**REPORT #785**

# TAX SECTION

# New York State Bar Association

Report on Proposed Qualified Electing Fund Election under Section 1295(a)

March 18, 1994

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# TAX SECTION
# New York State Bar Association

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March 18, 1994

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, D.C. 20224

Re: PFIC Election for Preferred Stock

Dear Secretary Samuels and Commissioner Richardson:

Enclosed are copies of a report by the New York State Bar Association Tax Section proposing a simplified regime for a "qualified electing fund" election under Internal Revenue Code Section 1295(a) to be made by taxpayers holding preferred stock of a passive foreign investment company. Under the proposal, a taxpayer making the election would agree to treat the preferred stock in a manner similar to debt held by an accrual basis taxpayer, so that, for example, dividends would be reported on the accrual basis without regard to whether the issuer had earnings and profits.

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We believe this proposal is consistent with sound tax policy and with the stated goals of the Treasury Department and the Internal Revenue Service to simplify the tax rules in the foreign area without opening up the potential for abusive transactions.[1/] We hope to have further simplification proposals in the future.

Very truly yours,

Michael L. Schler
Chair, Tax Section

cc: Cynthia G. Beerbower (Treasury)
Neil Z. Auerbach (IRS)
Gayle E. Novig (IRS)

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[1/] I understand that a proposal similar to that discussed herein was recently made on behalf of a specific taxpayer. To the best of my knowledge no one involved in the drafting or the approval process for this report was in any way connected with that effort.

NEW YORK STATE BAR ASSOCIATION TAX SECTION

# Report on Proposed Qualified Electing Fund Election under Section 1295(a)

March 18/ 1994

We understand that the Treasury Department and Internal Revenue Service are interested in the simplification of Regulations generally and, specifically, in the foreign area. On that understanding, this report[1]/ suggests a change that might be made by Regulations to the qualified electing fund election available under Section 1295(a) of the Internal Revenue Code to shareholders of passive foreign investment companies.

We have not considered other aspects of the passive foreign investment company regulations that might be simplified. Rather, in addition to more comprehensive reports, we expect to raise specific issues as they arise in practice, both in this area and in others, when we believe that the rules can be simplified on a basis that is consistent with sound tax policy. We hope that this approach will be helpful to the Treasury and the Internal Revenue Service.

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[1]/ The report was prepared by Willard B. Taylor and reflects comments received from David H. Brockway, Peter C. Canellos, Michael Hirschfeld, Robert A. Jacobs, Edward D. Kleinbard, Carolyn Joy Lee, Richard O. Loengard, Jr., Don J. Lonczak, Emily S. McMahon, Richard L. Reinhold, Stanley I. Rubenfeld, Michael L. Schler, Philip R. West and Ralph o. Winger.

Summary

The passive foreign investment company rules set out in Sections 1291 through 1297 of the Internal Revenue code are a major obstacle to the issuance of preferred stock in U.S. capital markets by a foreign corporation that is, or may be, a passive foreign investment company. Any interest charge imposed on a holder of preferred stock by Section 1291(a)(1)(C) of the Internal Revenue Code could ordinarily be avoided without any meaningful cost if the holder of the preferred stock made a so-called “qualified electing fund” election under Section 1295(a) of the Internal Revenue Code and Notice 88-125. This is, however, not a practical solution at this time because the rules for making the election in Notice 88-125 are complex and burdensome, both for holders and issuers. This obstacle could be substantially eliminated, without in any way limiting the purpose or effectiveness of the passive foreign investment company rules, if the Internal Revenue Service were to simplify the “qualified electing fund” election rules in Notice 88-125 and to provide by Regulations that any U.S. holder of preferred stock had, without more, made an effective “qualified electing fund” election with respect to preferred stock if the holder (a) reported any dividend payable with respect to that preferred stock on an accrual basis in the same fashion as though the stated rate of dividend were interest on a debt obligation and (b) noted on the holder's return for the first taxable year to which the election applied that such an election had been made. Dividend income would thus be accrued without regard to the issuer's earnings and profits, declaration or distribution dates; and would be treated in the same manner as accrued interest on a debt obligation in determining the allocation of purchase price to accrued dividends and in determining gain or loss on a sale of the preferred stock.

Preferred stock for this purpose would be stock that is described in Section 1504(a)(4) of the Internal Revenue Code, without regard to whether it had voting rights. Thus, it would include preferred stock that provided for dividends fixed by an auction or other market reset mechanism, as well as preferred stock with dividends that were fixed at issuance; and it would not include any preferred stock with liquidation or redemption rights that exceeded the issue price by more than a reasonable premium. It would be available for any instrument classified as equity for U.S. Federal income tax purposes if the instrument had the features set out in Section 1504(a)(4).

There are a number of analogies for this sort of "elective" simplification. One is the election given accrual basis holders of debt instruments by Regs. § 1.1272-3 to treat all interest and discount on a debt obligation as original issue discount, thus avoiding some of the complexities of the regulations concerning original issue discount, market discount and premium. Another is the election that would be given to regulated investment companies by Prop. Regs. § 1.1291-8 to report gain in respect of shares of a passive foreign investment company on a mark-to-market basis, thus eliminating the obstacles to investments by such companies in foreign corporations that are passive foreign investment companies.[2]/

[2]/ This would not in all cases be a practical alternative for other holders because of the difficulty of determining the value of shares that are not traded.

While not eliminating the need to have workable definitions of passive income and assets under Section 1296(b) of the Internal Revenue Code (particularly in respect of banks, insurance companies and securities dealers), a simplified qualified electing fund election would also have the benefit of reducing the pressure on those definitions.

## Background

The purpose of the passive foreign investment company provisions of the Internal Revenue Code is to eliminate the benefit to a U.S. shareholder of deferring tax on the shareholder's share of the income of the foreign corporation. If no qualified electing fund election is made, the effect of the rules is to assume that the "extraordinary" portion of any dividend received by the shareholder, and any appreciation in the value of a shareholder's shares, was earned over the entire period the shares were held. Section 1291(a)(1)(C) of the Internal Revenue Code imposes an interest charge on the shareholder on this assumption. While these rules generally make sense in the case of stock that participates in corporate growth, they do not make sense if the shares only entitle a holder to dividends payable on a fixed basis, whether dividends are fixed at the time of issuance or through a periodic auction or other market-reset mechanism, and to a return of capital in a fixed amount.

A holder of preferred stock takes dividends into income when they are received and thus reports currently its "share" of the issuer's earnings. Since the only reason why shares might be sold at gain[3]/ is because of changes in dividend rates prevailing in the market or in the creditworthiness of the issuer, there is no more logical justification for treating a dividend on preferred stock, or any gain from a sale of preferred stock, as ordinary income earned in a prior year (and thus subject to the interest charge imposed by Section 1291(a)(1)(C)) than there is for treating interest on, or gain from sale of, a straight debt instrument as subject to those rules.

To illustrate, if preferred stock pays a fixed quarterly dividend, there will be an “extraordinary” dividend only if, on account of default, dividends accumulate and are deferred, and a holder will realize a gain on a sale only if dividend rates prevailing in the market decline -- the extraordinary dividend and the gain in such a case are indistinguishable from the interest income or gain that would be realized under similar circumstances if the preferred stock were debt. If dividends are fixed through an auction or other market reset mechanism, there should ordinarily be no gain on a sale of the shares, since the price of the stock at any auction will always be the same and only the dividend rate will change; there will be an “extraordinary” dividend only if prevailing dividend rates increase sharply or there is a failed auction, resulting in dividends at an “upset” rate -- again, the extraordinary dividend is indistinguishable from the interest income that would be realized under similar circumstances if the preferred stock were debt.

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[3]/ Other than gain attributable to accrued but unpaid dividends.

Qualified electing fund election under Notice 88-125

A holder of preferred stock may in theory cure the problem of having dividends or gain thrown back to prior years under Section 1291(a)(1) and (2) by making a qualified electing fund election under Section 1295. In the case of preferred stock, the price of the election to a holder is simply that the holder will generally account for the dividends on an accrual basis (i.e., will report dividend income as it "accrues" rather than when, subject to the earnings and profits limitation, dividends are paid). Institutional holders of preferred stock are unlikely to object to this result, but the qualified electing fund election requires the holder to comply on an annual basis with substantial paper work requirements[4]/ and also requires the cooperation of the issuer (since, among other things, the issuer must provide information as to its ordinary earnings and capital gains, calculated on a U.S. tax basis, and must agree with the shareholder to make its books and records available for inspection[5]). Because of the complexity of the election, many purchasers simply will not purchase shares of a corporation that is (or may be) a passive foreign investment company, and the need for issuer cooperation (including, specifically, the requirement that the issuer calculate ordinary earnings and capital gains on a U.S. tax basis) is also an obstacle.

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[4]/ Specifically, Notice 88-125 and the instructions to Form 8621 requires a holder to file an election statement (the "Shareholder Section 1295 Election Statement"), an annual information statement (the "PFIC Annual Information Statement") and a completed Form 8621 for the year of election and, for each year thereafter, the information statement and Form 8621. These must generally be filed twice, once with the holder's return and separately with the Philadelphia Service Center. The Paperwork Reduction Act Notice that accompanies Form 8621 suggests that it requires some 16 hours to collect the required information and file the Form.

[5]/ The shareholder's failure to produce such books and records will invalidate its qualified electing fund election.

## Recommendation

We do not believe that the problem can be dealt with by simplifying the forms required to be filed by Notice 88-125 -- so long as an investment in preferred stock involves filings and other complexities not required for an investment in debt securities providing similar yields, potential investors are likely to be reluctant to make the investment.

Under these circumstances, we suggest that the Treasury and the Internal Revenue Service might simply provide in Regulations that a holder of preferred stock had made an effective qualified electing fund election if the holder reported dividends on preferred stock on an accrual basis. Since preferred stock eligible for the election would be defined by reference to Section 1504(a)(4) of the Internal Revenue Codes[6]/, its redemption and liquidation rights could only exceed its issue price by a reasonable premium. If there was nonetheless a concern about the treatment of any such premium, the Regulations might also require an electing holder to report as dividend income any excess of the stated mandatory redemption (or put) price of preferred stock over its issue price in the same manner as original issue discount income -- it should be borne in mind, however, that this would attach a price to a qualified electing fund election with respect to preferred stock that is not due in the case of the regular qualified electing fund election.

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[6]/ Except that it could be voting stock.

No separate form of election, or information with respect to the issuer, would have to be filed -- it would be sufficient that income was reported on this basis and that there was a notation of an election on the holder's return for the first taxable year for which the election was made.

As we contemplate it, this election would be available on a share-by-share basis[7]/ in any case in which there was a reasonable basis to believe that the issuer might be a passive foreign investment company[8]/; would be irrevocable; and would be made, by reporting the dividend income on an accrual basis, without regard to whether dividends were declared, on the holder's return for the first taxable year for which the election was made and noting that an election had been made on that return. Once made, the election would apply whether or not it was later determined that the issuing foreign corporation was not in fact a passive foreign investment company. This is important because the determination of whether a foreign corporation is a passive foreign investment company is often difficult and may change from year to year. Income accrued as a consequence of the election would be treated as dividend income, without regard to the issuing corporation's earnings and profits[9]/, and would be treated in the same manner as accrued interest on a debt obligation in determining gain or loss from the sale or exchange

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[7]/ Any shares of preferred stock for which the election was made would be excluded from the regular qualified electing fund election and such a regular election would have no effect on the shares of the preferred stock as to which the election had been made. See Prop. Regs. § 1.1295-1 (b)(2).

[8]/ Because, for example, the offering circular or placement memorandum for the shares advised prospective investors that the issuer was, or might be, classified as a passive foreign investment company.

[9]/ The election would not affect the issuer’s calculation of its own earnings and profits, which would continue for this purpose to be determined under the normal rules.

of the preferred stock or in respect of the subsequent receipt of a dividend.

We do not believe that such an election presents any particular opportunities for abuse. If the issuer has earnings and profits and the dividends are paid, the election might somewhat accelerate the holder's income; if the issuer did not have earnings and profits but paid the dividend, the election would turn what would otherwise be a return of capital into dividend income; and, if the issuer had no earnings and profits and defaulted in the payment of dividends, an election would create dividend income in a case where the holder would otherwise have had no income and no return of capital[10]/. The viability of the proposal would not be affected, however, by the inclusion of an anti-abuse rule in the Regulations so long as it was precisely drawn -- for example, the Regulations might provide that the election would not be available if a purpose for the terms of the preferred stock was to avoid the application of Section 1291 to the holders of any other class of stock of the issuing foreign corporation or inappropriately to back-load or front-load income. Holders of preferred stock that were entitled to a deemed paid foreign tax credit under Section 902(a) of the Internal Revenue Code might be made ineligible to elect if this situation is perceived to present a potential for abuse or undue complexity under the foreign tax credit rules.

Another solution, of course, would be simply to exclude preferred stock, as defined above, from the passive foreign investment company rules. This has the advantage of avoiding the need for an election, but we recognize that an exclusion for preferred stock would be a major step which it may not be practical to take within the time frame contemplated for the

[10]/ By analogy to debt, however, the holder at some point would not be required to accrue dividends.

issuance of Regulations relating to passive foreign investment companies.[11]/ Still another solution would be to adopt a simplified qualified electing fund election that did not treat preferred stock as debt to the extent described herein, but rather followed the usual rules for preferred stock except that the issuer would always be deemed to have sufficient earnings and profits so that all dividends would be taxable. This approach is closer to a traditional qualified electing fund election and does not require information from the issuer, but is generally more favorable to taxpayers than the approach described herein because dividends would not be taxable on the accrual basis.

If it would be useful for us to develop either of these alternatives in more detail, we would be pleased to do so. We would also be prepared to comment on other aspects of the passive foreign investment company regulations, if that would be helpful.

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[11]/ We note, however, that Section 1297(d) of the Internal Revenue Code provides authority to issue regulations "appropriate to carry out the purposes of" the passive foreign investment company rules.