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Removing PFIC Taint on Foreign Investments Through Subsequent Year QEF Elections

New Final PFIC Regulations and Navigating PFIC Rules of IRC Sections 1291-1298

WEDNESDAY, JUNE 30, 2021

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Emphasis:
International Tax
Tax Planning
Tax Controversy

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Emphasis:
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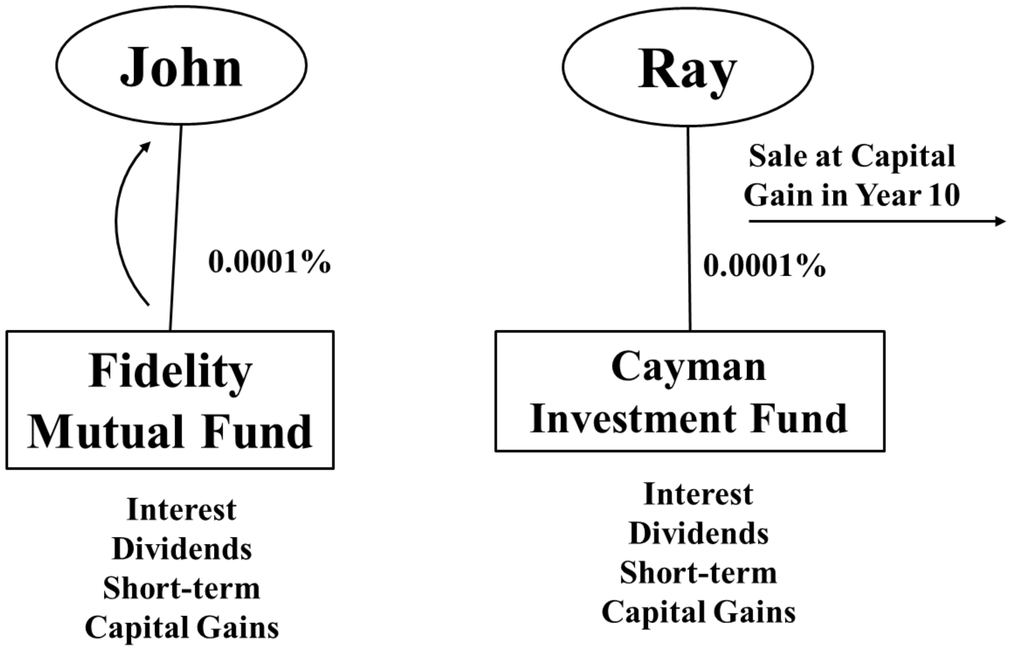
PFIC Basics

- The PFIC rules were enacted to level the playing field between onshore and offshore mutual funds, which without the PFIC rules would offer U.S. taxpayers deferral of tax on gains.



Common PFICs

- Foreign mutual funds
- Foreign hedge funds and other private investment vehicles
- Family / individual holding companies
- Foreign corporations in business sectors that can produce passive income, such as real estate or IP / licensing
- Foreign start-up companies with no active gross income ("accidental PFICs")
- Foreign SPACs

PFIC- The Two Tests

- A foreign corporation is a PFIC if, for any taxable year, it fails either the asset test or the income test.
- Income test: 75% or more of the corporation's gross income for the year is passive income.
- Asset test: 50% or more of the average value of the corporation's assets held during the year produce or are held for the production of passive income.

Steps to PFIC Analysis

1. Identify company's assets and income as active or passive.

2. Measure <u>gross passive and gross total income</u> for the taxable year, and calculate the ratio.

3. Measure <u>values of passive and total assets</u> on each measuring date (generally, the end of each quarter) for the taxable year, average the values of the passive assets, average the values of the total assets, and calculate the ratio.

Proposed PFIC Regulations

Proposed and Final Regulations

- On January 15, 2021, the Treasury and IRS published in the Federal Register final and proposed regulations providing guidance on PFICs under Code sections 1291, 1297, and 1298.
- Provide answers to questions regarding interpretations of income and asset tests.
- New regime for applying subsidiary look-through rule and related-party look-through rules.

Proposed PFIC Regulations

- Asset Test Changes:
  - Asset valuation: if shareholder has reliable information about value of asset that differs from its financial statement valuation, that information must be used to value the asset.
  - Limited exception for treating working capital (cash) as non-passive.
- Income Test Changes:
  - Elimination of intercompany dividends for purposes of income test to extent payment is attributable to income of a look-through subsidiary included in gross income by the tested foreign corporation

Proposed PFIC Regulations

- Effective Dates:
  - Apply for tax years beginning on or after the proposed regulations are finalized.
  - However, until finalized, taxpayers may rely on one or more of eight proposed rules with respect to a tested foreign corporation for any open taxable year provided they consistently follow each such rule for each subsequent taxable year beginning before the date the regulations are finalized.
  - For a taxable year beginning after December 31, 2017, taxpayers may rely on the proposed regulations' insurance exception, provided they obey the same consistency rule.
  - Certain 2019 proposed regulations can still be relied on for taxable years ending before January 14, 2021 (insurance rule) or on or before December 31, 2020 (other rules).

Final PFIC Regulations

Final PFIC Regulations

- Adopts top-down approach to attribution of ownership through tiered ownership structures.
- Income Test:
    - Netting of gains and losses of one look-through subsidiary or partnership against another.
    - Related person look-through rule expanded for interest and dividend payments.
    - Special rules for dispositions of look-through partnerships with unremitted earnings.
    - Further elimination of certain intercompany items.
    - Further exception for certain intercompany items that would be excluded from foreign personal holding company income under § 954(c).
- Asset Test:
    - Relief from measuring assets by their bases if CFC solely due to § 958(b)(4) repeal.
    - Bifurcation of assets between passive/non-passive

Final PFIC Regulations

- Effective Dates: Tax years beginning on or after January 14, 2021 (*i.e.*, 2022 taxable year for calendar year taxpayers).
    - Taxpayers may choose to apply final regulations with respect to a particular tested foreign corporation to any open tax year provided that all of the rules are applied consistently with respect to that tested foreign corporation for that year and all succeeding taxable years.

PFIC Ownership Rules

PFIC Ownership Rules

- PFIC shareholder: any US person that directly or indirectly owns stock of a PFIC.
- A domestic partnership, S corporation, or trust under the grantor trust rules is not a shareholder for most purposes.
- Once a PFIC is attributed to a U.S. person, the attribution process stops.

PFIC Ownership Rules

- § 1298 provides attribution rules for ownership of a tested foreign corporation. Provides attribution to U.S. persons from a:
    - Corporation. a person owning at least 50% of a foreign corporation's stock is considered an indirect owner of a proportionate part (by value) of any stock owned by the corporation, provided the corporation is not itself a PFIC.
        - If PFIC owns stock in another PFIC, the stock is attributed to all shareholders of the PFIC.
    - Stock owned by a partnership, S corporation, nongrantor trust, or estate is owned proportionately by its shareholders regardless of extent of their interest.

Final Regulation Changes PFIC Ownership Rules

- Top-Down approach:
  - Final regulations apply attribution rules to a tiered ownership structure involving a pass-through entity using a "top-down" approach, starting with a U.S. person and determining what stock is considered owned at each lower tier on a proportionate basis.

PFIC Asset Test

Passive Assets

- Asset test: 50% or more of the average value of the corporation's assets held during the year produce or are held for the production of passive income.
- Assets are characterized as active or passive based on the income they produce or are reasonably expected to produce.
    - If produce passive income, are passive assets.

Passive Assets

- Passive income generally is any income that would be subpart F / foreign personal holding company income if earned by a CFC:
  - Interest, dividends, rents and royalties (other than certain active rents and royalties)
  - Gains from the sale of passive assets
  - Other investment income

Passive Assets

- Under IRS interim guidance (Notice 88-22) assets are related to the income they have generated or reasonably could be expected to generate.
    - Cash is always a passive asset.
- Assets are generally valued based on financial statement (balance sheet) value.
    - If corporation is a CFC, must value assets based on their adjusted bases.
    - However, under § 1298(e), § 174 research or experimental expenditures paid or incurred during the tax year and prior two tax years can increase the basis of assets.
- The passive asset test is based on a quarterly measurement of assets held by the corporation during the year. Can use different measuring periods under the regulations.

Proposed Regulation Changes to the Asset Test

Proposed Regulation Changes to the Asset Test

- <u>Relief from Downward Attribution</u>: TCJA repealed § 958(b)(4), causing many "accidental CFCs."
    - A tested foreign corporation must measure its assets using their adjusted bases if such corporation is a CFC.
    - Thus, repeal of § 958(b)(4) might preclude a foreign corp. from using FMV to measure assets.
    - Final regulations provide relief: if corporation is a CFC solely due to § 958(b)(4) repeal, the corporation does not have to measure its assets with reference to their adjusted bases.

Proposed Regulation Changes to the Asset Test

- Treatment of cash for asset test:
    - Notice 88-22 – uniformly treated cash as a passive asset for PFIC purposes.
- Proposed regulations provide a limited exception to treat cash as a non-passive asset:
    - (a) Currency denominated in the functional currency of the tested foreign corporation
    - (b) That is held in a non-interest bearing financial account
    - (c) Held for the present needs of an active trade or business no greater than amount necessary to cover expenses incurred in ordinary course of the trade or business reasonably expected to be paid within 90 days.
    - Such amounts cannot be for future expansion/diversification.

Proposed Regulation Changes to the Asset Test

- Amounts eligible for the limited non-passive cash exception cannot be held for:
    - future diversification into a new trade or business,
    - expansion of trade or business activities,
    - future plant replacement, or
    - future business contingencies.

Proposed Regulation Changes to the Asset Test

- Consider a foreign corporation engaged in development and exploitation of software that is expensed on the balance sheet.
- The Company has cash reserves of $800,000 and fixed assets of $200,000 at the end of each measuring period.
- Without the working capital exception, the tested foreign corporation will flunk the PFIC asset test as 80% of its assets will be treated as passive (assuming the fixed assets are non-passive).
- Under the working capital exception, part of the $800,000 of cash may be treated as active if held for use for the next 90 days of the business.

Proposed Regulation Changes to the Asset Test

- Limited non-passive cash exception helpful for companies who hold cash for near-term requirements.
    - However are of little use to start-up companies who raise cash for purposes of one to two years funding requirements, including research and development.
- Applies only to cash, and not “cash equivalents” such as treasury bills, certificates of deposits, cryptocurrency.
- If foreign corporation is operating in a foreign currency as a functional currency, cannot rely on U.S. dollar balances.

Proposed Regulation Changes to the Asset Test

- Valuation of Assets: Proposed regulations provide guidance on how to value assets for purpose of the PFIC rules.
- Generally, tested foreign corporations use financial statement (GAAP/IFRS) as a reference for determining FMV of assets or adjusted bases.
- However, intangible property such as self-created intellectual property is either not included on financial statements or at a value less than the FMV of such asset.
- Under new proposed rules, if a tested foreign corporation has reliable information about the value of the asset that differs from its financial statement valuation, that information must be used to determine the value of the asset.

Proposed Regulation Changes to the Asset Test

- For example, consider a tested foreign corporation that is developing software for sale and has on its financial statements cash of $800,000 and fixed assets of $200,000 at the end of each measuring period.
    - Assume value of corporation's equity is $3,000,000 and it has no debt.
    - Software has no value on the financial statements.
- Using financial statement value, company is a PFIC (80%+ passive assets assuming the cash is all passive).
- However, if company can use $3,000,000 equity valuation to value its assets, this would create a valuation of $2,000,000 for the company's self-created intangible property, resulting in at most 33% of the assets of the company being passive.

Final Regulation Changes to the Asset Test

- Bifurcation of Assets:
    - The final regulations established a rule that assets that produce both passive and non-passive income are treated as two assets: one passive, and one non-passive (a "dual-character asset").
    - The value of the dual-character asset is allocated between the passive and non-passive assets in proportion of the relative amounts of income produced by the asset during the taxable year.

Final Regulation Changes to the Asset Test

- Valuation of Assets based on Value or Adjusted Basis for Publicly Traded Corporations:
    - The final regulations adopt guidance on how to apply the asset test when a corporation changes between CFC and non-CFC status or becomes publicly traded.
    - For example, foreign issuers that had IPOs during the taxable year had to measure asset based on their adjusted bases prior to being publicly traded and then measure on value after going public.
        - In these situations, final regulations provide that companies that are publicly traded for part of the year measure assets on basis of value if corporation is publicly traded on majority of days of the year.
        - If not publicly traded on majority of days of year, must use adjusted basis to measure assets if it is a CFC.

PFIC Income Test

Passive Income

- Income test: 75% or more of the corporation's gross income for the year is passive income.
- Passive income generally is any income that would be subpart F / § 954(c) foreign personal holding company income if earned by a CFC:
    - Interest, dividends, rents and royalties (other than certain active rents and royalties)
    - Gains from the sale of passive assets
    - Other investment income

PFIC Income Test: Passive Income

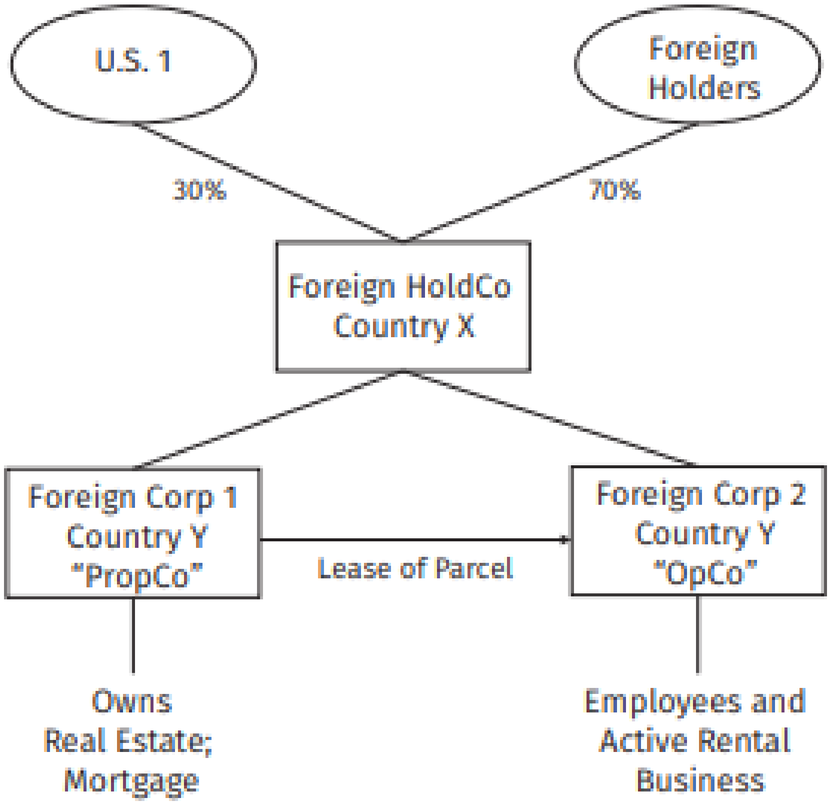
- § 954(c) contains several exceptions from FPHC income, including:
    - Active rents and royalties exceptions
    - Same-country exceptions
    - "Look-through" for interest, dividends, rents and royalties paid between CFCs that are related parties
    - Active finance exception
- § 1297 at same time has its own parallel exceptions for PFIC purposes only, including:
    - Payments paid or accrued from a related party
    - Income from an active banking business
    - 25% subsidiary look-through rule

Final Regulation Changes to PFIC Income Test

Final Regulation Changes to PFIC Income Test

- The application of Subpart F exceptions for PFIC purposes has been clarified.
- Active rents and royalties exceptions apply for PFIC purposes.

Final Regulation Changes to PFIC Income Test



- Useful where activities and ownership of income producing assets are in different entities.
- Ex. "OpCo" "PropCo" structure in real estate.
- PropCo derives rental income from leasing real estate to its affiliate OpCo for use in OpCo's active business.
- Foreign Corp 1 does not conduct activities in its own active conduct of a trade or business. (Foreign Corp 2 conducts such activities.)
- Thus, possible for Foreign Corp 1 to be a PFIC.
- Regulations provide for aggregation of business activities to a foreign corporation from its "qualified affiliates" to deem income to be active.
- "Qualified Affiliates": corporations or partnerships that would be members of the same affiliated group within the meaning of § 1504(a), without the bar on foreign entities or partnerships, and with certain other adjustments.

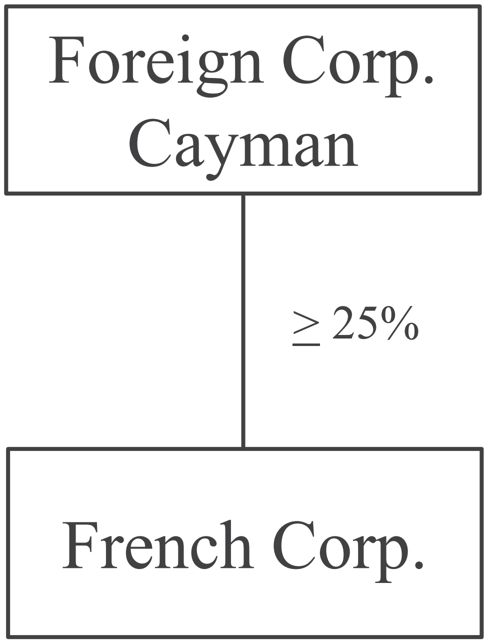
Final Regulation Changes to PFIC Income Test

- Same-country exception and CFC look-through rules in § 954 do not apply for PFIC.
- Instead, a PFIC related-party look-through rule in § 1297(b)(2)(C) applies.
    - Such rule is taxpayer favorable, as it does not adopt the "cream-skimming rule" that applies in the Subpart F context (priority rule for interest payments being treated as passive).
    - Rules apply exception to passive income treatment of interest, dividends, rents and royalties from a related party that are attributable to the related party's non-passive income.

Subsidiary Look-Through Rule

Subsidiary Look-Through Rules

- For PFIC purposes, a corporation is treated as directly owning its share of the assets and earning its share of the income of a 25%-or-greater subsidiary.

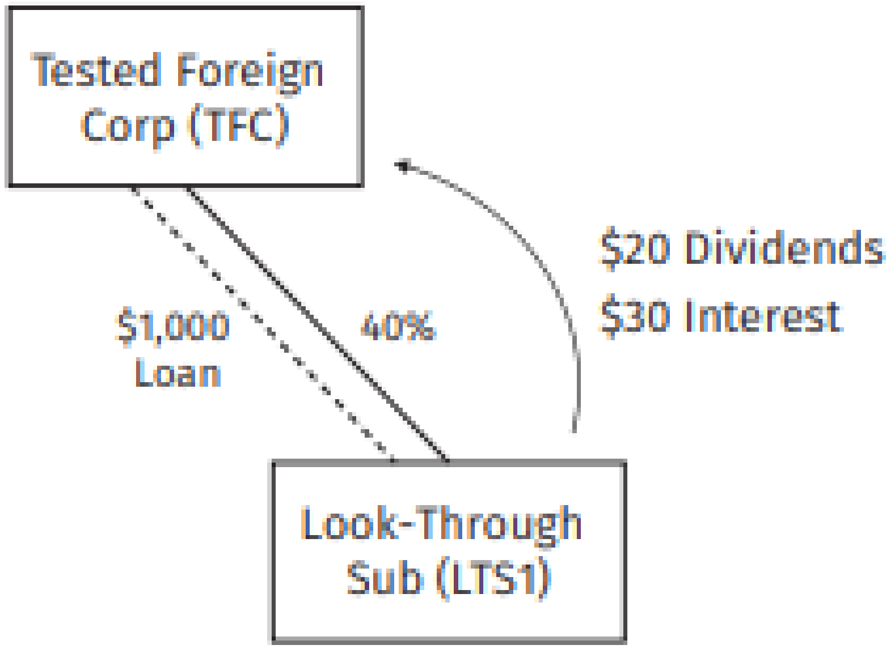


Final Regulation Changes to Subsidiary Look-Through Rule

Final Regulation Changes to Subsidiary Look-Through Rule

- Subsidiary look-through rules of § 1297(c) treat an upper-tier entity as earning the income and owning the assets of a lower-tier corporation in which it owns, directly or indirectly, at least 25% of the stock by value.
- Attribution of activities from a look-through subsidiary to the upper-tier corporation: regulations provide for attribution if the look-through subsidiary is also a 50% or greater owned "qualified affiliate."
- Treatment of intercompany transactions:
    - Detailed set of elimination rules by and among foreign corporation and its look-through subsidiary.
    - Dividends are disregarded; certain obligations are eliminated.
    - Sales and services not eliminated.
    - Gain on sale: disregarded to extent of "unremitted earnings." Passive or non-passive based on ratio of subsidiary's assets.

Final Regulation Changes to Subsidiary Look-Through Rule



- TFC owns 40% of LTS1. Under look-through rule, TFC is treated as owning 40% of LTS1's income.
- TFC has a loan receivable from LTS1 of $1,000 and also receives $30 interest and $20 dividends during the year.
- Since LTS1 is a look-through subsidiary, the dividend is disregarded, and the interest income is partially eliminated to extent of 40% stake. Thus TFC has 60% * $30, or $18 of passive interest income

Final Regulation Changes to Subsidiary Look-Through Rule

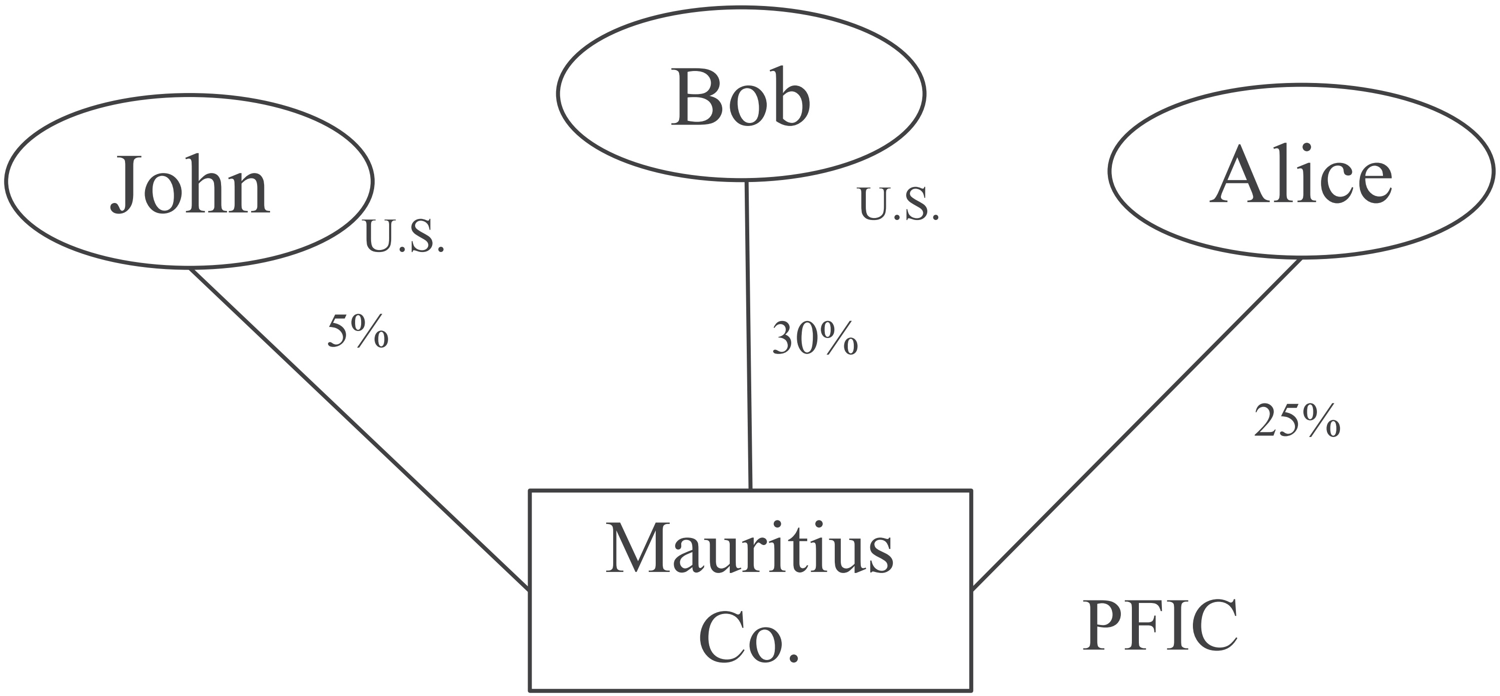
- Partnerships: same look-through rules apply (25% or more).
- If a tested foreign corporation does not own 25% or more of a partnership, the partnership is viewed as a passive asset giving rise to passive income.
    - Final regulations provide an exception: active partner test.
    - To satisfy active partner test, foreign corporation must not be a PFIC without regard to interest in partnership.

CFC Overlap Rule

Ownership of an Interest in a PFIC

- Individuals are treated as owning PFIC stock indirectly held through foreign entities – including partnerships, trusts, and 50%-or-greater owned foreign corporations.
- CFC overlap rule. Stock in a foreign corporation is not treated as a PFIC if (1) the foreign corporation is a CFC and (2) the shareholder is a United States shareholder (10% or greater ownership by vote or value) subject to subpart F rules.

Example of CFC/PFIC Overlap



- Bob and Alice are not subject to the PFIC rules because they are United States shareholders in a CFC. John however does own stock in a PFIC.

CFC/PFIC Overlap Rule

- Under § 1297(d), the CFC overlap rule "turns off" the PFIC rules for persons that are United States shareholders of a CFC.
- Historically, smaller US partners that owned the CFC stock through a US partnership that was a US shareholder were shielded from the PFIC rules by partnerships being US shareholders subject to the overlap rule.
- Post-TCJA, regulations have provided that a US partnership is not viewed as an inclusion shareholder for GILTI purposes, relieving small US partners that own CFC stock from being subject to GILTI.
    - Currently, those partners must still include Subpart F and § 956 amounts in income. However proposed regulations adopt aggregate treatment consistent with the GILTI rules for Subpart F.
    - But if the small partners are no longer subject to Subpart F, does the CFC/PFIC overlap rule still apply?

QEF Elections and Alternatives

QEF Election and

- Qualified Electing Fund Election – shareholder picks up a ratable share of the PFIC's net income on a flow-through basis.
- Alternatives:
  - Mark-to-Market Election: shareholder includes changes in the value of the PFIC's trading price as ordinary income.
    - Generally requires regular trading of PFIC stock to establish quoted price.
    - If loss during year, prior mark-to-market gains ("unreversed inclusions") may allow losses to be treated as ordinary.
  - Default § 1291 Rules: ordinary income plus interest charge imposed on sales of stock or "excess distributions" out of the company.
    - "Excess distributions": current dividends minus 125% of past three years' average dividends plus capital gain on sale.

QEF Implications

- Flows through both capital gains and ordinary income similar to a partnership.
- Shareholder needs to receive information about the company's net income – QEF information statement or review of books and records.
- Flows through net capital gains of the Fund.
- Gain on sale may still be capital gains.

Making a QEF Election

- If QEF election not made in first year of acquisition of PFIC stock, it is considered a PFIC that was not a QEF.
  - Once a PFIC, Always a PFIC: If a corporation was a PFIC for any previous year during the holding period, the stock is PFIC stock.
  - A QEF with prior PFIC history (unpedigreed QEF) will be taxed both under QEF rules and § 1291 rules. QEF inclusions increase shareholder basis.
- Purging the PFIC Taint:
  - Deemed sale election: shareholder treated as selling PFIC stock at FMV and including gain as an excess distribution.
  - Deemed dividend election: if corporation is also a CFC at the time of the purge, shareholder can include pro rata share of corporation's retained earnings as an excess distribution.

Making a QEF Election

- John, a U.S. citizen, acquires a 40% interest in a UK real estate holding company in 2017 in exchange for $500K. He receives no distributions from the company.
- In 2021, John learns that the company likely is considered a PFIC. The value of his equity is $750K. The Company has retained earnings post-2017 of $100K.
- What consequences will there be of PFIC status? What elections are available to John?
    - Could make a QEF election for flow-through taxation, but what about the built up value between 2017 and 2021? How will that be taxed?

Making a QEF Election

- If a PFIC is a QEF, the shareholder is required to include its share of the QEF's net income for all years in which it is a PFIC or treated as a PFIC.
- If election is timely or purging election is made, John includes his share of net income for years in which the company is passive. If company becomes active for year, John no longer includes income for that year. Gains on sale are capital gains.
- If no timely election or purging election, John includes his share of the company's net income for all years (passive and active). Gain on sale is ordinary and an excess distribution.

Final Regulation Changes to QEF Elections

Preamble to Final Regulations

- Treasury commented on concerns regarding inconsistent application by taxpayers of the "once-a-PFIC, always-a-PFIC" rule.
- Under prior law, a shareholder seeking to end PFIC treatment as a result of a change of law or facts would need to make a purging election under § 1298(b)(1) and Reg. § 1.1298-3(b) or (c) on a Form 8621. Would apply beginning on end of year in which purging election is made.
- Under final regulations, PFIC shareholders may request consent of Commissioner to make a late purging election, taking effect as of end of tested foreign corporation's taxable year in the taxpayer's most recent closed taxable year.

Preamble to Final Regulations

- Result of a late purging election: shareholder potentially treated as no longer holding stock of a foreign corporation that was ever a PFIC during their holding period, so the once a PFIC, always a PFIC rule no longer applies.

Preamble to Final Regulations

- Suppose a shareholder's taxable years from 2017-2019 are open years.
- In 2015, the shareholder acquired stock in a foreign corporation and did not make a QEF election.
- Under prior law, that foreign corporation was a PFIC, but due to a new provision in the final regulations, the corporation would not have been a PFIC at any time.
- Under the final regulations, the taxpayer may apply the PFIC final regulations to cleanse PFIC taint attributable to ownership in any open year.