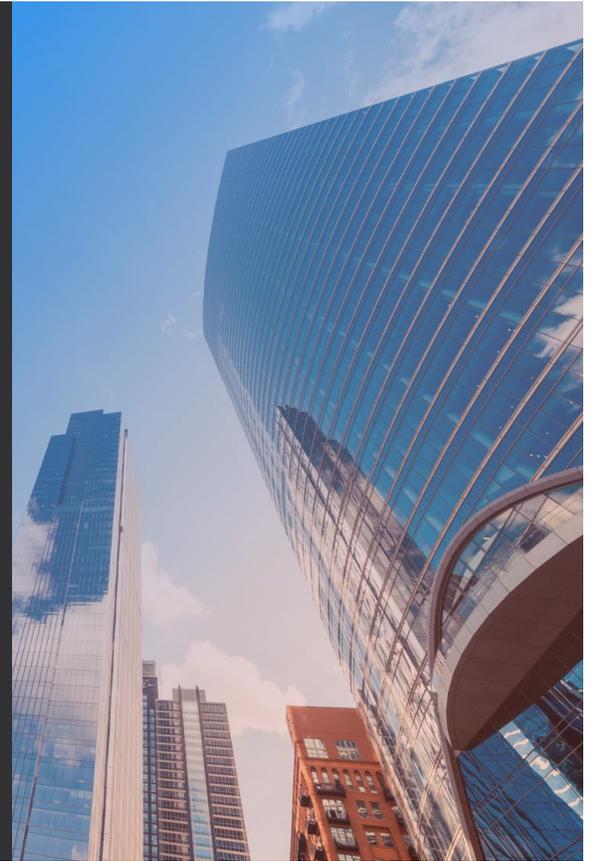




# Focusing on PFICs

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## Focusing on PFICs: Certain Fun Facts



Enacted as part of the 1986 Tax Reform Act.



“Sort of” repealed in the 1997 Taxpayer Relief Act for US multinational companies. Still highly relevant for closely held foreign corporations with US investors.



Perhaps the most common four-letter word in the international tax lexicon.

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FENWICK

ANDERSEN 

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# AGENDA



Refresher on Basics of PFIC Taxation



Common Pitfalls



Purging elections



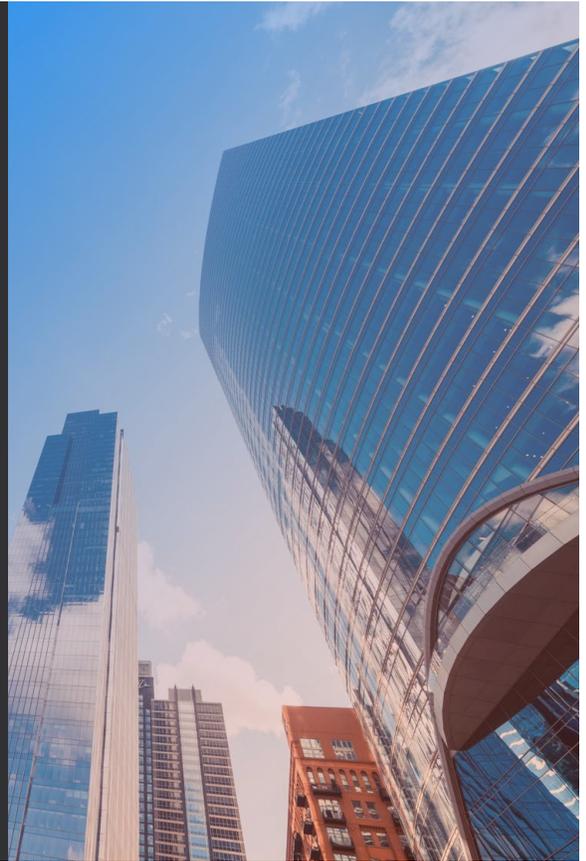
Aggregate vs. Entity treatment for domestic partnerships investing in PFICs

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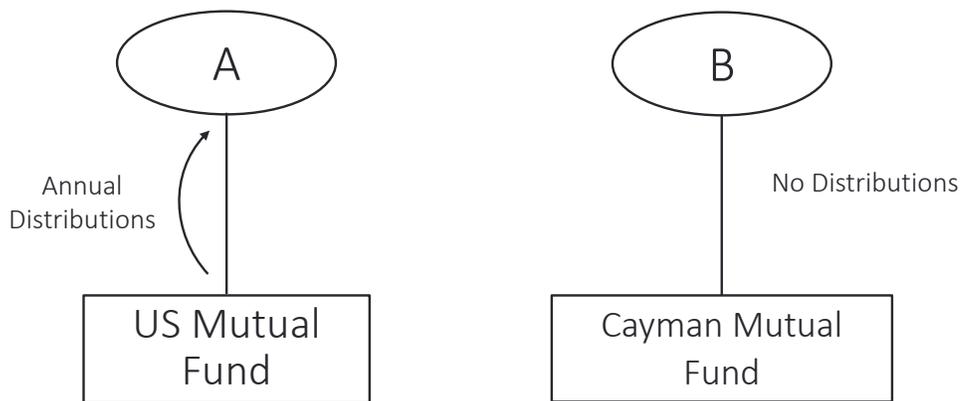
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# PFIC Refresher



## Paradigm Case for Why Congress Enacted the PFIC Rules



PFIC rules ensure that the two funds are taxed similarly – as offshore vehicle could otherwise allow for deferral of tax and character conversion.

## Definition of a PFIC

PFIC is a foreign corporation with respect to a US shareholder, if for any year in the shareholder's holding period:

**75%** or more of the corporation's gross income is passive income (generally defined by reference to Section 954(c)) (the "income test"), OR

Assets that produce or are held for the production of passive income (the "asset test") are or more of the average percentage of assets of the corporation for the **50%** year



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## Definition of PFIC

For purposes of the asset test, assets are valued using their adjusted tax basis if the corporation so elects or is a "controlled foreign corporation" (CFC).

If the corporation is publicly traded or is non-publicly traded and does not elect to use the tax book value method, the corporation's assets are valued at their fair market values.

- Once a corporation is a PFIC, it is always considered a PFIC with respect to the shareholder, unless the shareholder has made a QEF election as of the first day of its holding period or "purged" any pre-QEF election ownership period.



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## Consequences of PFIC Status – Section 1291 Funds

General rule – Section 1291 fund status: all dividends and gains are ordinary income. No long-term capital gains are available on sale.

“Excess distributions,” including dividends in excess of 125% of three-year average and gains on disposition of stock, are subject to interest-based penalties based on shareholder’s entire holding period.

Other special rules in Section 1291 apply, including limitations on the shareholder’s ability to avail itself of non-recognition treatment on certain transfers.



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## The QEF Election

A shareholder of a PFIC or potential PFIC may make an election to be taxed on ownership of the PFIC as a “qualified electing fund” (QEF).

Under the QEF Rules (IRC section 1293), the shareholder takes into account its distributive share of positive capital gains and ordinary earnings of the PFIC on a current basis as earned by the PFIC.

Unlike a partnership, a net loss does not flow through.

Actual distributions are subject to treatment similar to subpart F PTEP under Sections 959 and 961.

If QEF election is made for the first year of the shareholder’s ownership, the corporation is a “pedigreed QEF” and the section 1291 rules do not apply.



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## The MTM Election

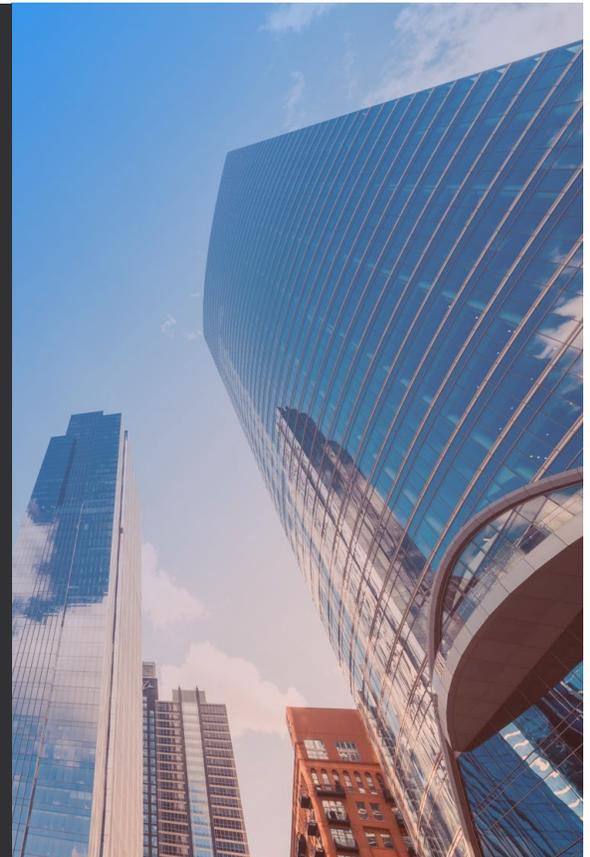
Alternatively, a shareholder of a PFIC whose stock is “marketable” may make a Mark-to-Market (MTM) election with respect to the PFIC stock.

Increase in value of the PFIC stock during the year creates a positive MTM inclusion. Decrease in value during the year creates a MTM loss to the extent of previously unreversed MTM inclusions. All MTM items are ordinary.

The interest-based penalties of section 1291 do not apply for periods in which the MTM election is in effect.



Common Pitfalls;  
What to Do if You Find a PFIC Issue Late



## Common Traps For The Unwary

- Non-Publicly Traded CFC - Method for Measuring Assets
  - Assets are measured using adjusted tax basis for all measuring periods within the taxable year
    - A CFC for this purpose means a CFC within the meaning of §957, without applying §318(a)(3)(A) through §318(a)(3)(C) so as to consider a U.S. person as owning stock that is owned by a non-U.S. person.
- PFIC Status Exemption for Start-Up
  - A foreign corporation will not be classified as a PFIC during its start-up year if it meets the following criteria:
    - No predecessor of the corporation was a PFIC
    - Satisfactory evidence is provided to the Secretary that the corporation will not be a PFIC for either of the first two taxable years following the start-up year
    - The foreign corporation does not qualify as a PFIC for either of the first two taxable years following the start-up year.
  - Question: What if there is interest income in the first year?
- PFIC Status Exemption for Corporation Changing Business
  - A. Neither the corporation nor any predecessor was a PFIC in any prior taxable year
  - B. It is convincingly demonstrated to the satisfaction of the Secretary that (i) substantially all of the passive income in that taxable year results from the proceeds of active trades or businesses; (ii) the corporation will not be a PFIC for either of the first two taxable years following such taxable year, and (iii) the corporation does not qualify as a PFIC for either of those two taxable years



## Common Traps For The Unwary

### Cash – Active asset or Passive Asset

- Notice 88-22 treats cash and easily convertible current assets, including working capital of an active business, as passive assets for the Asset Test. This treatment is based on the notion that working capital generates passive income, such as interest income.
- Treasury Department and IRS recognize issues with treating all working capital as passive assets (per Notice 88-22).
- The PFIC final regs reserve on issue.
- Under proposed Treas. Reg. §1.1297-1(d)(2), cash held in non-interest-bearing accounts for present active trade or business needs, not exceeding 90 days of ordinary operating expenses, is exempt from passive asset treatment.



## The Solution for a Late Diagnosis – the Purging Election

- Options for U.S. Shareholders in Delayed QEF Elections
  - Late QEF or MTM election vs. Purging election
- Limited Effectiveness of Late Elections
  - PFIC rules consider deferral, and time value of money
  - Late election usually imposes penalties
- Timing of a Purging Election
  - “Once a PFIC, Always a PFIC” rule still applies in case of a late QEF election and US Shareholder faces PFIC excess distribution taxation
  - US shareholder wishes to make a QEF election for a foreign corporation that is still a PFIC, but the election cannot be made promptly
- Who makes the Election – Shareholder
  - The 2022 proposed regulations, discussed below, address definition of “shareholder” for purposes of partnerships and S Corps.



## Purging Elections Overview

- There are at least eight different purging elections. Two main purging elections are:
  - The deemed sale election
  - The deemed dividend election – available if PFIC is also a CFC
- When a foreign corporation remains a PFIC, a U.S. shareholder making a purging election must make a simultaneous QEF election or qualify under the CFC overlap rule of §1297(d).
- Different rules apply to inclusion shareholders of a PFIC/CFC compared to shareholders who are not inclusion shareholders.
- Late QEF elections and late purging elections have their unique rules, with late QEF elections being retroactive and having strict eligibility criteria.
- Late purging elections for former PFICs have more relaxed rules compared to CFCs.



## Purging Elections Types – Summary

- At least eight different purging elections.
  - The deemed sale plus QEF election under § 1291(d)(2)(A) for continuing PFICs
  - The deemed sale election for former PFICs under § 1298(b)(1) and regulated by Treas. Reg. § 1.1298-3(b)
  - The deemed dividend plus QEF election, specifically for PFICs that continue to be PFICs but are excluded as a result of being CFCs, made under Treas. Reg. § 1.1291-9. The deemed dividend election is available to U.S. shareholders of CFCs and does not require the U.S. shareholder to be an inclusion shareholder with respect to the CFC
  - The deemed dividend election for former PFICs that are CFCs, governed by Treas. Reg. § 1.1298-3(c)
  - A deemed dividend election for U.S. inclusion shareholders of a CFC under Treas. Reg. § 1.1297-3(c)
  - A deemed sale election for U.S. inclusion shareholders of a CFC under Treas. Reg. § 1.1297-3(b)
  - Late election to inclusion shareholders of CFC under Treas. Reg. § 1.1297-3(e)
  - Late elections for former PFICs under Treas. Reg. § 1.1298-3(e)



## Purging Election- Deemed Sale Election

- Applicable to foreign corporation that continues to be a PFIC.
- The deemed sale election treats the investor as having sold all PFIC stock at its fair market value on the "qualification date."
- Making this election results in recognizing the unrealized appreciation within the stock of unpedigreed QEF and PFIC becomes a pedigreed QEF.
- The recognized gain is taxed as an excess distribution under §1291, received on the qualification date.
- Consequently, the shareholder is liable for deferred taxes and interest on the gain from the deemed sale.
- The shareholder increases their adjusted basis in the PFIC stock by the amount of the recognized gain.
- Any realized losses on the deemed sale are not recognized and do not decrease the shareholder's adjusted basis in the PFIC stock.
- This election gives the shareholder a new holding period in the PFIC stock, effectively purging it of PFIC status.



## Purging Election- Deemed Dividend Election

- This election is made by shareholders of an unpedigreed QEF that is also a CFC for the PFIC's taxable year.
- This election is limited to shareholders of PFICs that are CFCs. However, it doesn't require the U.S. shareholder to be an inclusion shareholder.
- This election requires a U.S. shareholder to include in gross income a share of the CFC's undistributed earnings and profits ("E&P") during the pre-QEF holding period.
- Post-1986 E&P refers to E&P accumulated after 1986, while the CFC was a PFIC. It's included in the shareholder's holding period, even if the PFIC wasn't a CFC at that time.
- The deemed dividend is taxed as an excess distribution on the qualification date.
- The U.S. shareholder can increase their adjusted basis in the stock owned directly.



## Greenbook FY2024 - Gift for PFIC Shareholders?

- Under present law, the QEF election can be made before the due date or retroactively with IRS consent.
  - The special consent procedure permits retroactive QEF elections under specific conditions.
  - However, the existing special consent procedure has limitations and high costs, deterring retroactive QEF elections.
- The Greenbook would modify Section 1295(b)(2) to allow retroactive QEF elections in a broader range of circumstances to be prescribed by regulations.
  - Retroactive QEF elections would be allowed without consent if they do not prejudice the U.S. Government.
  - In cases where the taxpayer owned the PFIC in closed assessment years, compensation to the government would be required.
  - The proposal would also extend the authority to partnerships and non-individual taxpayers.
  - Proposal would be effective upon enactment.
  - Expected that regulations would permit taxpayers to amend previously filed returns for open years.



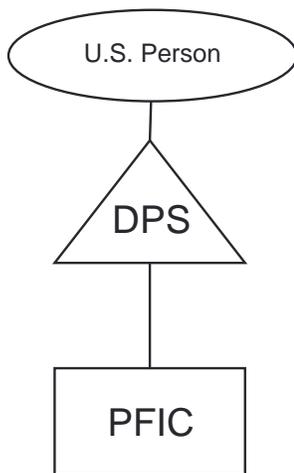
## Entity v. Aggregate Treatment of Domestic Partnerships



### Proposed Regulations (REG-118250-20)-An Aggregate Approach

- Consistent with the aggregate approach taken in the final section 958 regulations (see TD 9960), Treasury has proposed regulations that would adopt a more aggregate approach to applying the PFIC regime.
- The proposed regulations, if finalized, would dramatically alter the application of certain PFIC provisions.
- The proposed regulations generally are prospective.
  - They generally are proposed to apply to taxable years beginning on or after the date of publication of the Treasury decision adopting such rules as final regulations in the Federal Register
- What follows is a comparison of current law with the rules contained in the proposed regulations.

## Who is the Relevant U.S. Person Under the PFIC Regime and for What Purpose?



- It is important to determine who is considered a PFIC shareholder for various purposes including:
  - Who is considered a shareholder for purposes of the excess distribution regime.
  - Who makes a QEF election and who has the QEF inclusions.
  - Who makes a MTM election and who includes/deducts the MTM amounts.
  - Who makes the various purging elections under the PFIC regime.
  - Who has an informational reporting obligation.

## Definition of PFIC Shareholder – Current Law

- Current Law: Excess Distribution Regime
  - Under Reg. 1.1291-1(b)(7), a *shareholder* of a PFIC generally is defined as a U.S. person that owns PFIC stock directly or indirectly through certain corporations or pass-through entities (an *indirect shareholder*), within the meaning of sections 1298(a) and Reg. 1.1291-1(b)(8) (collectively, a *PFIC shareholder*).
  - For purposes of sections 1291 and 1298, neither a domestic partnership nor an S corporation is treated as a PFIC shareholder except for purposes of any information reporting requirements (including the requirement to file an annual report under section 1298(f)) or where otherwise explicitly provided in regulations.
  - Regulation 1.1291-1(b)(8)(iii)(A) and (B) provides that if a domestic partnership or S corporation owns PFIC stock, the partners or S corporation shareholders, respectively, are considered to own the PFIC stock proportionately in accordance with their ownership interests. No guidance has been issued as to how to measure a partner's proportionate interest.
  - As a result, if a domestic partnership or S corporation owns PFIC stock, the excess distribution rules apply at the partner or S corporation shareholder level.

## QEF Elections – Current Law

- Current Law: QEFs
- Under Reg. 1.1295-1(j), domestic partnerships and S corporations are treated as PFIC shareholders for purposes of the QEF rules.
  - A PFIC shareholder making a valid QEF election effective as of the beginning of its holding period in the PFIC stock is not subject to the excess distribution rules with respect to that PFIC (a *pedigreed QEF*). Conversely, a PFIC shareholder that makes a QEF election effective after the beginning of its holding period in the PFIC stock is simultaneously subject to the excess distribution rules and the QEF rules with respect to that PFIC (an *unpedigreed QEF*).
- A domestic partnership or S corporation that owns PFIC stock generally makes the QEF election with respect to the PFIC under Regs. 1.1295-1(d)(2)(i)(A) and (d)(2)(ii).
- Reg. 1.1293-1(c)(1) provides that the domestic partnership or S corporation recognizes any QEF inclusions at the entity level, and each U.S. person that is an interest holder in the domestic partnership or S corporation takes into account its pro rata share of the inclusions.



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## MTM Elections – Current Law

- Current Law: Mark-to-Market (MTM)
  - If a domestic partnership or an S corporation owns or is treated as owning under Reg. 1.1296-1(e) (providing ownership rules for PFIC stock owned through certain foreign entities) section 1296 stock, the domestic partnership or S corporation can make an MTM election with respect to the PFIC because the election is made by the U.S. person owning or treated as owning the stock. See Reg. 1.1296-1(h)(1)(i).
  - The domestic partnership or S corporation, by virtue of being a U.S. person, includes or deducts any MTM amounts at the entity level. See Reg. 1.1296-1(c)(1) and (3).



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## Purging Elections – Current Law

- Section 1291(d)(2) Purging Elections—The section 1291 purging elections are made by a PFIC “shareholder” as defined in Reg. 1.1291-9(j)(3), which is a U.S. person that is a shareholder or indirect shareholder, as defined in Reg. 1.1291-1(b)(7) or (8), respectively. If the PFIC shareholder makes one of the section 1291 purging elections, the QEF is a pedigreed QEF with respect to the shareholder.
- Section 1298(b)(1) Purging Elections—The rules applicable to the section 1298 purging elections in Regs. 1.1297-3(a) and 1.1298-3(a) are substantially the same as those applicable to the section 1291 purging elections, including that each section 1298 purging election is made by a PFIC “shareholder” as defined in Reg. 1.1291-9(j)(3).
- In the preamble of the PFIC proposed regulations, Treasury states the following:
  - Under the current regulations, it may be unclear whether a domestic partnership or an S corporation that owns PFIC stock is eligible to make a PFIC purging election, particularly with respect to the section 1291 purging elections, both of which require simultaneous QEF elections that are generally made by domestic partnerships and S corporations.



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## PFIC Information Reporting – Current Law

- Under Reg. 1.1298-1(b)(2)(ii), an indirect PFIC shareholder that is required to either recognize QEF inclusions under section 1293(a) or MTM amounts under section 1296(a) is generally not required to file Form 8621 if another PFIC shareholder through which the indirect PFIC shareholder owns its interest in the PFIC timely files Form 8621.
  - Thus, if an indirect PFIC shareholder is treated as owning an interest in a PFIC by reason of an interest in a domestic partnership or S corporation and the domestic partnership or S corporation recognizes QEF inclusions or MTM amounts and timely files Form 8621, the indirect PFIC shareholder is generally not required to file Form 8621.
- Pursuant to Reg. 1.1298-1(b)(2)(ii), this exception does not apply to a PFIC shareholder that transfers stock of a QEF to a domestic partnership or S corporation if the domestic partnership or S corporation does not make a QEF election with respect to the transferred stock after the transfer, in which case the transferor shareholder is still required to file Form 8621.



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## Proposed Regulations: Definition of a PFIC Shareholder

- For purposes of the QEF and MTM rules, the definition of shareholder under Reg. 1.1291-1(b)(7) would be updated to reflect aggregate treatment for purposes of the PFIC regime.
- Under the proposed regulations, neither domestic partnerships nor S corporations are considered shareholders for purposes of making QEF or MTM elections, recognizing QEF inclusions or MTM amounts, making PFIC purging elections, or filing Forms 8621. See Prop. Reg. 1.1291-1(b)(7), 1.1295-1(j)(3), 1.1296-1(a)(4).
  - The proposed regulations provide certain transition guidance along with certain other changes.



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## Practical Concerns and Issues

- Concerns have been expressed that the proposed regulations would expand exponentially the number of additional filings.
  - Under current law, a domestic partnership can make certain PFIC elections and filings at the partnership level
  - Under the proposed regulations, each U.S. shareholder, no matter how small, would need to make their own elections and filings.
- The preamble asks for comments on this issue
- If the IRS considers allowing a partnership to make elections and filings on behalf of its U.S. partners, might that approach extend to foreign partnerships?

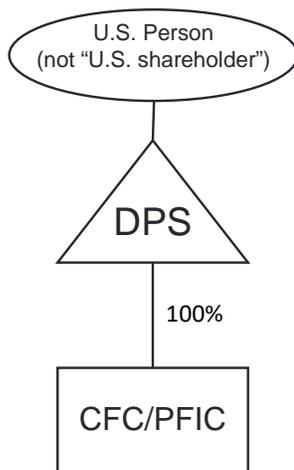


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## Proposed Regulations: CFC/PFIC Overlap Rule

- Section 1297(d) provides:
  - For purposes of this part, a corporation shall not be treated **with respect to a shareholder** as a [PFIC] during the qualified portion of **such shareholder's** holding period with respect to stock in such corporation. . . .For purposes of this subsection, the term qualified portion means the portion of **the shareholder's** holding period . . . 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.

## Proposed Regulations: CFC/PFIC Overlap Rule (cont.)



- In the preamble to REG-118250-20, Treasury concludes that, although section 1297(d) does not define the term “shareholder” for this purpose, under Reg. §1.1291-1(b)(7), a domestic partnership or S corporation is not a shareholder to which the CFC overlap rule applies.
  - Under the proposed regulations, a U.S. partner of DPS that is not a section 951(b) shareholder of the foreign corporation held by DPS does not receive the benefit of the CFC/PFIC overlap rule.
  - However, as discussed below, the proposed regulations provide a transition rule that may provide some relief.

## Proposed Regulations: CFC/PFIC Overlap Rule (cont.)

Footnote 2 in the preamble notes the following:

Reg. 1.1291-1(b)(7) provides that a PFIC shareholder is a U.S. person that directly owns PFIC stock or that is an indirect shareholder under §1.1291-1(b)(8); further, it states that for purposes of sections 1291 and 1298, neither a domestic partnership nor an S corporation is treated as a PFIC shareholder, except for information reporting purposes. This definition of shareholder was first adopted as a temporary regulation, applicable to taxable years of shareholders ending on or after December 31, 2013 (T.D. 9650, 78 FR 79602, 79608 (Dec. 31, 2013)) and was subsequently issued as a final regulation without substantive change with the same applicability date (T.D. 9806, 81 FR 95459, 95465 (Dec. 28, 2016)). Both temporary and final §1.1291-1(b)(7) were issued after several private letter rulings (“PLRs”), such as PLR 201108020 (Feb. 25, 2011) and PLR 200943004 (Oct. 23, 2009), which were issued with respect to the application of section 1297(d) to domestic partnerships.



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## Proposed Regulations: CFC/PFIC Overlap Rule (cont.)

Prop. Reg. 1.1291-1(c)(5) provides:

For purposes of section 1297(d), with respect to a partner or S corporation shareholder that would be considered an indirect shareholder, through its ownership in a domestic partnership or S corporation, with respect to a foreign corporation that is a PFIC and a controlled foreign corporation (as defined in section 957), the term qualified portion does not include any portion of such indirect shareholder's holding period during which it was not a U.S. shareholder (as defined in section 951(b)) with respect to the foreign corporation.



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## Proposed Regulations: CFC/PFIC Overlap Rule (cont.)

- Proposed Reg. 1.1291-1(c)(5)(ii) provides the following transition rule:
  - For taxable years of shareholders beginning before [date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register], or for taxable years of shareholders of an S corporation in which the S corporation elects to apply Reg. 1.958-1(e), for purposes of section 1297(d), a partner's or S corporation shareholder's qualified portion with respect to the foreign corporation includes the portion of its holding period during which it—
- (A) Is an indirect shareholder under paragraph (b)(8)(iii)(A) or (B) of this section with respect to the foreign corporation; and
- (B) Included in gross income its distributive or pro rata share of any amount that the domestic partnership or S corporation, respectively, included under section 951(a)(1) and 951A(a) with respect to stock in the foreign corporation (treating the requirement in this paragraph (c)(5)(ii)(B) as not satisfied to the extent Reg. 1.958-1(d)(1) through (3) is applied with respect to the domestic partnership or S corporation before their general applicability date under Reg. 1.958-1(d)(4) or the domestic partnership or S corporation relied on the earlier proposed version of such provisions). See, for example, Reg. 1.951A-1(e)(2).



# QUESTIONS?

