 1997 return, it will have an excess distribution of \$100.⁵⁶ If it first distributes \$12.5 then makes the election the following year, it will have an excess distribution of only \$87.5.

Further, such a distribution will alleviate the foreign tax credit problems associated with excess distributions, as discussed below.

This current distribution pattern can be extended for several years to reduce retained E&P to zero before making the QEF election. Also, the "distribution" could be accomplished by a Section 956 investment in U.S. property, such as a loan to a U.S. affiliate. The authors recommend that Section 1291 be revised so that only PFIC-year E&P is an excess distribution on making the CFC deemed dividend election.

Failure to Demonstrate E&P

The Temporary Regulations require that "the shareholder must attach a schedule to Form 8621 that demonstrates the calculation" of includable E&P when making the CFC Deemed Dividend election.⁵⁷ As worded, failure to attach such a schedule invalidates the election. Further, it appears that an aggressive Service agent could contend that the election is invalid if there are errors in the calculation, or if it is presented in what the agent considers inadequate detail. The calculation must be "demonstrated" to the satisfaction of the Service.

The Service should clarify what is meant by the requirement that E&P be demonstrated in a statement attached to the electing shareholder's return.

Elections Only in PFIC Years

Temporary Regulation 1.1291-9T(h)(2) states that the QEF election "may not be made if the corporation does not qualify as a PFIC" in the

⁵⁵ Reg. § 1.1291-9T(b).

⁵⁶ Under Reg. § 1.1291-9T(a)(1), the entire deemed dividend is considered an excess distribution.

⁵⁷ Temp. Reg. § 1.1291-9T(d)(1).

year the election is intended to apply. Thus, if a CFC becomes a PFIC one year, the purging election may not be made until the next year in which it is actually a PFIC. The election would appear to work the second PFIC year, but this is little consolation for the undetected inadvertent PFIC.⁵⁸ For example, if a CFC becomes a PFIC but does not qualify as a PFIC again for ten years, the shareholder faces ten years of interest charge on any PFIC E&P on making a purging election the next year it is available. The authors believe the CFC deemed election should be permitted for any year and allowed on amended returns.

Section 78 Inclusion

When a corporation distributes a dividend to its 10 percent or more corporate shareholder in a year the shareholder has elected to credit foreign taxes, the shareholder must include in its income the amount of flow-through taxes attributable to the dividend. The Proposed Regulations include this amount in the definition of distribution for calculating excess distributions.⁵⁹ This could be either an advantage or disadvantage. For example, the Section 78 amount will tend to inflate prior distributions where the PFIC experiences declining tax rates (e.g., in the U.K. in the mid-1980s). Alternatively, if the subsidiary's effective current tax rate increases dramatically, such as due to expiration of a tax holiday, this alone can cause a cash distribution equal to the prior three years' average cash distribution to be an excess distribution.

In the author's opinion, there should be a change in the law to exclude Section 78 grossup from the calculation of whether a distribution exceeds 125 percent of the average distribution for the prior three years.

Deemed Sale of Pledged Stock (Revisited)

As discussed above, when PFIC stock is pledged, the lesser of the value of the stock or the amount of the obligation guaranteed is treated as proceeds on disposition. Under the Proposed Regulations, this rule is applied where stock has been previously pledged and the foreign corporation becomes a PFIC.⁶⁰ This can be especially burdensome to a shareholder who has structured pledges to comply with the two-thirds rule in the CFC

⁵⁸ Of course, "protective" QEF elections can be made. As discussed elsewhere in this article, however, there may be significant disadvantages to QEF elections.

⁵⁹ Prop. Reg. § 1.1291-2(b)(1).

⁶⁰ Prop. Reg. § 1.1291-3(d)(1). Note that under subparagraph (3), the deemed sale treatment does not apply if the shareholder would recognize a loss.

Regulations, discussed above, since there is no exception for pledges of less than two-thirds of the stock.⁶¹

Relief should be provided such that previously pledged stock, which did not result in Section 956 treatment (e.g., because of the two-thirds rule), does not result in deemed sale treatment immediately upon the CFC becoming a PFIC.

Limited Flow-Through of Foreign Tax Credits

In general, foreign taxes may be either deducted or credited at the choice of the taxpayer. This choice may be made or changed for ten years after the tax return due date.⁶² While credits are usually more beneficial, deductions may be chosen because of limits on utilization of credits. Foreign taxes paid by 10 percent or more corporate subsidiaries "flow through" with dividends and may be used to offset the shareholder's taxes.⁶³

The Proposed Regulations allow the use of foreign taxes as credits in computing the PFIC tax on excess distributions only if the shareholder elects credits in the current year.⁶⁴ This can force a taxpayer to choose an undesirable result for a particular year in order to prevent worse results because of PFIC distributions. There is no correlation between the credit election in the year to which the excess distribution is ratably allocated and the allowance of credits against excess distribution taxes. This can be either an advantage or disadvantage as shown in the following examples.

Example 4. US Co. owns 40 percent of Fore Corp., a foreign corporation. Fore Corp. is a PFIC whose other shareholders are not U.S. persons. Fore Corp. earns substantial profits and pays substantial tax. US Co. also operates a profitable branch in a foreign country, paying foreign tax at 50 percent of its pretax income. In 1991, US Co. incurs a U.S. net operating loss that substantially exceeds its aggregate 1988, 1989, and 1990 taxable income. If Fore Corp. makes no excess distribution in 1991, US Co. should choose to deduct foreign taxes for 1988 through 1991, if it has determined that credits would be worthless.⁶⁵ However, if it makes an

⁶¹ Reg. § 1.956-2(1)(2), for which there is no counterpart in the PFIC regulations, excludes pledges of up to two thirds of stock of a CFC from the definition of U.S. property for purposes of deemed dividend treatment under I.R.C. § 956.

⁶² I.R.C. § 6511(d)(3).

⁶³ I.R.C. § 902.

⁶⁴ Prop Reg. § 1.1291-5(a).

⁶⁵ Subject to any value of carryovers. Note that the 1988-1991 returns can later be amended to again claim credits if carryforward credits can be used.

excess distribution in 1991, US Co. must weigh the cost of lost deductions for branch foreign taxes for 1988 through 1991 against the cost of lost credits for the PFIC foreign taxes.

Example 5. Assume the same facts as in the previous example and that Fore Corp. makes no excess distribution in 1991. Also, US Co. has profits in 1992 in excess of loss carryovers and can use its foreign tax credits (subject to the Section 904 limit). If Fore Corp. makes an excess distribution in 1992, it may choose foreign tax credits and use them to offset PFIC taxes for all post-86 years, regardless of the choice of deductions for 1988–1991.

The authors believe that the rules on flow-through of foreign taxes should follow Sections 902 and 960.

No Carryover of Foreign Tax Credits

Under normal foreign tax credit rules, excess foreign tax credits (FTCs) may be carried back two years and forward five. FTCs on excess distributions, however, are limited under the Proposed Regulations to the year to which attributed.⁶⁶ Since the excess distribution and creditable taxes are both allocated pro rata to the holding period, this will cause problems only where U.S. tax rates change from year to year. In addition, the lack of carryover coupled with the lack of aggregation inherent in the PFIC tax regime can cause loss of benefit of otherwise creditable foreign taxes due to an excess distribution.

Example 6. Assume PFIC1 makes an excess distribution allocable to 1991 and 1992 of \$2 million cash plus \$1.2 million of Section 78 grossup (and creditable tax). PFIC2 makes an excess distribution allocable to 1992 of \$1 million with no tax. Under the Proposed Regulations, which determine FTCs separately for separate excess distributions, the corporate shareholder can use \$544,000⁶⁷ of credit per year. Had the distributions not been excess distributions, the \$600,000 creditable taxes for 1992 would be used in full.

The Regulations should be revised to integrate the calculation of foreign tax credits on excess distributions with that for calculating regular taxable income in a manner similar to Section 1341, with a *de minimis* exception, and allow carryover and carryback of excess credits.

⁶⁶ Prop. Reg. §§ 1.1291-5(b)(2), 1.1291-5(c)(2). Note that the proposed regulations omit guidance on carryovers related to noncontrolled I.R.C. § 902 corporations.

⁶⁷ 34 percent of (\$1,000,000 + \$600,000). No credits are available to offset tax on the \$1 million distribution from PFIC2.

Distributions in Excess of E&P Are Passive Basket

Consistent with the treatment of excess distributions as equivalent to a sale, the amount of any excess distribution in excess of E&P is passive basket income.⁶⁸ This converts an otherwise nontaxable return of capital distribution into a payment subject to the PFIC tax regime. While basis in the PFIC shares is stepped up, this may provide little relief, since it may only serve to create or increase a capital loss on liquidation or disposition of the PFIC shares.⁶⁹

Gain Recognition by Decedents

Generally gain or loss is not recognized by a decedent on death. However, the Proposed Regulations provide for gain recognition by the decedent on death if the decedent's estate has any foreign beneficiaries or the will provides for transfers of the PFIC shares to a trust.⁷⁰ Thus, if a taxpayer dies while owning shares of a PFIC and leaves his foreign cousin \$100 cash, his entire PFIC shares, which may have been transferred to U.S. persons, will be considered sold at fair market value. Also, if the estate incorporates a QTIP trust to which the PFIC shares are transferred, deemed sale will occur. In either case, gain is recognized and subject to the excess distribution tax and interest.

Gain Recognition on Partnership Distribution

Partners generally do not recognize gain on distributions of assets.⁷¹ This rule is continued for PFIC stock, subject to an exception under the Proposed Regulations. Nonrecognition applies only to the extent the partner owns the PFIC stock after the distribution.⁷² Thus PFIC stock is similar to Section 751 assets. Proper planning of distributions can avoid, to the extent possible, possible inequitable application of this rule.

Gain Recognition on S Corporation Contribution

A similar rule applies to Section 351 contributions to S corporations that result in a decrease of proportionate ownership of the PFIC stock.⁷³

⁶⁸ Prop. Reg. § 1.1291-5(c)(1)(i)(C), referring to the separate limitation category in I.R.C. § 904(d)(1)(A). Note that distributions from a non-PFIC CFC in excess of its E&P are treated as a return of capital then capital gain. See I.R.C. §§ 1248, 301, *et seq.* Such capital gains are passive income under I.R.C. § 904(d)(1)(A).

⁶⁹ However, see I.R.C. § 165(g) for ordinary loss on abandonment.

⁷⁰ Prop. Reg. § 1.1291-6(c)(3)(iii)(B).

⁷¹ I.R.C. § 731. Exceptions apply to cause recognition of gain on distribution of cash or "hot" assets under I.R.C. § 751.

⁷² Prop. Reg. § 1.1291-6(c)(3)(ii).

⁷³ Prop. Reg. § 1.1291-6(c)(3)(iii).

The only way to avoid gain recognition for a less than 100 percent shareholder is not to transfer PFIC shares to an S corporation. Note that with the proportionate attribution rules, gain will be recognized only on the difference between 100 percent and the shareholder's post-contribution ownership percentage.

The Service should revise the Proposed Regulations to conform gain recognition for decedents, partners, and S corporation shareholders to other gain recognition rules for those taxpayers.

Conclusion

As part of tax planning and analysis, the taxpayer and its advisers should review PFIC exposure for all foreign companies with U.S. shareholders. For both actual and potential PFICs, the taxpayer should be detecting PFIC issues, avoiding PFIC excess distributions, and planning distributions to reduce PFIC effects. Errors in applying the PFIC rules can be costly, since many PFIC errors cannot be corrected after the fact.