REPORT #897

TAX SECTION

New York State Bar Association

Report on Proposed Regulations Relating
to a Special Preferred Stock QEF Election

March 17, 1997

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Hon. Donald C. Lubick
Acting Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

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

Re: Report on Proposed Regulations Relating to a Special Preferred Stock QEF Election

Dear Secretary Lubick and Commissioner Richardson:

The enclosed report, prepared by an ad hoc committee of the Tax Section, comments on proposed regulations issued on December 24, 1996 that would provide a simplified qualified electing fund elections for certain preferred stock of passive investment companies.

The proposed regulations generally respond to a recommendation that we had previously made, in a report filed in March of 1994, about the need to provide a simple rule for such preferred stock, and we very much appreciate the effort that has been made by the Internal Revenue Service and Treasury to develop such a rule. We do believe, however, that without further simplification the election provided by the proposed regulations will be perceived as no easier than the regular qualified electing fund election that is now available and will therefore not be of much use. This and or our other comments are set out more fully in the enclosed report.

We would be pleased to comment further if that would be helpful.

Very truly yours,

Richard Loengard, Jr.
Chair

cc: Joseph H. Guttentag
International Tax Counsel

Michael Danilack
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Tax Report #897

March 17, 1997

Report on Proposed Regulations Relating to a Special Preferred Stock QEF Election

This report,[*] comments on proposed regulations issued on December 24, 1996 that would provide a simplified qualified electing fund election for certain preferred stock of passive foreign investment companies.[**]

In a report filed in March of 1994, we recommended that a holder of preferred stock issued by a passive foreign investment company in effect be excluded from the passive foreign investment company rules if the holder elected to report dividends on the preferred on an accrual basis[***] and noted the election on the holder's return for the first taxable year for which the election was made. The proposed regulations generally respond to our recommendation, and we very much appreciate the effort made by the Internal Revenue Service and the Treasury to develop sensible rules. The proposed regulations seem to miss one of our central points, however, which was that such an election will be useful only to the extent that it is in fact materially simpler than the regular qualified electing fund election that is generally available to shareholders of passive foreign investment companies under Section 1295 of the Internal Revenue Code and

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[*] The report was prepared by Willard Taylor and reflects comments received from Shelley Grant, Richard Loengard, Jr., David S. Miller, Michael Hirschfeld and Yaron Reich.

[**] 61 F.R. 67752 (1996).

[***] NYSBA Tax Section, Report on Proposed Qualified Electing Fund Election under Section 1295(a), reprinted in Tax Notes Today (March 25, 1994).

Notice 88-125.[*] We strongly recommend that the Treasury and Internal Revenue Service reconsider the complexity of the special election provided by the proposed regulations and adopt the simplified election that we had recommended in our March 1994 report. We continue to believe that it is important to develop workable rules. Without simplification, however, we doubt that the special election provided by the proposed regulations will be of much use. This and our other comments on the proposed regulations are set out more fully below.

Background

The passive foreign investment company rules sometimes operate like the now-repealed interest equalization tax -- in effect precluding, because of the tax consequences, the ownership in the United States of equity of foreign corporations. While the resolution of this issue depends principally on the development of workable definitions of passive income and passive assets, we concluded in our prior report that regulations which addressed the treatment of preferred stock would relieve some of the pressure that exists in the absence of such definitions.

Specifically, the ownership of conventional fixed or adjustable rate preferred stocks issued by a passive foreign investment company does not present the abuse that the passive foreign investment company rules were directed at. A U.S. holder will generally include in income, when earned, the holder's share of the earnings and profits of the issuer and the gain, if any, realized by a holder on a sale of the preferred will reflect changes in dividend rates prevailing in the market or in the creditworthiness of the issuer. It is no more logical to treat

[*] 1988-2 C.B.535.

such an instrument as subject to the passive foreign investment company rules than it would be to extend the passive foreign investment company rules to non convertible debt instruments. Whatever minor potential for abuse might be involved in the ownership of preferred stock of a passive foreign investment company can be cured by putting U.S. holders on an accrual basis with respect to dividends and other payments to which the holder is entitled. Even this might be considered unnecessary in the case of preferred that was not issued at a discount from mandatory redemption price and pays dividends on a quarterly basis.

Because conventional fixed or adjustable rate preferred stocks do not present the abuse that the passive foreign investment company rules were directed at, we recommended in our prior report that a holder of preferred stock issued by a passive foreign investment company be treated as having made a qualified electing fund election if the holder accrued dividends on the preferred to which the holder is entitled in the same way as if the dividends or other payments were interest on debt. We concluded that there was authority to so provide under Section 1297(f).* We recognized that a U.S. holder could make a qualified electing fund election under Section 1295 and Notice 88-125 but concluded that the availability of this election did not solve the problem because (as explained below) of its complexity.

The Proposed Regulations

Consistent with our report, the proposed regulations provide for a special preferred qualified electing fund election.

* And indeed that this provided the basis for arguably more extensive elections, such as the election provided to regulated investment companies by Prop. Regs. § 1.1291-8 to use mark-to-market accounting for shares in passive foreign investment companies.

A U.S. shareholder who makes the special election will accrue dividends and discount on a ratable daily basis.[*] Distributions of accrued amounts will not be taxable, and basis will be adjusted to reflect accruals and non-taxable distributions. In effect, such preferred stock, if not issued at a discount from redemption price, is treated like debt held by an accrual basis taxpayer except that dividends are accrued on a ratable daily basis. If the preferred is term preferred that is issued at a discount from redemption price, an electing holder must also accrue the discount on a ratable daily basis.

Preferred stock is eligible for the special election provided by the Proposed Regulations if (1) the holder does not own, directly or indirectly, 5% or more in vote or value of any class of stock of the issuer,[**] (2) the issuer certifies in writing, directly to the electing shareholder or to U.S. holders generally, that it is, or reasonably believes it is, in the year in which the election is made, a passive foreign investment company and not a controlled foreign corporation, (3) the issuer indicates in the offering document or another written statement available to U.S. holders that it has no current intention or belief that it will not pay dividends currently and that the other eligibility requirements of Prop. Regs. § 1295-2(b)(1) are met, (4) no regular qualified electing fund election has been made and (5) the stock meets the other eligibility requirements set out in Prop. Regs. § 1.1295-2(b)(1)(2).

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[*] Prop. Regs. § 1.1293-2.

[**] Prop. Regs. § 1.1295-2(c)(2).

Among these other eligibility requirements are rules that limit the election to shares with a fixed redemption or liquidation price and require that any redemption premium either not be taxable as a dividend, under Regs. § 1.305-5(b), or not exceed 5% of the liquidation or redemption amount and, in the case of shares purchased in the secondary market, exclude shares if the shares are term shares and the amount payable on redemption exceeds the purchase price by more than 1% or if the shares are perpetual shares and the amount payable on liquidation exceeds the purchase price by more than 10%.[*]

An election can be made with respect to eligible preferred stock issued 30 days or more after the adoption of the proposed regulations as final Regulations.[**]

Comments on Proposed Regulations

Our comments on the proposed regulations are as follows:

Mechanics of election. In order for the election to be available under the proposed regulations, the issuer must certify in writing to all U.S. holders that it is, or reasonably expects to be a passive foreign investment company and not a controlled foreign corporation for the year in which the shareholder acquired the shares; the shareholder must elect on Form 8621 (Return of Shareholder of a Passive Foreign Investment Company or Qualified Electing fund) and must report the required income inclusion on that form; the shareholder must attach a statement (the so-called preferred QEF statement) setting out certain information and sign that statement under penalties of perjury;

[*] Prop. Regs. § 1.1295-2(b).

[**] Prop. Regs. §§ 1.1292-2(e) and 1.1295-2(h).

and the shareholder must file Form 8621 annually thereafter so long as it holds the shares.

The recommendation in our prior report was for a much simpler election -- there would be an election if the holder reported dividends on an accrual basis and noted that it had made the election on the return filed for the year of election. This was intended not only to be simple, but also to permit a holder to elect in respect of preferred stock if the holder concluded that it was issued by a foreign corporation that was, or might be, a passive foreign investment company, whether or not the issuer had reached that conclusion. Thus, for example, the election could be made in respect of preferred stock purchased in the secondary market, even though such stock had not been initially targeted to U.S. purchasers. We saw no harm in permitting a holder to treat preferred stock of a foreign corporation as debt even if it turned out that the foreign corporation was not a passive foreign investment company.

In formulating this recommendation, we took into account the fact that the holder of preferred stock of a passive foreign investment company may make a qualified electing fund election under Section 1295 and Notice 88-125. That election is made on Form 8621, and a holder must each year thereafter also file Form 8621 and a annual information statement[*]. These must generally be filed twice, once with the Philadelphia Service center and once with the holders return. In addition, the passive foreign investment company must annually provide information with respect to the holder's share of its earnings and profits and net capital

[*] As set out in Notice 88-125 and the instructions to Form 8621.

gain and with respect to distributions and agree to make its books and records available to the shareholder to the extent relevant to establish this information.

In general, the price of the election is the same as if the holder were to make the special election provided by the proposed regulations -- that is, the holder will generally account for dividends on an accrual basis. The special election provided by the proposed regulations, however, is more expensive because it requires ratable accrual of dividends and, in the case of term preferred stock issued at a discount, requires the holder to accrue the discount into income on a ratable basis.
As between the election provided by the regulations and the regular qualified electing fund election, it is difficult to see why the special preferred stock election provided by the proposed regulations will be any simpler. Both elections require initial and on-going special filing requirements by the shareholder; the regular qualified electing fund election requires the corporation to provide annual information with respect to earnings and distributions[*] and agree to permit shareholders to inspect so much of its books as are relevant and, while that is not required for the special preferred stock election, the special preferred stock election does require the issuer to certify in writing to each shareholder that it is, or reasonably believes it is, a passive foreign investment company and not a controlled foreign corporation, that it has no current intention or belief that it will not pay dividends currently and that the other eligibility requirements of Prop. Regs. § 1295-2(b) are met. In addition, the special election will be more expensive to the holder than the

[*] Notice 88-125.

regular qualified electing fund election because it will require ratable accrual of dividends and, in some cases, discount.

Since the special preferred stock election is, in our judgment, not materially simpler than the regular qualified electing fund election, we question whether it will be of much use. We strongly recommend, therefore, that the Treasury and Internal Revenue Service reconsider the complexity of the special election provided by the proposed regulations and adopt the simplified election that we had recommended in our March 1994 report.

The proposed regulations seem to assume that the "problem" with a regular qualified electing fund election is obtaining earnings information from the issuer.[*] That is not always correct -- it may be equally as much the reluctance of U.S. investors to comply with the filing requirements for the regular qualified electing fund election. Moreover, any requirement that the issuer be involved in the election will be a problem unless the shares were targeted to the U.S. market.[**]

Other comments. Our other comments on the proposed regulations are as follows:

1. Exclusion of foreign currency preferred. Prop. Regs. § 1.1295-2(b)(1)(iii) excludes from the definition of qualified preferred shares any share of stock if any amount

[*] Thus, the preamble states that the special election "should only apply with respect to foreign corporations that are not expected to be in a position to provide U.S. accounting information to shareholders".

[**] As a practical matter, where shares are targeted to the U.S. market, the holder's share of the earnings and profits of the issuer would be equal to the dividends to which it is entitled, and the accounting information provided by the issuer would thus be relatively straightforward.

payable with respect to the share is not denominated in U.S. dollars or is determined by reference to the value of a currency other than the U.S. dollar. We question why this should be so. As previously stated, if the preferred stock has the other features of conventional fixed or floating rate preferred, there is no more reason to apply the passive foreign investment company rules to the stock than to apply those rules to debt instruments. Since the passive foreign investment company rules do not apply to foreign currency debt instruments, we do not believe that they should apply to preferred that is denominated in, or provides for payments determined by reference to, a foreign currency. The special preferred qualifying electing fund election would also be an. election to apply the rules in Section 988 as though the preferred was a "section 988 transaction".

2. Requirement of issuer statement with respect to the payment of dividends. Prop. Regs. § 1295-1(b)(1)(xi) excludes from the definition of qualified preferred shares any shares unless the issuer of the share has indicated in the offering document relating to its original issuance or otherwise in writing to U.S. holders that the issuer has no current intention or belief that it will not pay dividends on the share on a current basis and that the share meets the other conditions of Prop. Regs. § 1295-1(b)(1). Since qualified shares must be issued for value to unrelated persons and cannot be issued at a significant discount, we question why the first statement is required -- how could the shares be sold without a significant discount unless the purchasers had concluded that the issuer would pay dividends? Asking for the issuer's certification that the requirements of the proposed regulations are met seems to us to serve no function.*

* In substance, it amounts to a requirement that the issuer hire U.S. legal advisors.

3. Requirement of issuer statement with respect to status of the issuer. Prop. Regs. § 1295-2(c)(3) makes a holder ineligible for the election unless the issuer has provided a written statement in respect of the year in which the election is made certifying that it is, or reasonably expects to be, a passive foreign investment company and not a controlled foreign corporation. To begin with, this requirement would seem to effectively exclude from the election any shareholder who, in a year after the offering, acquires shares in the market -- on what basis can such a shareholder be expected to extract the required statement from the issuer? In addition, we question whether it serves any useful purpose -- what is the damage if, contrary to the expectations of the shareholder, it subsequently turns out that the issuer is not a passive foreign investment company? Since eligible shareholders, by definition, can never be United States shareholders within the meaning of Section 957, we do not see the utility of asking for a certification that the issuer is not a controlled foreign corporation. We would have no objection to providing that, by making the election, the holder is certifying that the holder cannot determine that the foreign corporation is not a passive foreign investment company and is agreeing to treat the corporation as a passive foreign investment company for so long as the holder remains its shareholder. The holder's conclusion might be based on a statement from the issuer or on the holder's own analysis of the issuer's operations.

4. Exclusion of convertible preferred. Prop. Regs. § 1.1295-2(b)(1)(iv) excludes from the definition of qualified preferred shares any shares which participate in corporate growth to a significant extent within the meaning of Section 1504(a)(4)(B) of the Internal Revenue Code. Given this restriction, it seems to us to be unnecessary to separately

exclude, in Prop. Regs. § 1.1295-2(b)(1)(x), shares that are convertible into stock other than qualified preferred shares.

5. Exclusion of 5% or greater holders. Prop. Regs. § 1.1295-2(c)(2) makes shares ineligible for the election if the shareholder owns, directly or constructively 5% or more in vote or value of the class of shares. We question the need for such a broad limitation. If the point is to exclude major shareholders, the restriction should be written in terms of voting power alone.