Report #994

New York State Bar Association Tax Section Report on Proposals for Guidance with Respect to Passive Foreign Investment Companies[1]

Summary

This Report addresses certain aspects of the current passive foreign investment company ("PFIC") rules that may cause foreign companies that are engaged in *active* businesses to be inappropriately classified as PFICs. To address the problems that may result in unintended PFIC classification, we have developed proposals for Treasury regulations along the following lines: (i) to address problems that arise with respect to companies that raise a significant amount of capital (such as through a public offering or private venture capital investments), we propose that liquid assets held for the reasonable needs of an active business (and the earnings thereon) not be treated as passive assets (or passive income); (ii) to address start-ups with small amounts of passive income which income is more than offset by expenses, we propose providing a "deemed" QEF election for shareholders and optionholders if the company has no net earnings; (iii) to address companies that, in the course of an active trade or business, derive rents, royalties or income from sales of commodities which are classified as "passive" under the rigid subpart F definition of "foreign personal holding company income," we propose that in the PFIC context, the subpart F regulations be applied by disregarding the "substantially all"/"85 percent test" applicable to commodities gains and by applying the PFIC look-

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[1] This Report was prepared by the Committee on Corporations with significant participation by Pamela J. Campbell, Erin H. Glenn, Briana King, Matias Milet, David R. Sicular and Diana L. Wollman. Substantial comments were received from Kimberly S. Blanchard, Tim Devetski, Samuel J. Dimon, Gary M. Friedman, Robert Jacobs, Anthony Leitner, Richard O. Loengard, Jr., John Lutz, Vadim Mahmoudov, David W. Mayo, John Narducci, Yaron Z. Reich, Michael L. Schler, David H. Schnabel, Elizabeth A. Smith, Burton B. Smoliar, Lewis R. Steinberg, Marcus H. Strock and any others. Although members of the Tax Section have represented clients that are affected by the issues discussed in this Report, the Report was not prepared at the request or on behalf of any client.

through rules to take into account activities of employees of subsidiaries and certain affiliates of the corporation whose income is being tested for PFIC status; (iv) to clarify the treatment of gain recognized from sales of related entities, we propose that it be clarified that where a foreign corporation sells stock in a 25 percent owned subsidiary or an interest in a 25 percent owned partnership, the gain is characterized as if the corporation had held and sold directly its proportionate share of the assets of the subsidiary or partnership; (v) to address the problems created for optionholders, who are currently unable to make a QEF election, we propose a modified version of the existing QEF election that would be available to optionholders; (vi) to clarify how a foreign corporation takes into account an interest in a partnership, we propose that it be specifically provided that, if the corporation owns a significant interest in the partnership, the corporation's proportionate share of a partnership's income and assets will be treated as if derived and held by the corporation directly; and (vii) to address the restrictive requirements for being eligible to make a retroactive QEF election, we propose modifying the requirements to make the retroactive QEF election more widely available. We also discuss the rules that allocate "excess distributions" among the years in the shareholder's holding period on a ratable basis for purposes of computing the interest charge on the excess distribution, and suggest that the statute be changed to allocate the excess distributions on a yield-to-maturity basis instead.

Section I. Introduction

The principal purpose of this Report is to describe how certain aspects of the current rules defining a passive foreign investment company ("PFIC") may result, we believe improperly, in active companies being classified as PFICs, and to propose regulatory solutions to these problems. The PFIC rules are extremely complex and, where they apply, potentially draconian. This Report does not address whether this draconian approach is appropriate in situations where the PFIC rules were intended to apply. Instead, the Report addresses our concern that these draconian and complex rules may often apply in situations where they were *not* intended to apply. We believe these problems can and should be resolved through the issuance of Treasury regulations. The

last two sections of this Report include certain other suggestions that we believe would improve the operation of the PFIC rules.

The PFIC rules, contained in Sections 1291 through 1298 of the Internal Revenue Code of 1986 (the "Code"),[2] were enacted in 1986 with the stated intent of preventing U.S. taxpayers from deferring or avoiding taxes on income and gains from passive investments by making the investments through a foreign corporation that would accumulate the investment profits rather than distribute them.[3] The legislative history indicates that Congress was concerned that U.S. persons were able, by limiting their stock ownership in foreign passive asset holding corporations, to avoid then-existing anti-deferral rules, all of which apply only if the foreign corporation is controlled by U.S. persons (*i.e.*, the controlled foreign corporation ("CFC"), personal holding company, foreign personal holding company and foreign investment company rules).[4] Since 1986, however, it has become apparent that despite their stated intent to target *passive* investments, the PFIC rules, due largely to their breadth in defining passive income and passive assets, often apply to *active* businesses.

At least four types of active businesses may get caught in this trap:

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2 All Section and Regulation references are to the Code and the Treasury regulations promulgated thereunder, unless otherwise noted.

3 The Joint Committee on Taxation's *General Explanation of the Tax Reform Act of 1986* (the "1986 Bluebook") describes the purpose of the PFIC rules as follows: "Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation." Staff of the Joint Comm. on Taxation, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, at 1023 (Comm. Print 1987).

4 Generally, the CFC rules do not apply unless at least 50 percent of the corporation's shares are owned by U.S. persons, each of whom owns at least 10 percent of the shares; the personal holding company and foreign personal holding company rules do not apply unless more than 50 percent of the corporation's stock is held by 5 or fewer individuals; and the foreign investment company rules do not apply unless 50 percent or more of the corporation's stock is owned by U.S. persons. *See* Sections 542(a)(2), 552(a)(2), 951(b), 957(a) and 1246(b).

1. Active companies that are in a start-up mode for several years (including, among others, information technology and service companies that provide customers with information, services and other intellectual property rather than tangible goods; biotechnology companies; and companies engaged in long-term infrastructure, mining or oil and gas exploration projects). The exception from PFIC classification for start-up companies, which is aimed at preventing a nascent active business from being classified as a PFIC, does not protect most start-ups since it applies only to the first taxable year the corporation has gross income.[5]

2. More established active companies that raise a significant amount of capital (for example, through private venture capital investments or an initial public offering) for future use.

3. Companies that derive rents, royalties or income from sales of commodities in the course of an actively conducted business. These companies may be classified as PFICs due to the unanticipated interplay of the PFIC rules and definitions imported into the PFIC rules from the subpart F area.

4. Any foreign corporation not otherwise in danger of PFIC classification may become a PFIC in a single year as a result of a sale of equity interests in an operating subsidiary or partnership.

In some cases, the "qualified electing fund" ("QEF") regime provides substantial tax relief; however, its complexity and the substantial administrative and recordkeeping burdens it imposes on the foreign corporation and its U.S. shareholders may, as a practical matter, make it unavailable. The requirements associated with a QEF election often present substantial complications to structuring an investment. It is often quite difficult in practice to explain these requirements to the officers and representatives of the foreign corporation, to obtain the necessary detailed information to determine if the company may in fact be a PFIC under the technical rules, and to devise a workable

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[5] Section 1298(b)(2).

solution that permits the U.S. shareholders to receive the necessary information from the company each year to comply with the QEF election. In the case of a corporation caught in the PFIC definition even though it is engaged in a profitable active business, the logistics and economic costs of a QEF election may be insurmountable obstacles, despite the willingness of the parties to try to overcome them. Where an offering of shares must include a U.S. tax disclosure, it may be extremely difficult to prepare disclosure that is clear, complete and informative given the complexity of the PFIC rules and uncertainty as to whether the company will or will not be a PFIC.

We believe that it is clear from the legislative history, as well as Congress' attempt to craft exceptions from the PFIC rules for certain types of companies, that the rules were not intended to apply to investments in active businesses and were not intended to deter or prevent U.S. persons from investing in active foreign businesses.[6] However, in many cases the PFIC rules are, in fact, a significant deterrent to U.S. persons investing in a foreign corporation that all would agree is an active business and not a passive investment vehicle. In other cases, these investment opportunities will not even be made available to U.S. persons since many foreign corporations, once having been advised of the problems U.S. shareholders may face, simply decide to not even attempt to raise equity capital in the U.S. markets.

Furthermore, where the foreign corporation is engaged in an active business, U.S. investors and the officers of the foreign corporation may *never realize* that the PFIC rules – which were intended to target passive investments – might, technically, apply. Parties in this situation are, of course, unlikely even to attempt to comply with the PFIC rules. Even where the company realizes that the PFIC rules might apply and discloses this to

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[6] To the contrary, the 1986 Bluebook states that "[a] foreign corporation engaged in an active trade or business generally will not be a PFIC." 1986 Bluebook at 1032. *See also* Section 1297(b)(2)(A) and Prop. Treas. Regs. § 1.1296-4 (exception for income earned in the active conduct of a banking business); Section 1297(b)(2)(B) (exception for income earned in the active conduct of an insurance business); Section 1298(b)(2) (start-up exception); Section 1298(b)(3) (exception for company that is a PFIC solely as a result of the sale of a division).

investors, the complexities of the rules may ultimately foster an indifference to compliance, particularly among individuals who are investing in the shares solely to diversify their investment portfolios, have not faced PFIC issues before and are not accustomed to obtaining (or needing to obtain) sophisticated tax advice.

We believe that these problems – *i.e.*, the possibility that an active business will be inappropriately classified as a PFIC, the difficulties associated with attempting to describe the consequences of the PFIC rules to prospective investors, and the complexity and costs associated with a QEF election – contribute to the public's perception that the U.S. tax laws are unfair and overly complex, that many other taxpayers are ignoring the laws without punishment and that it does not make sense to employ a tax advisor to determine what you "properly" owe when the odds of winning the "audit lottery" are so favorable.

We believe that these unintended consequences of the PFIC rules are a serious problem that is worthy of your attention. Accordingly, we respectfully submit the proposals described below to address these unintended consequences. All of these proposals call for the issuance of Treasury regulations, except the final proposal, which would require a statutory amendment. We believe that Section 1298(f), which provides that the Secretary shall prescribe such regulations as may be "necessary or appropriate to carry out the purposes of this part" (*i.e.*, Sections 1291-1298), authorizes the Treasury to adopt regulations along the lines we are proposing.

In summary, our main proposals are that Treasury regulations be issued as follows:

- Providing that liquid assets held for the reasonable needs of an active trade or business (and the earnings thereon) will not be treated as passive assets (or as passive income). (This proposal is discussed in Section IIIA.)
- Providing a "deemed" QEF election for shareholders and optionholders of foreign corporations that have no net earnings. (This proposal is discussed in Section IIIB.)

- Providing that the "substantially all"/"85 percent test" applicable under Section 954 to active commodities gains will not apply for PFIC purposes. (This proposal is discussed in Section V.)

- Applying the PFIC look-through rules so as to take into account employees of subsidiaries and certain affiliates of the corporation being tested for PFIC status in determining whether commodities gains, rents and royalties are active or passive income. (This proposal is discussed in Section V.)

- Clarifying that when a foreign corporation sells stock in a 25 percent owned subsidiary or an interest in a 25 percent owned partnership, the gain is characterized as if the corporation had held and sold directly its proportionate share of the assets of the subsidiary or partnership. (This proposal is discussed in Section V.)

- Providing a modified version of the existing QEF election to be available to U.S. holders of options on PFIC stock (*i.e.*, options not covered by the proposed deemed QEF election). (This proposal is discussed in Section VIA.)

- Clarifying that compensatory stock options on PFIC stock are not treated as "options" under the PFIC rules. (This proposal is described in Section VIB.)

- Clarifying that a corporation's proportionate share of a partnership's income and assets is treated as if derived and held by the corporation directly if the corporation holds a significant interest in the partnership. (This proposal is discussed in Section VID.)

- Modifying the requirements for making a retroactive QEF election to make the election less restrictive and available to a larger number of shareholders. (This proposal is discussed in Section VI.)

We believe that all of these regulations should, at a taxpayer's election, apply retroactively to all open years. We also urge Treasury to finalize all outstanding temporary and proposed regulations in the PFIC area.

Our final, legislative, proposal is as follows:

- Amending Section 1291 to provide that the interest charge imposed with respect to excess distributions (where the shareholder has not made a QEF or mark-to-

market election) be computed by allocating the excess distribution on a yield-to-maturity basis (rather than ratably). (This proposal is discussed in Section VIII.)

Section II of this Report describes the existing PFIC regime, how the PFIC passive income and passive asset tests often result in start-ups and active companies that have recently raised new capital being classified as PFICs, and why the existing QEF and mark-to-market regimes are not an adequate solution to these problems. Section III discusses two proposals we believe would address the inappropriate PFIC classification of start-ups and companies that have raised new capital. Section IV then explores the difficulties that arise in applying the PFIC rules to businesses earning active commodities income and businesses using individuals employed by affiliates to generate active rents and royalties. Section IV also discusses how the sale of an operating subsidiary or partnership may create a PFIC problem even though the sale of an operating division generally would not. Section V suggests solutions to the problems discussed in Section IV. Section VI then makes certain additional regulatory proposals relating to the PFIC rules: namely, adding a modified QEF election for options, clarifying that compensatory options on PFIC stock are not treated as PFIC stock, clarifying the treatment of partnerships in the PFIC context, modifying the regulatory requirements for making a retroactive QEF election, and adding a protective QEF election for debtholders. Section VII then discusses the parameters of a general anti-abuse rule proposed to address potential abuses with respect to these proposals. Finally, Section VIII proposes legislation that would revise the method for computing the interest charge imposed on excess distributions from a PFIC.

Section II. The Existing PFIC Regime

A. Definition of a PFIC

Generally, a PFIC is any foreign entity classified as a "corporation" for U.S. federal income tax purposes if, during the taxable year: (i) 75 percent or more of the corporation's annual "gross income" is "passive income" (the "Income Test") or (ii) 50

percent or more of the corporation's assets (by value) produce (or are held to produce) passive income (the "Asset Test").[7]

For purposes of these rules, "passive income" is defined as any income of a type that would be foreign personal holding company income as defined in Section 954(c), which generally includes interest, dividends, rents and royalties (unless derived in the active conduct of a trade or business), annuities, gains from the sale of property that gives rise to any of the foregoing, and certain gains from transactions in commodities.[8]

B. Consequences of Classification as a PFIC

Every U.S. person that owns shares in a PFIC is subject to the onerous rules provided for by Section 1291, unless the shareholder makes a QEF election or a mark-to-market election (both of which may be unavailable or problematic, as discussed in detail below in Section IIF).[9] Under Section 1291, all gain recognized on a sale or disposition of the shares, and the portion of any distributions (whether or not out of earnings and profits) made by the PFIC in any taxable year that exceeds 125 percent of the average annual distributions received in the three preceding taxable years (or, if shorter, the shareholder's holding period before the taxable year), are considered "excess distributions." Excess distributions are allocated ratably to each day of the shareholder's holding period.[10] The amounts allocable to prior years are taxed at the highest rates in effect for ordinary income for the shareholder in those prior years, and the resulting taxes

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7 Section 1297(a). We have not included an exhaustive description of the PFIC rules as we believe that is beyond the scope of this Report.

8 There are a number of exceptions in Section 1297 to the classification of income as passive, including exceptions for income earned in the active conduct of a banking business or the active conduct of an insurance business. *See* Sections 1297(b)(2)(B) and (A); *see also* Prop. Treas. Regs. § 1.1296-4.

9 In addition, for periods beginning after December 31, 1997, a 10-percent U.S. shareholder of a CFC is not also subject to the PFIC rules. Section 1297(e).

10 Section 1291(a)(1)(A) and Prop. Treas. Regs. § 1.1291-2(e).

are subject to a compounding interest charge at the rate applicable to deficiencies in income taxes, as if the taxes had been due in the prior years.[11] These rules are intended to put the U.S. shareholder in the same position he or she would have been in if the PFIC had actually distributed its current earnings and profits at the end of each year. Of course, they do so imperfectly because, among other things, unless the income was actually earned ratably (which is not likely to have been the case), the interest charge is inflated.[12] For non-corporate shareholders, the interest charge is particularly onerous since existing regulations provide that it is not deductible.[13]

As discussed below, a shareholder can avoid the excess distribution regime by making a QEF election if the PFIC provides the necessary information and documentation. The QEF election requires the shareholder to pay tax currently on the PFIC's earnings whether or not distributed. In the case of an investor in a plain-vanilla PFIC (*i.e.*, an offshore mutual fund), the QEF election will put the investor on essentially the same footing as an investor in a U.S. regulated investment company, which appears to have been the intent of these rules.

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11 Sections 1291(a)(1)(C), (a)(2) and (c) and Prop. Treas. Regs. §§ 1.1291-2(e), 1.1291-3 and 1.1291-4(c). Under the "once-a-PFIC, always-a-PFIC" rule, once PFIC status has attached to a share of stock, all subsequent distributions on the share (or gains on a disposition) will, in the absence of a QEF or mark-to-market election, be subject to the excess distribution rules (regardless of whether the corporation otherwise would be a PFIC in the year of distribution or disposition). *See* Sections 1297(b) and (d); Prop. Treas. Regs. §§ 1.1291-1(b)(1)(ii) and (2) and 1.1291-2(a).

12 In addition to inflating the interest charge, these rules tax all of the "excess distributions" as ordinary income, even if they exceed the PFIC's earnings and profits and they apply the highest tax rate applicable to ordinary income for each prior year without regard to the rate that would actually have applied had the shareholder received a dividend in that year.

13 *See* Section 1291(c), Prop. Treas. Regs. § 1.1291-4(b) and Temp. Treas. Regs. § 1.163-9T(B)(2)(i)(B) (interest paid by an individual under Section 1291(c) is personal interest and therefore nondeductible).

C. The Income Test and the Definition of Gross Income

As noted above, the Income Test measures whether 75 percent or more of the foreign corporation's "gross income" consists of "passive income." The Service has held, in at least one private letter ruling, that, because there is no specific guidance in the PFIC rules on how to determine "gross income," it is "appropriate to adopt the principles of Sections 11 and 61 of the Code."[14] Under Section 61 and Treasury Regulations § 1.61–3, gross income equals (i) the excess of (a) revenues from operations (referred to as "gross receipts") over (b) the cost of goods sold (this excess is referred to as "gross margin"), plus (ii) interest, dividends and any other items of income. Trade or business expenses that are not properly considered "costs of goods sold" (*e.g.*, marketing expenses, salaries, research and development costs, depreciation of equipment, supplies, overhead, etc.) ("Section 162 expenses") are *not* taken into account in computing gross income.[15] Section 162 expenses are taken into account in computing "net income," as are interest expenses and certain taxes (under Sections 163 and 164).[16]

To illustrate how these definitions work, consider a company that pays $30 for raw materials and $50 in salaries, sells its inventory for $100, and earns $15 on its cash in the bank. The company would have $100 of gross receipts, $70 of gross margin, $85 of gross income and $35 of pre-tax net income.

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14 PLR 9447016 (Aug. 19, 1994) (citing Treas. Regs. §§ 1.61-3(a) and 1.952-2(c)(4)).

15 *See* Treas. Regs. § 1.61-3; *see also* Treas. Regs. § 1.9524-2(c)(4) (explaining that gross income is not synonymous with gross receipts and that gross income is determined by subtracting costs of goods sold from gross receipts and then adding income from investments and other outside sources).

16 *See generally* Sections 63, 161, 162, 163 and 164 (trade or business expenses, interest and certain taxes deductible in computing net taxable income).

D. The Asset Test and the Treatment of Liquid Assets

Under the Asset Test, a foreign corporation is a PFIC if "the average percentage of assets . . . held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent."[17] The percentage of the corporation's assets that are passive in any year is determined by averaging the percentages as of the end of each quarter of the year.[18] The only example of a passive asset given in the 1986 legislative history is corporate stock — *i.e.*, an asset that would produce dividend income.[19]

In 1988, the Service issued Notice 88-22 to provide guidance with respect to the definition of a PFIC pending the issuance of Treasury regulations.[20] Notice 88-22 provides that generally an asset will be treated as passive "if it has generated (or is reasonably expected to generate in the reasonably foreseeable future) passive income in the hands of the foreign corporation." Notice 88-22 then provides, under a formalistic reading of the statutory language defining passive income as including all "interest," that because "[c]ash and other current assets readily convertible into cash, including assets which may be characterized as the working capital of an active business, produce passive income" (*i.e.*, interest) the assets are therefore passive assets for purposes of the Asset

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17 Section 1297(a)(2).

18 Section 1297(a)(2); *see also* Notice 88-22, 1988-1 C.B. 489, *modified by* Notice 89-81, 1989-2 C.B. 399 (discussing the mechanics of the Income and Asset Tests).

19 *See* 1986 Bluebook at 1024; S. Rep. No. 99-313, at 395 (1986) (referring to corporate stock paying no current dividends); H.R. Rep. No. 99-426, at 410 (1985) (referring to stock paying no dividends currently but potentially able to pay dividends in the future).

20 Notice 88-22 makes reference to the definition of "passive income" under Section 904(d)(2)(A) (rather than Section 954(c)) because, when initially enacted, the PFIC rules had defined "passive income" by reference to Section 904(d)(2)(A) which itself refers to Section 954(c)). After Notice 88-22 was issued, Congress revised the PFIC definition to refer directly to Section 954(c). *See* Technical and Miscellaneous Revenue Act of 1988, P.L. 100–647, § 1012 (p)(5).

Test (the "Cash Rule").[21] In other words, all cash and all other liquid assets are treated as passive assets generating passive income under the Cash Rule, regardless of how the company intends to use the funds.[22]

E. How the Treatment of All Liquid Assets and All Earnings Thereon as Passive May Cause Active Corporations to be PFICs

1. The Income Test

The first problem under the current Income Test is that an active business, still in its start-up phase, may be classified as a PFIC solely as a result of the earnings on its liquid assets, even if the company is not generating a profit (*i.e.*, the company has a net loss for the year). This could occur under any of the following scenarios:

(i) it has no revenues from operations but a small amount of passive interest income from its bank account, and therefore its entire gross income is passive;

(ii) it has positive gross margin that is less than 25 percent of its total gross income (*e.g.*, its interest on its bank balance is at least three times as much as its gross margin); or

(iii) it has negative gross margin and a small amount of passive income (in excess of the gross margin deficit), and thus all of its gross income is passive.

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21 Notice 88-22 provides that taxpayers may rely on the Notice until the issuance of Treasury regulations. To date, no such regulations have been issued or proposed (other than certain regulations proposed with respect to income of foreign banks, securities dealers and brokers).

22 One exception to the general rule in Notice 88-22 that liquid assets constitute passive assets is trade and service receivables. Notice 88-22 states that receivables derived from sales that produce nonpassive income will be treated as nonpassive assets, even if they incidentally produce interest. In a letter ruling, the Service has indicated that it will not differentiate between short term and long term receivables or between receivables derived from sales to related and unrelated parties. PLR 9643011 (July 19, 1996). We urge Treasury to confirm this ruling in regulations.

In each case, even if the start-up has no net income (because its Section 162 expenses *exceed* its gross income) it is classified as a PFIC.

In a variation of scenario (iii), the start-up may escape being classified as a PFIC if its gross margin deficit exceeds its passive income — in other words, if enough of its expenses are counted in cost of goods sold so that it has negative *gross* income rather than only negative *net* income. This was the situation in a 1994 private ruling in which the Service held that the foreign corporation was not a PFIC because it had no gross income.[23]

As these scenarios demonstrate, an active operating company technically may be a PFIC, even though it has no investment assets, other than a small amount of cash on hand, and even if it is operating at a loss. In addition, two corporations with identical amounts of active revenues, expenses and passive income may fare differently under the PFIC rules if, for example, one is manufacturing-oriented (such that the bulk of its expenses are included in its cost of goods sold and therefore reduce its gross income) while the other, because it is service-oriented, has primarily Section 162 expenses (*e.g.*, salaries) that will not reduce its gross income. In some cases it will be the manufacturing company that is at risk of PFIC classification, and in others it will be the service company. This is because the inclusion of expenses in cost of goods sold reduces total gross income and thus the denominator of the 75 percent Income Test fraction (*i.e.*, passive income divided by total gross income).[24] In the private letter ruling discussed above, if that taxpayer had been a service company with Section 162 expenses instead, it would likely have had positive gross income and been a PFIC.

To see how the results could be the opposite under different facts, consider a manufacturing company that pays $90 for raw materials, sells its inventory for $100 and

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23 *See* PLR 9447016, *supra*. Of course, if that foreign corporation had earned enough interest on its bank account to cause it to have even $1 of gross income, or if enough of its "cost of goods sold" expenses were instead Section 162 expenses, such that it had positive gross income, it would have been classified as a PFIC.

24 In PLR 9447016, this helped the taxpayer because the taxpayer had zero gross income.

has $40 of passive income. The company would have $10 of gross margin (*i.e.*, active gross income) and $50 of total gross income — thus, 80 percent of its gross income would be passive and it would be a PFIC. A service company in the same situation, except with $90 of salary costs instead of raw material costs, would have $140 of gross income, $100 of which was active and $40 of which was passive, and therefore would not be classified as a PFIC.

In fact, a wide range of businesses are affected by the rules in Notice 88-22 that classify all earnings on liquid assets as passive and treat a corporation as a PFIC even when it is operating at loss. The types of businesses that usually have long start-up periods during which they derive little or no operating revenues include: (i) biotechnology companies, which may take years to develop a new drug or a new diagnostic or surgical tool before bringing it to market; (ii) infrastructure companies, which may spend years building a power plant, a toll road, a tunnel, a bridge or the like before they begin collecting revenues; (iii) companies engaged in mining or oil and gas exploration and development, which may be in an exploration and development mode for years before they begin extracting, processing and selling their output; and (iv) information technology companies, which may spend years developing and marketing information-based technology products or services before they have an established product and clientele.

The second problem under the Income Test is that, because all interest income is treated as passive, an active company that is earning a profit may subsequently be classified as a PFIC simply as a result of a substantial capital infusion. The reality of the capital markets is that a company seeking funds for future development and expansion will usually need to raise all or most of the funds that it anticipates it will need in either a single offering or a small number of offerings, as opposed to frequent periodic offerings as the project progresses. In most cases, the company will not be able to utilize all of the funds immediately and, if the interest it earns on the as-yet-unexpended funds during any taxable year is more than three times the company's gross margin in that year, the company will be a PFIC in that year. This may occur in a company that is in one of the long start-up period industries described above, as well as a more traditional

manufacturing-type company that may, for example, want to build a new plant or diversify by acquiring or developing a new line of business.

2. The Asset Test and the Cash Rule

The Asset Test also may result in a foreign start-up or a more established corporation being classified as a PFIC following an infusion of new capital (in the form of equity or debt). If the new capital (plus whatever other liquid and other "passive" or investment-type assets the corporation has on hand) represents 50 percent or more of the total post-investment value of the corporation for the year (determined by averaging the percentages as of the end of each quarter), the corporation will be a PFIC under the Asset Test. This is because, under the Cash Rule, all cash and other liquid assets are classified as passive assets, even if they are earmarked for use in the company's active trade or business.

Specifically, a start-up company, particularly one in the biotechnology or information technology fields, will often operate for a number of years with few hard assets, a relatively small amount of operating revenue and a large pool of liquid funds provided by founders or third-party investors, such as venture capitalists or, in some cases, a large number of smaller investors. [25] Determining the value of the company's technology under development during those years may be difficult (if not impossible); accordingly, the company's cash and other liquid assets could easily constitute at least 50 percent of the asset value of the company for a number of years. [26] It is also common for these types of companies to enter into joint ventures with one or more other companies (often more established companies) to, for example, develop new products, expand their

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25 As noted above, the current start-up exception permits a company to avoid PFIC classification for only one start-up year.

26 Congress, recognizing that companies conducting research and licensing intangibles may face an inadvertent PFIC problem, provided a measure of relief to CFCs that might otherwise be treated as PFICs. In measuring the assets of a CFC for purposes of the Asset Test, adjusted basis of total assets was increased to reflect research and experimentation expenditures and fees for licenses of intangibles. Sections 1298(e)(1) and (2), added by P.L. 103-66, Section 13231(d)(4) (1993).

potential customer base, or gain access to the joint venturer's expertise. Any less-than-25 percent interest in such a joint venture (assuming it is classified as a corporation for U.S. tax purposes) will also constitute a passive asset. Given the statutory classification of less-than-25 percent stock interests as passive, we believe this common business practice of using joint ventures to develop and expand a company's business makes it easier for these types of companies to exceed the 50 percent threshold as a result of a cash infusion.

A more established company may also get caught under the 50 percent Asset Test, particularly if it is in a capital-intensive industry and is raising funds for a significant project that will take a number of years to complete. For example, if a foreign corporation has gross assets of $200 million, approximately $80 million of which are passive assets, consisting primarily of a controlling (but less than 25 percent by value) stake in another operating company and cash held for operating expenses, and $120 million of which constitute nonpassive assets, the company would not be a PFIC under the Asset Test. But if that company then raises $100 million to build and equip a new plant (a project which is expected to take at least 18 months), the company might become a PFIC before the project is completed depending on how quickly the new funds are expended: immediately after the funding, the value of the company's passive assets (*i.e.*, $180 million) would exceed 50 percent of its total assets (*i.e.*, $300 million).[27]

F. The QEF and Mark-to-Market Elections for PFIC Shareholders

Once a foreign corporation is classified as a PFIC, a U.S. shareholder will be subject to the excess distribution regime described above, unless the shareholder makes a QEF election or a "mark-to-market" election. As discussed below, these elections may not always be available and, when they are, the consequences may be excessively burdensome and inconsistent with the policies behind the PFIC rules.

1. The QEF Election

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27 For an additional discussion of other pitfalls of the Income and Asset Tests see Dunn, H. Stewart, Jr., *PFIC Rules: Tax Policy Gone Awry*, 39 Tax Notes 625 (1988).

The excess distribution regime will not apply to a U.S. shareholder if the shareholder elects to treat the company as a QEF. In that case, the shareholder includes currently in income, for each year the corporation is a PFIC, a pro rata share of the company's ordinary income and net capital gains for the year (at the rates applicable to ordinary income and capital gains, respectively).[28] These amounts must be included in the shareholder's income on its year-end tax return, even if the company does not distribute these earnings to shareholders (unless the shareholder makes an election to defer this tax liability and pay an interest charge).[29]

The shareholder must also file, with its year-end income tax return, a Form 8621 (Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) for each year in which it owns shares in the PFIC, and check the box indicating that it has elected to treat the company as a QEF.[30] In order to comply with the election and complete the required Form, the shareholder must obtain, also on an annual basis, information from the company sufficient to compute the shareholder's pro rata share of the company's ordinary income and net capital gain for the year as determined under U.S. federal income tax principles.[31] Thus, the company essentially will need to maintain a separate set of books and records in accordance with U.S. federal income tax principles. A foreign corporation with a minority of U.S. shareholders is likely to find this requirement not only costly but also inexplicable and without justification. In addition, if the company has a mature business (and has not previously had U.S. shareholders — *e.g.*, a company that is turning to the U.S. capital markets for the first time), it simply may not

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28 Sections 1291(d)(1), 1293(a) and (b) and 1295 and Prop. Treas. Regs. § 1.1293-1. The QEF inclusion is limited to the shareholder's pro rata share of the PFIC's current earnings and profits.

29 Section 1294. *See also* Sections 1293(c) and (d). The shareholder's basis in the stock of the company will be increased to reflect the taxed but undistributed income. Section 1293(d).

30 *See generally* Section 1295(b) and Treas. Regs. §§ 1.1295-1(e), (f) and (g).

31 Treas. Regs. §§ 1.1295-1(e), (f) and (g).

be possible, as a practical matter, to reconstruct the company's financial history so as to provide the necessary information to its shareholders. It is also not clear how such a company would account for certain items that are subject to different treatment under the U.S. tax laws depending upon elections and identifications made by the taxpayer, such as start-up costs that may be amortized over a period selected by the taxpayer under Section 195, research and development costs that may be either deducted or amortized under Section 174, and hedging transactions that must be identified as such on the day they are entered into (under Treasury Regulations §§ 1.446-3, 1.1221-2 or 1.954-2).[32]

In addition, under existing Regulations, a QEF election is not effective unless the U.S. shareholder obtains from the PFIC a "PFIC Annual Information Statement" at the end of each year. This statement must be signed by the PFIC or an authorized representative of the PFIC and include, among other things, (1) either (a) a statement of the shareholder's pro rata share of the PFIC's "ordinary income" and "net capital gain," as defined and computed under U.S. tax rules, (b) sufficient information to enable the shareholder to calculate these amounts, or (c) a statement that the PFIC has permitted the shareholder to examine the PFIC's books of account, records and other documents to calculate these amounts *and* (2) a representation "that the PFIC will permit the shareholder to inspect and copy the PFIC's permanent books of account, records, and such other documents as may be maintained by the PFIC to establish that the PFIC's ordinary earnings and net capital gain are computed in accordance with U.S. income tax principles, and to verify these amounts and the shareholder's pro rata shares thereof."[33]

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32 These difficulties were, we believe, not contemplated when the PFIC rules were developed since the rules were intended to apply to investment companies, for which maintaining U.S. tax numbers would be far less complicated.

33 Treas. Regs. § 1.1295-1(g). The Regulations provide that in "rare and unusual circumstances" the Commissioner will consider accepting alternative documentation pursuant to a private letter ruling and closing agreement entered into by the Commissioner and the PFIC. Needless to say, a foreign corporation with no U.S. ties other than minority U.S. shareholders is not likely to be eager to go to these lengths to accommodate those investors.

In a privately negotiated investment, these informational requirements (and the reasons for them) are not only difficult to explain and justify but also add substantial complexity and cost to the negotiations. If the potential U.S. investors are acquiring only a small stake in the foreign company they may lack the bargaining power to insist that the company provide the required information and make the necessary representations regarding allowing the U.S. shareholder unlimited access to review and copy the PFIC's books and records. In larger stock offerings, disclosure documents provided to potential investors often state that, if the issuer is a PFIC, it will *not* provide the information required for a QEF election. Because the QEF election will therefore be unavailable, potential U.S. investors may simply turn down the opportunity to invest.

In other cases, the foreign company may realize that it might be a PFIC and may explain this to potential investors in an offering document and undertake to provide the PFIC Annual Information Statements so that U.S. shareholders may make the QEF election. In that case, it may be the U.S. investors who do not understand the PFIC rules. These potential investors may be "scared away" by an offering document that states that special U.S. tax forms and elections are required to avoid onerous penalty taxes. A U.S. investor who takes the plunge may not know what to do with the PFIC Annual Information Statement that he or she receives from the corporation or understand the importance of making the QEF election for the first year in which the shares are held (*i.e.*, in order to completely avoid application of the excess distribution regime, a shareholder must generally make a QEF election for the first taxable year that the corporation is classified as a PFIC).[34] For example, the PFIC Annual Information Statement sent by the corporation may simply state the shareholder's pro rata amount of the ordinary earnings and net capital gain of the corporation for the taxable year *or* "sufficient information to enable the shareholder to calculate its pro rata shares of the

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[34] A shareholder may make a QEF election in a later year, but the shareholder will be subject to the "excess distribution" regime with respect to the portion of its excess distributions allocable to the pre-QEF years. Prop. Treas. Regs. §§ 1.1291-1(c)(2) and 1.1293-1(a).

PFIC's ordinary earnings and net capital gain for the year."[35] U.S. investors, who are accustomed to receiving a Form 1099-DIV and including on their tax returns the total stated on the Form 1099-DIV, may not realize that they essentially need to create their own 1099-DIVs for the QEF inclusions. The failure to comply with all QEF election requirements normally will invalidate the election and subject the unknowledgeable U.S. investor to the onerous excess distribution regime.[36] In this respect, the QEF rules are a classic trap for the unwary investor who seeks to diversify into foreign equities.

These numerous complexities and difficulties seem to be particularly inappropriate in the case of a company that is operating at a net loss, since the QEF rules require electing U.S. shareholders to include in income only their pro rata share of the company's *net earnings* and to do so *only* in years that the company is a PFIC.[37] Thus, in the case of an active company inadvertently caught in the PFIC rules under the Income Test, but that has sufficient expenses to offset all or most of its gross income such that it has no, or a very small amount of, net earnings, the shareholders' QEF inclusions will be negligible. In the years when the active company has sufficient earnings from operations to offset its passive income (and sufficient active assets), it will not be a PFIC and thus there will be no QEF inclusion.[38]

The administrative complexities are not the only unjustified burdens imposed by the QEF rules: in the case of an active company classified as a PFIC during a start-up or

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35 Treas. Regs. § 1.1295-1(g)(1)(ii).

36 *See, e.g.*, Treas. Regs. § 1.1295-1(i) (Commissioner has discretion to invalidate or terminate a QEF election if requirements for making QEF election not satisfied (including PFIC's information requirements); in which case, (i) all Section 1294 elections (extension to pay tax on undistributed PFIC earnings) are terminated and the undistributed PFIC earnings tax and interest become due; (ii) the Commissioner has the discretion to deem that a sale of the QEF stock has occurred on the last day of the PFIC's last taxable year as a QEF; and (iii) the shareholder is subject to any other conditions the Commissioner determines are necessary to ensure compliance with the PFIC provisions).

37 *See* Treas. Regs. § 1.1295-1(c)(2)(ii).

38 Treas. Regs. § 1.1295-1(b)(2)(ii).

expansion period, to the extent that the corporation's deductible expenses do *not* offset its interest earnings, a QEF election will result in income inclusions although the company is unlikely to be able to make distributions for a number of years; and, if the company has an established active business, there may be a sizeable QEF inclusion that consists in large part of active income from operations (particularly if the new equity is funding expenses that are capitalized rather than being currently deducted). These results are clearly *not* what the QEF rules were intended to accomplish.

Moreover, even if the foreign company is amenable to providing the information required for a QEF election, the election is currently completely unavailable to holders of the company's warrants or convertible securities.[39] It is not uncommon for investments in start-ups and other speculative foreign ventures to be structured as convertible debt or a combination of stock or debt with warrants, in order to provide some downside protection to the investor. Because the PFIC ownership rules treat an option on PFIC stock as stock, optionholders are subject to the excess distribution regime when they dispose of the option or receive an excess distribution with respect to the stock acquired upon exercise. In addition, the interest charge on the excess distribution is computed by taking into account the entire period the option (or convertible debt) and the stock received on conversion has been held.[40]

2. The Mark-to-Market Election

Under the "mark-to-market election," a U.S. shareholder may elect to mark to market the PFIC stock at the end of each year, but only if the stock is actively traded on a qualified stock exchange (or the company is essentially identical to a U.S. regulated investment company).[41] In that case, the mark-to-market inclusions and any realized

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39 Treas. Regs. § 1.1295-1(d)(5).

40 *Id.;* Prop. Treas. Regs. §§ 1.1291-1(d) and (h)(3).

41 Treas. Regs. § 1.1296(e)-1(a).

gains on a disposition will be taxed entirely as ordinary income.[42] Thus, not only does this election require shareholders to take into income unrealized gains, but in the case of an individual investor it also entirely eliminates the benefit of the preferential capital gains rates, no matter how long the shareholder holds the shares. Furthermore, because the mark-to-market election is available only if the shares are publicly traded, it will not be available for the early years of most start-ups.

G. Summary of the Problems for Start-Ups and Companies that Raise New Capital

Thus, under the current PFIC rules, active businesses — corporations that do not exist to shield investment income — run the risk of being classified as PFICs simply because their cash (and other liquid assets) on hand, raised to develop or expand an active business, and the interest earned thereon are treated as passive. A QEF or mark-to-market election often will not be a viable solution. This is not the effect the PFIC rules were intended to have and it is complicating and deterring investments by U.S. persons in active companies operating outside the United States.

Section III. Proposals to Address the Improper Classification of Active Companies as PFICs Due to the Classification of Liquid Assets and all Earnings Thereon as Passive

We have developed two complementary proposals to address the problems described above:

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42 Section 1296 and Treas. Regs. § 1.1296(e)-1. More specifically, if a U.S. shareholder elects to mark to market a PFIC's shares, the shareholder will take into account each year as ordinary income any appreciation in value of the shares during the year. If the shares decrease in value, the shareholder will take into account an ordinary loss, but only to the extent of the prior years' mark-to-market income inclusions not yet offset by such losses. The adjusted basis of the shares will be increased or decreased by the amount of the income included or deduction allowed in each year. Any gain on a disposition of the shares will also be treated as ordinary income, and any loss on a disposition will be treated as ordinary loss to the extent it does not exceed prior years' mark-to-market income inclusions not yet offset by mark-to-market losses; any additional loss will be treated as capital loss if the shares are held as a capital asset. *Id.*

- modifying the Cash Rule to exclude from passive assets (and passive income) liquid assets (and the earnings thereon) held for the reasonable needs of an active trade or business; and
- providing a "deemed" QEF election for shareholders and optionholders of corporations that have no net earnings.

Given the broad regulatory authority under Section 1298(f), which provides that the Secretary shall prescribe such regulations as may be "necessary or appropriate to carry out the purposes of this part," and the importance of resolving the problems we have described above, we believe both proposals could be implemented through Treasury regulations and would not require Congressional action.

A. Modify the Cash Rule and the Definition of Passive Income to Exclude From Passive Assets and Passive Income Liquid Assets Held for the Reasonable Needs of an Active Trade or Business and the Earnings Thereon

1. The Purpose of This Proposal

Our first proposal is that Treasury issue regulations or other guidance revising the Cash Rule set forth in Notice 88-22 and the classification of earnings on all liquid assets as passive to provide that cash and other liquid assets held for the reasonable needs of an active business (including an active business under development) are not passive assets and that the earnings thereon are not passive income.[43]

This proposal is intended to address the problems created by treating every dollar of cash (or temporary investments) held by a corporation as a passive asset, and every

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[43] Proposals to completely repeal the Asset Test were opposed by Treasury in 1995 because it believed that the concerns regarding the ability of investors in foreign corporations to achieve income deferral through the accumulation of passive assets abroad remained valid. *See* Statement of Treasury Assistant Secretary for Tax Policy Leslie B. Samuels, RR-481 (July 28, 1995). Our proposal, however, is far more limited and, as discussed in more detail below, we believe it does not threaten the achievement of the policy objectives of the PFIC rules. In addition, because the Cash Rule was originally implemented by the Service in Notice 88-22, we see no procedural or policy reason why the Service could not modify the rule through regulations (or a subsequent notice).

dollar of interest earned on those liquid assets as passive income, without regard to how the corporation acquired the funds or what it intends to do with them. As noted above, start-ups, as well as more established companies seeking to expand, will tend to raise a large amount of capital at one time. The expense, effort, planning and months of work that are required to initiate and complete an offering of equity or debt to new investors, and the reality of how the capital markets function (including the importance of timing the offering appropriately), mean that a corporation will almost invariably seek to raise a sizeable amount of funds in a single tranche, even though it may anticipate that the funds will not be fully deployed for some period of time. For many companies, the amount of capital raised in an offering (plus whatever other "passive" assets it has on hand) may well exceed 50 percent of the post-investment value of the company, and/or the earnings on the new capital may well exceed 75 percent of the company's gross income, for one or more years following the offering.

This often occurs in capital-intensive companies, such as infrastructure or mining and exploration companies that raise capital to fund projects that involve new or ongoing construction, exploration and/or purchases of equipment and other capital assets. These projects often take several years to complete and may generate substantial capital expenditures that will not offset current income earned on the funds. It also occurs in less capital-intensive companies, such as biotechnology and information technology companies that may spend years developing a new drug or a new product or service. During that period, the company's most valuable asset is likely to be its staff and its technology and it is likely to have relatively few hard assets. Accordingly, the cash needed to fund the first several years of development will frequently trigger the Asset Test and, in many cases, the Income Test as well because the company's expenses (whether deductible under Section 162 or required to be capitalized) will not be deductible in computing gross income.

We believe that it is inappropriate for a company that has an active business or is trying to develop an active business to be classified as a PFIC as a result of having successfully raised a significant amount of capital to fund its development or expansion. It would be consistent with the intent of the PFIC rules and appropriate as a policy matter

to provide that cash and other liquid assets held for the reasonable needs of an active business (either existing or under development) are not passive assets and that the earnings thereon are not passive income.

This proposal is also consistent with the spirit (if not the letter) of Notice 88-22, because these liquid assets are *not* being held to generate passive income or to invest in passive assets, but rather are being held to fund operating expenses and the acquisition and development of assets that will generate active income. Recognizing this distinction, Notice 88-22 provided that the following assets will be treated as nonpassive: (1) depreciable property used in a trade or business that does not produce passive income; and (2) trade and service receivables derived from sales or services provided in the ordinary course of a trade or business that produces nonpassive income (notwithstanding that the receivables may incidentally generate interest).

2. How to Determine the Reasonable Needs of the Business

There currently exists, in the accumulated earnings tax ("AET") arena (Sections 531 through 537), a large body of law that could provide guidance in determining whether the company's liquid assets exceeded the "reasonable needs of the business" for this purpose.

a. The Principles Used in the AET Context

The AET is generally imposed on the accumulated taxable income of a corporation formed or availed of for the purpose of avoiding income tax with respect to its shareholders through the accumulation, rather than the distribution, of its earnings and profits.[44] If the corporation has accumulated earnings "beyond the reasonable needs of the business," an intent to avoid income tax by accumulating profits is presumed.[45] In addition, the fact that a corporation is a "mere holding or investment company" is "prima

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44 *See* Section 532(a).

45 Section 533(a).

facie evidence of the purpose to avoid the income tax with respect to shareholders."[46] Conversely, to the extent the accumulated earnings can be shown to be held in connection with the reasonable needs of the business, the earnings are not treated as though they are being held to avoid having the shareholders taxed on the corporation's earnings.

In the PFIC context, the liquid assets will more frequently represent the proceeds of an equity or debt offering rather than retained earnings (the focus of the AET rules). Nevertheless, we believe that the "reasonable needs" principles of the AET rules provide a useful starting point for developing similar rules in the PFIC area because both sets of rules are intended to apply to a corporation that is holding liquid assets for investment, rather than its business needs.[47] The AET rules, in one form or another, have been in the Code since 1913 and have generated an extensive body of regulatory, administrative and judicial guidance for determining a business's reasonable needs.[48]

Detailed guidelines and principles are set forth in Treasury Regulations under Section 537. These Regulations begin by stating that an amount "is in excess of the reasonable needs of the business if it exceeds the amount that a prudent businessman would consider appropriate for the present business purposes and for the reasonably anticipated future needs of the business."[49] The Regulations provide that the need must be "directly connected with the needs of the corporation itself and must be for bona fide business purposes."[50]

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46 Section 533(b).

47 *See also* H.R. Rep. No. 100-795, at 273 (1988) (legislative history to the 1988 PFIC amendments, describing the AET rules as "essentially equivalent" to the PFIC rules).

48 *See, e.g.*, Revenue Act of 1913, Section 11(A)(2) (imposing on each individual shareholder a tax equal to one percent of his or her share of "gains and profits . . . of all corporations, joint-stock companies or associations . . . formed or fraudulently availed of for the purpose of preventing the imposition of such tax through the medium of permitting such gains and profits to accumulate instead of being divided or distributed").

49 Treas. Regs. § 1.537-1(a).

50 *Id.*

According to the Regulations, in order to justify retaining amounts for the future needs of the business, the corporation must have "specific, definite and feasible plans for the use" of the retained amounts and those amounts must be used within a time reasonable under all the facts and circumstances relating to the future needs of the business. An accumulation is not justified if the needs of the business are "uncertain or vague," if the plans for the future use are "not specific, definite, and feasible," or if the execution of the plan is "postponed indefinitely."[51] The business of the corporation includes not only the business or businesses that it has previously carried on, but also any line of business that it might undertake.[52]

The Regulations provide a number of grounds for establishing the business's reasonable needs for cash, including:

(i) to provide for a business expansion or plant replacement,

(ii) to acquire another business enterprise (whether in the form of stock or assets),

(iii) to provide for the retirement of indebtedness created in connection with the business,

(iv) to provide for investments or loans to suppliers or customers if necessary to maintain the business of the corporation, and

(v) to provide necessary working capital for the business, [53] such as for the procurement of inventories.[54]

The Regulations also provide examples of reasons for retaining earnings that "may indicate" the retained funds *exceed* the reasonable needs of the business, including:

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51 Treas. Regs. § 1.537-1(b)(1).

52 Treas. Regs. § 1.537-3(a).

53 *See also* IRS Manual, Ch. 638.2 (guidelines with respect to the AET rules) ("the need for working capital has long been recognized as the main reason for accumulating earnings and profits...").

54 Treas. Regs. § 1.537-2(b).

making loans to shareholders or other related persons, making loans that have no reasonable relation to the conduct of the business, and making investments in properties or securities that are unrelated to the business activities.[55]

Whether the reasons for the accumulation of cash indicate the cash is being held for the reasonable needs of the business or beyond those needs is determined based upon the particular circumstances of the company in question.[56] With respect to the "working capital" component, judicial and administrative authorities have addressed in detail how to account for a company's current liabilities and anticipated operating expenses (such as salaries, accounts payables and marketing expenses) and in determining the appropriate amount of "working capital" in the case of that specific corporation.[57]

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55 Treas. Regs. § 1.537-2(c).

56 Treas. Regs. § 1.537-2(a).

57 For a manufacturing business, a reasonable amount of working capital is often determined using the so-called "*Bardahl* Formula," which computes the amount of working capital necessary to cover the anticipated business expenditures during one "operating cycle" (defined generally as the period starting with the purchase of raw materials or inventory and ending with the receipt of cash upon collection of receivables generated from product sales). *Bardahl Mfg. Corp.* v. *Comm'r*, 24 T.C.M. (CCH) 1030 (1965).

In the context of a service business, both the courts and the Service (in the IRS Manual) have indicated that the *Bardahl* Formula should be modified in certain respects to account for the fact that a service business will have little or no inventory. Thus, the relevant operating cycle for purposes of applying the *Bardahl* Formula to a service business has been held to be the average length of time required to perform on a contract. *See, e.g., C.E. Hooper, Inc.* v. *U. S.*, 539 F.2d 1276, 1281-82 (Ct. Cl. 1976); IRS Manual, Ch. 638.2 ("[f]or service businesses, the formulas should be modified to consider the average length of time required to perform on a contract rather than use the operating inventory turnover concept"); *Simons-Eastern Co.* v. *U.S.*, 354 F. Supp. 1003, 1007 (N.D. Ga. 1972) (operating cycle based on receipt of payment for services plus two additional months of payroll).

Another method employed by the courts and the Service for determining the reasonableness of a corporation's accumulation of working capital is to compare the corporation's current assets to current liabilities: generally, the Service has supported a ratio of 2-to-1 or 2.5-to-1, although courts have gone farther where appropriate. *See, e.g., Cadillac Textiles* v. *Comm'r,* 34 T.C.M. 295 (1975) (refusing to apply *Bardahl* Formula

Judicial authority is particularly useful in determining how factors specific to a certain industry or company should be taken into account in measuring a company's reasonable needs for capital. For example, the Tax Court has recognized that a company may need to hold reserves to cover certain contingent liabilities, such as litigation costs, worker strikes, and increased employee benefits costs.[58] Courts have also provided guidance on determining reasonable levels of capital for developing new products or expanding a business.[59]

In 1984, Congress expressed approval of the rules developed in the AET context and directed Treasury to incorporate those principles in Code Section 6166 because similar principles were involved. Under Section 6166, the estate tax attributable to an interest in a closely held trade or business may be deferred, except to the extent of the portion of the estate tax attributable to "passive assets" held by the business. Passive assets held by the business are defined in Section 6166 as "any asset other than an asset used in carrying on a trade or business."[60] When the exception for passive assets was added to Section 6166 in 1984, Congress noted that passive assets did not include the working capital of a business or assets that were "reasonable reserves for financing of a specifically identified project," such as "a reserve for expansion of a factory building that

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and finding a current assets to liabilities ratio of 6.9-to-1 reasonable for the business in issue).

See also Bremerton Sun Publishing Co. v. *Comm'r*, 44 T.C. 566, 586-87 (1965) (noting that working capital requirements varied from one business to another and that another common "rule of thumb" is the accumulation of earnings to meet operating expenses for at least one year).

58 *See, e.g., Eden* v. *Comm'r*, T.C. Memo. 1987-101; *Dielectric Materials Co.* v. *Comm'r*, 57 T.C. 587 (1972); *Bremerton Sun Publishing Co., supra.*

59 *See, e.g., Eden, supra*; *Faber Cement Block Co.* v. *Comm'r*, 50 T.C. 317 (1968). In addition, a number of courts have noted that companies in certain industries may have capital needs not directly linked to current operating costs, such as capital levels required to obtain performance bonds. *See Thompson Engineering Co.* v. *Comm'r*, 55 AFTR 2d 85-576 (6th Cir. 1985); *Peterson Brothers Steel Erection Co.* v. *Comm'r*, T.C. Memo. 1988-381.

60 Section 6166(b)(9)(B).

is reasonably expected to be completed within two years of the time the contributions to the reserve fund are made."[61] Congress also directed that Treasury Regulations be issued to define the circumstances under which assets would be treated as passive and expressed its expectation that the regulations would generally contain rules similar to those governing the AET.[62] Although regulations have never been issued under Section 6166, in private letter rulings the Service has applied the AET rules in the Section 6166 context.[63] In addition, by referring to the AET rules in this context, Congress indicated that the reasonable needs principles developed under the AET rules have a broad applicability.[64]

b. Recommendation: Determine the Reasonable Needs of the Business Using the AET Rules With Modifications

Therefore, we recommend that the reasonable cash needs of an active business be determined for PFIC purposes using the basic guidelines set forth in the Regulations under Section 537,[65] but also taking into account certain additional considerations that are appropriate in the PFIC context. These include the following:

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61 S. Rep. No. 98-169, at 714 (1984) ("1984 Senate Report"). *See also* Staff of the Joint Comm. on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 1113 (Comm. Print 1984).

62 1984 Senate Report at 715.

63 *See, e.g.*, PLR 9250022 (Sept. 11, 1992); PLR 8829013 (Apr. 15, 1988).

64 This principle has also been reflected in private letter rulings. *See, e.g.*, PLR 200021046 (Feb. 28, 2000) (cash raised to fund an expansion of business that was ultimately called off was taken into account in determining that the taxpayer substantially complied with the requirements of an active asset test under the Section 367(a) Regulations applicable to outbound transfers of domestic corporations, notwithstanding that the "anti-stuffing" rule specifically called for the cash to be disregarded because it was raised in a public offering within 36 months of the Section 367(a) transaction).

65 These Regulations could be repeated or simply incorporated by reference. The PFIC regulations should also provide that taxpayers may rely not only on the AET Regulations, but also on any other authorities developed in the AET or Section 6166 context, unless such reliance is unreasonable under the circumstances (including because there is contrary authority under the PFIC rules).

i. Capital Raised to Fund a Specific Business Plan

One factor that is not relevant in the AET context, but is critical in the PFIC context, is the practical difficulty of raising capital and the benefits of raising large amounts at one time, for use over an extended period. This factor is not relevant in the AET context because the AET rules focus on whether the *earnings* of the corporation that have not yet been distributed are beyond its reasonable business needs. As discussed above, one of the most significant factors causing active companies to be classified as PFICs is that these companies often raise large amounts of capital at one time and then use that capital over a number of months or years.

In order to make our proposal more effective at addressing this problem and more workable, it would be extremely useful to provide a safe harbor (or a rebuttable presumption) that funds raised for future use in an active business are not passive assets and the earnings thereon are not passive income. For example, the safe harbor (or presumption) might apply only:

(a) to funds raised pursuant to a prospectus, offering memorandum or similar document and in respect of which the issuer, its directors and/or officers have liability for misstatements or omissions of material facts under the Securities Act of 1933, the Securities Exchange Act of 1934, rules thereunder or comparable provisions of any foreign securities laws or regulations;

(b) if the offering document provided that the capital was being raised to fund a specific and detailed business plan (relating to an active trade or business) adopted by the issuer and described in the offering documents (as opposed to being raised to fund "general corporate purposes");

(c) to the portion of such capital that the offering document indicates the corporation expects to spend pursuant to the business plan within the 60-month period following the offering; and

(d) during the period the business plan (or, due to a change in circumstances, a successor business plan) is being pursued.

The listed requirements would insure that the business plan is reasonable and that the funds are being raised to fund the active trade or business.

While we think this safe harbor would be extremely helpful in certain cases, it should not be the sole means of establishing the reasonable needs of the business (nor should the reasonable needs of any business be limited to the amount of funds that fall within the safe harbor).

ii. Take Into Account Reasonable Needs of 25 Percent Owned Subsidiaries

The reasonable needs of a corporation (and the safe harbor) should take into account capital intended to be used either by the corporation directly or by any 25 percent owned subsidiary. The AET Regulations take into account the reasonable needs of a subsidiary only if the parent owns at least *80 percent* of the subsidiary's *voting* stock and *both* the parent and the subsidiary are engaged in active trade or business.[66] In the PFIC context, we believe that this principle should be broadened to encompass any subsidiary 25 percent or more (by value) owned by the parent, since the parent's PFIC status in that case will be determined by attributing to the parent its proportionate share of the subsidiary's assets and income. (This 25 percent look-through rule is discussed in more detail in Section IV below). In addition, the parent should not have to be directly engaged in a trade or business as this is inconsistent with the purpose of the 25 percent look-through rule (discussed below in Section IV) and the fact that the funds may be raised in an offering of debt or equity securities by a holding company parent, rather than generated by the operating subsidiary directly. We also believe that Treasury and the Service should consider extending the rule to partnership subsidiaries in which the parent holds a minimum threshold interest for the same reason (see discussion of partnerships in Section VI below). However, the intent that the subsidiaries or partnerships will use the funds should be clearly expressed in the parent's business plan or permanent records in order for the funds to be considered as part of its reasonable cash needs.

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66 Treas. Regs. § 1.537-3(b).

iii. Interest on Active Short-Term Trade Receivables Should Be Active Income

Under Notice 88-22, all interest received incidental to trade and service receivables is considered passive income. Just as earnings on cash held for the reasonable needs of an active business should not be passive, we believe that interest on a trade receivable should not be passive if the underlying trade receivable is active income and the trade receivable has a short term (we propose 12 months or less). Such a rule would be consistent with the principles behind the PFIC rules and permit active businesses to collect receivables in a commercially reasonable and customary manner without generating passive income.

3. The Reasonable Cash Needs of an Active Business Rule Should Not Apply to Corporations Engaged in Banking, Insurance, Securities or Other Financial Services Businesses

We think it is very important that any relaxation of the existing Cash Rule not allow companies that Congress had intended would be PFICs to escape PFIC classification – including, for example, many financial services businesses where cash has traditionally been viewed as an operating asset. Congress has already addressed which types of financial services businesses should not be subject to PFIC treatment by providing carefully targeted exceptions.[67] A revised cash rule must not jeopardize the integrity of the existing exceptions for active banking and active insurance companies – by allowing companies that are engaged in banking, banking-related insurance, or insurance-related businesses but would not qualify for the exception to escape PFIC classification (or conflict with the issuance and subsequent repeal of the narrowly drawn

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67 *See also* S. 676, 107th Cong., 1st Sess. (March 30, 2001) (Senator Hatch, in introducing a bill to extend permanently the exclusion from subpart F for active financing income otherwise scheduled to expire at the end of 2001, explaining that such a provision is particularly important in today's global economy and stressing that "it is essential that our tax laws adapt to the fast-paced and ever-changing business environment...).

exception for securities dealers – by allowing companies in securities and securities-related businesses to escape PFIC classification).[68]

Accordingly, we propose that the reasonable cash needs rule not apply to a corporation or group of corporations engaged in (i) any of the "banking activities" set forth in Section II (A)(3) of Notice 89-81,[69] or Proposed Regulations § 1.1296-4(f),[70] (ii)

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68 In addition to finalizing all outstanding temporary and proposed regulations in the PFIC area, we encourage Treasury to issue proposed regulations expanding on the insurance company exception of Section 1297(b)(2)(B).

69 Notice 89-81 lists as banking activities: (1) accepting deposits from unrelated persons; (2) making or participating in loans or advances to unrelated persons, including banks, and servicing such loans; (3) factoring evidences of indebtedness for unrelated persons; (4) purchasing, selling, discounting, or negotiating for unrelated persons notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; (5) issuing letters of credit to unrelated persons and negotiating drafts drawn thereunder; (6) performing trust services, including activities as a fiduciary, agent, or custodian, for unrelated persons, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities, or similar financial instruments; (7) arranging foreign exchange transactions, or engaging in foreign exchange transactions, for unrelated persons; (8) entering into interest rate and currency swaps and other hedging transactions with or on behalf of unrelated persons; (9) underwriting issues of stock, debt obligations, or other securities under best efforts or firm commitment agreements, with unrelated persons; (10) providing charge and credit card services, or factoring receivables obtained in the course of providing such services, for unrelated persons; (11) providing traveller's check and money order services for unrelated persons; (12) providing correspondent bank services for unrelated persons; (13) providing agency paying and collection agency services for unrelated persons; or (14) any other activity (or variation of an activity described in (1) through (13)) that the Commissioner determines to be a commercial banking activity generally conducted by active foreign banks in the ordinary course of their banking business.

70 Proposed Regulations § 1.1296-4(f) includes as banking activities: (1) lending activities described in Proposed Regulations § 1.1296-4(e); (2) factoring evidences of indebtedness for customers; (3) purchasing, selling, discounting, or negotiating for customers notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; (4) issuing letters of credit and negotiating drafts drawn thereunder for customers; (5) performing trust services, including activities as a fiduciary, agent or custodian, for customers, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities or similar financial instruments; (6) arranging foreign exchange transactions (including any Section 988 transaction within the meaning of Section 988(c)(1)) for, or engaging in foreign exchange transactions with, customers; (7) arranging interest rate or currency futures, forwards, options or notional principal contracts for, or entering into such transactions with, customers; (8) underwriting issues

any of the "securities activities" set forth in Proposed Regulations § 1.1296-6(e)(2) (activities of securities dealers),[71] (iii) any of the activities giving rise to "active financing

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of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers; (9) engaging in finance leases, as defined in Treasury Regulations § 1.904-4(e)(2)(i)(V); (10) providing charge and credit card services for customers or factoring receivables obtained in the course of providing such services; (11) providing traveller's check and money order services for customers; (12) providing correspondent bank services for customers; (13) providing paying agency and collection agency services for customers; (14) maintaining restricted reserves (including money or securities) as described in paragraph (g) of this section; and (15) any other activity that the Commissioner determines, through a revenue ruling or other formal published guidance to be a banking activity generally conducted by active banks in the ordinary course of their banking business. Additionally, Proposed Regulations § 1.1296-4(d) provides that, as a general rule, to be an active bank for purposes of such Regulation, the foreign corporation must in the ordinary course of its trade or business, regularly accept deposits from customers who are residents of the country in which the corporation is licensed or authorized.

[71] Proposed Regulations § 1.1296-6(e)(2) includes as securities activities: (1) purchasing or selling stock, debt instruments, interest rate or currency futures or other securities or derivative financial products (including notional principal contracts) from or to customers and holding stock debt instruments and other securities as inventory for sale to customers, unless the relevant securities or derivative financial products (including notional principal contracts) are not held in a dealer capacity; (2) effecting transactions in securities for customers as a securities broker; (3) arranging futures, forwards, options, or notional principal contracts for, or entering into such transactions with, customers; (4) arranging foreign exchange transactions (including any Section 988 transaction within the meaning of Section 988(c)(1)) for, or engaging in foreign exchange transactions with, customers; (5) underwriting issues of stocks, debt instruments, or other securities under best efforts or firm commitment agreements with customers; (6) purchasing, selling, discounting, or negotiating for customers on a regular basis notes, drafts, checks, bills of exchange, acceptances or other evidences of indebtedness; (7) borrowing or lending stocks or securities for customers; (8) engaging in securities repurchase or reverse repurchase transactions with customers; (9) engaging in hedging activities directly related to another securities activity described in this paragraph; (10) repackaging mortgages and other financial assets into securities and servicing activities with respect to such financial assets (including the accrual of interest incidental to such activities); (11) engaging in financing activities typically provided by an investment bank, such as (a) project financing provided in connection with, for example, construction projects; (b) structured finance, including the extension of a loan and the sale of participations or interests in the loan to other financial institutions or investors; and (c) leasing activities to the extent incidental to financing activities described in this paragraph (11) or to advisory services described in paragraph (12) of this section; (12) providing financial or investment advisory services, investment management services, fiduciary services, trust services or custodial services; (13) providing margin or any other financing for a customer secured by securities or money market instruments, including repurchase agreements, or providing

income" under Treasury Regulations § 1.904-4(e)(2) (which includes income from insurance and insurance-related activities),[72] or (iv) trading in stocks, securities or commodities for the taxpayer's own account.[73]

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financing in connection with any of the activities listed in paragraphs (1) through (12) herein; (14) maintaining deposits of capital (including money or securities) described in Proposed Regulations § 1.1296-6(f); and (15) any other activity that the Commissioner determines, through a revenue ruling or other formal published guidance, to be a securities activity generally conducted by active dealers or active brokers in the ordinary course of their securities business.

[72] Treasury Regulations § 1.904-4(e)(2) generally includes as active financing income: (1) income that is of a kind that would be insurance income as defined in Section 953(a); (2) income from the investment by an insurance company of its unearned premiums or reserves ordinary and necessary to the proper conduct of the insurance business, income from providing services as an insurance underwriter, income from insurance brokerage or agency services, and income from loss adjuster and surveyor services; (3) income from investing funds in circumstances in which the taxpayer holds itself out as providing a financial service by the acceptance or the investment of such funds, including income from investing deposits of money and income earned investing funds received for the purchase of traveller's checks or face amount certificates; (4) income from making personal, mortgage, industrial, or other loans; (5) income from purchasing, selling, discounting, or negotiating on a regular basis, notes, drafts, checks, bills of exchange, acceptances, or other evidences of indebtedness; (6) income from issuing letters of credit and negotiating drafts drawn thereunder; (7) income from providing trust services; (8) income from arranging foreign exchange transactions, or engaging in foreign exchange transactions; (9) income from purchasing stock, debt obligations, or other securities from an issuer or holder with a view to the public distribution thereof or offering or selling stock, debt obligations, or other securities for an issuer or holder in connection with the public distribution thereof, or participating in any such undertaking; (10) income earned by broker-dealers in the ordinary course of business (such as commissions) from the purchase or sale of stock, debt obligations, commodities futures, or other securities or financial instruments and dividend and interest income earned by broker dealers on stock, debt obligations, or other financial instruments that are held for sale; (11) service fee income from investment and correspondent banking; (12) income from interest rate and currency swaps; (13) income from providing fiduciary services; (14) income from services with respect to the management of funds; (15) bank-to-bank participation income; (16) income from providing charge and credit card services or for factoring receivables obtained in the course of providing such services; (17) income from financing purchases from third parties; (18) income from gains on the disposition of tangible or intangible personal property or real property that was used in the active financing business but only to the extent that the property was held to generate or generated active financing income prior to its disposition; (19) income from hedging gain with respect to other active financing income; (20) income from providing traveller's check services; (21) income from servicing mortgages; (22) income from a finance lease (for this purpose, a finance lease is any lease that is a direct financing lease or a leveraged lease

While we strongly believe that an exception to the modified cash rule for financial services companies is necessary and must be broad enough to insure that the reasonable cash needs of the business rule is not used inappropriately, we are concerned that the financial services companies exception will be triggered far too often if it applies whenever a corporation conducts any one of the financial services activities referred to above. For example, a retailer who provides credit card or check-cashing services to customers as part of its retail activities or allows customers to pay on an installment basis could not use the reasonable cash needs rule because providing credit card services is listed as a banking activity in Notice 89-81 and Proposed Regulations § 1.1296-4(f) and also gives rise to active financing income under the Section 904 Regulations. The reasonable cash needs rule would also be unavailable, for example, to a manufacturer that entered into hedging transactions to hedge currency exchange or price risks on raw materials purchases because such hedging transactions could also give rise to active financing income.

We believe there are a variety of possible ways to accommodate these concerns, each having advantages and disadvantages. One way would be to provide that the reasonable cash needs rule is available only if the corporation (or a shareholder) can establish that less than some percentage, say 20 percent, of the corporation's gross (or net) income is from financial services activities. While this type of test might do a good job of distinguishing the companies that as a policy matter should not have the benefit of the rule from those that should, as a practical matter it would impose a significant burden

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for accounting purposes and is also a lease for tax purposes); (23) high withholding tax interest that would otherwise be described as active financing income; (24) income from providing investment advisory services, custodial services, agency paying services, collection agency services, and stock transfer agency services; and (25) any similar item of income that is disclosed in the manner provided in the instructions to the Form 1118 or 1116 or that is designated as a similar item of income in guidance published by the Service.

[73] *Cf.* Section 864(b)(2) (generally providing that the term "trade or business within the United States" does not include trading in stocks, securities or commodities for the taxpayer's own account (excluding, however, dealers in stocks, securities or commodities)).

on a foreign corporation and exacerbate the uncertainties in the determination of PFIC status.

A second proposal would be to say that the reasonable cash needs rule is unavailable to a company that engages in any listed financial services activities unless those activities are undertaken in connection with an underlying trade or business that does not involve any financial services activities. This would permit the rule to be available to the retailer which sells on the installment basis and the manufacturer which hedges currency exchange risks. Yet, it raises some difficult line-drawing issues, such as, when does a check-cashing service offered to shoppers go from being an accommodation and an adjunct of sales of merchandise to a separate, but connected, business, and should that matter?

A third proposal would be to provide that the reasonable cash needs of a business simply do not include any cash held to fund any financial services activities. Theoretically, this should produce the right result, but practically it may be difficult to apply to the types of companies the reasonable cash needs rule is intended to help. For example, can the appliance store that permits customers to pay in installments identify the portion of its cash held to fund that service, or can the manufacturer identify the portion of cash held to fund its hedging activities? Notwithstanding these concerns, we believe that this third proposal is the best since it will allow cash that has been raised or retained to fund a specific project or expansion to qualify for the reasonable cash needs rule and gives a corporation some flexibility to establish what portion of the remainder of its cash is being used to fund non-financial services activities.

4. The Reasonable Cash Needs of an Active Business Rule Should be Subject to an Anti-Abuse Rule

In addition to the specific exception for cash held to fund financial services activities discussed in the previous section, we believe it is important that any modifications to the existing Cash Rule be accompanied by a general anti-abuse rule. No matter how carefully the rule and any exceptions thereto are designed, it is undoubtedly the case that some passive businesses will seek to utilize the reasonable cash needs rule inappropriately to escape classification as a PFIC.

We considered several possible approaches for delineating an anti-abuse rule. For example, an anti-abuse rule could provide that the Commissioner would have broad authority to disallow a corporation from using the modified Cash Rule if certain factors indicative of a principal intent to evade classification as a PFIC through manipulation of the modified Cash Rule were present, such as:

(i) the corporation's stock or debt was marketed to potential investors on the basis of returns linked to the performance of the corporation's investments; or

(ii) assuming full implementation of its business plan, the corporation would not be considered to be conducting an active trade or business under the active trade or business exception set forth in Section 367(a)(2) and Treasury Regulations § 1.367(a)-2T.

The Commissioner's authority to disallow use of the reasonable cash needs rule should be available for all open years in a shareholder's holding period. [74]

5. Summary

Modifying the Cash Rule for liquid assets held for use in an active business is consistent with the policy of the PFIC rules. We recognize, however, that this proposal has a cost in terms of administrability. The existing rule, which classifies all cash and other liquid assets (and all earnings thereon) as passive, has the benefit of being a bright-line rule that is easily administered and thereby generally avoids uncertainty and subjectivity in the classification of liquid assets. In our experience, however, this bright-line rule leads to too many inappropriate results. Therefore, the costs of a somewhat more subjective "reasonable needs of the business" test are well justified and will be

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[74] We considered whether the normal three-year statute of limitations would provide the Service with enough time to detect and investigate the situation. If that is a concern, perhaps the normal statute of limitations could be deemed to have been waived or extended where a shareholder wants to rely on the modified Cash Rule and the anti-abuse rule would otherwise apply.

minimized by the existence of a fairly well-developed body of law under the AET rules (and, hopefully, a clearly defined safe harbor) to help in its implementation.

B. Provide a Deemed QEF Election for Shareholders and Optionholders of a PFIC With No Net Earnings

1. Recommendation

Our second proposal is to provide in regulations that U.S. shareholders and optionholders (referred to here simply as "shareholders") of a PFIC will be deemed to have made a QEF election and fully complied with the required reporting requirements in each year the company is operating at a net loss, provided the company had no net earnings in any prior year in which it was classified as a PFIC. This proposal should have no net effect on the Government's collection of revenues because, whether the shareholder makes an affirmative QEF election under the QEF regime as currently in effect or is deemed to have made a QEF election as is proposed, the U.S. shareholder would not include any amount in income because the annual income inclusions under the QEF regime are limited to current earnings and profits. A deemed QEF election would, however, eliminate layers of complex and burdensome recordkeeping and reporting for a company with no net earnings and its U.S. shareholders, and reduce the likelihood of an unknowledgeable investor inadvertently holding stock subject to the excess distribution regime.

Where the deemed QEF election applied, it would prevent inadvertent PFIC classification and PFIC taint from attaching to shares in a foreign entity operating an active business. For example, take a U.S. person who invests in a foreign start-up that has FPHCI in its first three years (even though it is operating at a net loss) and thereafter ceases being a PFIC under the Income and Asset Tests; due to a lack of information or sophisticated tax advice, the shareholder fails to make a QEF election. In year six, when the company is profitable and no longer a PFIC under the Income and Asset Tests, the shareholder sells his shares at a gain of $60 (perhaps following an IPO by the company). Because the shareholder failed to make the QEF election for the first year the corporation was a PFIC during which the shareholder held the shares, the excess distribution regime

applies such that: (1) the entire $60 of gain is allocated ratably to each year during which the shareholder held the shares ($10 per year); (2) the gain allocated to each year prior to the year in which the sale occurs is subject to tax computed using the highest U.S. tax rate in effect for that year for the investor (without regard to other income or expenses) and to an interest charge at the underpayment rate; and (3) the gain attributed to the year of sale is taxed at ordinary income rates (but is not subject to an interest charge).[75]

Under our proposal, in any year the company or any U.S. shareholder can establish that the company has no net earnings (and provided it has not been classified as a PFIC in any prior year in which it had net earnings), each U.S. shareholder would be deemed to have made a QEF election.[76] The U.S. shareholders would not be required to file Form 8621 nor would the corporation be required to provide the shareholders with a PFIC Annual Information Statement.

The deemed QEF election would remain in effect until the first taxable year in which the company both has net earnings and is classified as a PFIC (if ever). In that year, the deemed QEF election would terminate and each U.S. shareholder could, at that time, choose whether or not to make an affirmative QEF election under the rules currently in effect. For a U.S. shareholder who chose to make a QEF election, the PFIC would be considered a "pedigreed QEF." For a shareholder who chose not to make an affirmative election, the holding period of the stock for purposes of the excess

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75 *See* Prop. Treas. Regs. §§ 1.1291-1(b)(3) and (4) and 1.1291-2(a).

76 As originally enacted, a QEF election was made by the foreign corporation. In 1988, Congress amended Section 1295, effective for taxable years beginning after December 31, 1986, to provide that the election would be made separately by each U.S. shareholder. *See* Technical and Miscellaneous Revenue Act of 1988, *supra*. The policy reason for the change was to allow the individual shareholder to decide whether to recognize phantom income currently or wait and pay taxes on any excess distributions. Our proposal, which provides that the QEF election is automatic, does not implicate this policy because the deemed election will apply only when the corporation has no net earnings (and thus there are no QEF inclusions). Once a foreign corporation has earnings and is classified as a PFIC, the deemed QEF election ceases to apply; the deemed election is merely a means of reducing administrative burdens and preventing the PFIC taint from inadvertently and unfairly attaching to the shares.

distribution regime would begin on the first day of that taxable year — in other words, the deemed-QEF years would be treated essentially as pre-PFIC years (and not as "prior PFIC years") under Proposed Treasury Regulations §§ 1.1291-1(b)(3) and (4). If the company starts generating a profit and is no longer a PFIC, the shareholder will not be subject to the excess distribution regime at all (because the once-a-PFIC, always-a-PFIC rule of Proposed Treasury § 1.1291-1(b)(1)(ii) does not apply if a QEF election was in effect for all PFIC years).[77] If the company is a PFIC, the shareholder would have the option of electing the QEF regime or of treating the shares as newly acquired for PFIC purposes. In each case, the shareholder would not be inappropriately treated as if he or she had deferred taxes during the years the company was operating at a loss.

If the company is a PFIC going forward, we considered whether it was more appropriate to require a shareholder who had relied on the deemed QEF election to continue to treat the company as a QEF. This would be more consistent with the statutory rule that a QEF election, once made, cannot be revoked without the consent of the Secretary.[78] While we do not believe that the statute would require that a deemed QEF election (along the lines we are proposing) be made irrevocable, we would not object to that being a condition to relying upon the deemed QEF election.

We believe the deemed QEF election should also apply to U.S. persons holding options or warrants on stock of the PFIC. As noted above, the current QEF election does not apply to optionholders, although the excess distribution regime applies to them as if they had held stock during the period they held the option. Applying the deemed QEF election to optionholders is clearly appropriate since the deemed QEF would apply to them if they had already converted into stock, so they would not be avoiding any U.S. taxes by holding the option instead of stock. In addition, the deemed QEF election would

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77 Prop. Treas. Regs. §§ 1.1291-1(b)(1)(ii) and 3(v) (once-a-PFIC, always-a-PFIC rule applies only to a "Section 1291 fund" and a "pedigreed QEF" is not a "Section 1291 fund").

78 Section 1295(b)(1).

not raise the computational difficulties which were the stated reason for denying the QEF election to optionholders.[79]

2. Determining Net Earnings For Purposes of Deemed QEF Election

The deemed QEF election would not eliminate all recordkeeping and accounting burdens, however, because it would still be necessary to determine on an annual basis whether the company had net earnings for the taxable year. The current PFIC rules generally require that this determination be made by applying U.S. tax principles in *all* cases; however, we believe that the logistical difficulties and expense of requiring an active company that is operating at a loss to maintain U.S. tax accounts is unjustified. Treasury and the Service have recognized the burden of such a requirement in the context of the Section 964 rules, which provide that for purposes of subpart F a foreign corporation will compute its earnings and profits "according to rules substantially similar to those applicable to domestic corporations, under regulations prescribed by the Secretary." In 1992, proposed Treasury Regulations were issued permitting foreign corporations to depart from U.S. tax rules in certain respects in order to simplify their earnings and profits computations.[80]

Accordingly, we believe it would be appropriate to permit a PFIC to determine its "net earnings" for purposes of the deemed QEF election rules by applying an accounting method that is less burdensome administratively, provided it has some safeguards to protect against abuse and to indicate that the corporation is indeed operating at a loss.

The possibilities we have considered include:

(i) the accounting method the corporation uses in maintaining its permanent books and records and reporting earnings to shareholders and creditors;

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79 This is discussed in more detail below in Section VIA.

80 *See* Prop. Treas. Regs. §§ 1.964-1(c)(i), (ii), (iii) and (v), INTL-0018-92 (July 1, 1992) (generally allowing CFCs to use U.S. financial accounting principles to take into account inventories and depreciation) and Preamble thereto.

(ii) the generally accepted accounting principles in the local jurisdiction in which the corporation operates or international generally accepted accounting standards ("local GAAP"), if these principles differ from the method described in (i) above;

(iii) U.S. generally accepted accounting principles ("U.S. GAAP");

(iv) the tax rules applicable in the jurisdiction in which the corporation is resident or is otherwise subject to tax on a net income basis;

(v) the rules provided for in the Regulations under Section 964 for a CFC to compute its earnings and profits for subpart F purposes; and

(vi) some combination or modification of any of the foregoing.

We believe the method used to report earnings to shareholders and creditors should in most cases provide a fair representation of the earnings situation of the company, even though it may differ from net income under U.S. tax principles. In addition, this method comes with its own built-in checks and balances in that a company is unlikely to seek to under-report its earnings to its shareholders and creditors.

We recognize that Treasury and the Service may be concerned that an earnings statement presented to shareholders and creditors could be subject to manipulation. However, safeguards could be added to prevent this problem: for example, requiring that the earnings statement have indicia of reliability under all the facts and circumstances and providing a non-exclusive list of factors to be considered in determining that the numbers are a reliable and accurate indication of the company's performance and that deductions are not being overstated. The regulations might also provide that if a specified number of the factors are present, the statement will be considered reliable.

Such factors might include the following:

(i) the statement has been delivered to the company's shareholders and at least a specified number, perhaps 10, of the shareholders (counting any group of shareholders acting in concert as a single shareholder) are not related persons (within the meaning of Section 267) to the company or to other shareholders;

(ii) the statement was prepared or verified by an independent auditor or administrator;

(iii) the company is subject to supervision or regulation by a U.S. or foreign government, agency or instrumentality that requires the company to submit a profit and loss statement annually and has enforcement powers authorizing it to impose significant economic or other penalties in case of any false or inaccurate disclosure or deceptive practices, and the profit and loss statement is in fact submitted to or filed with that agency;

(iv) the statement is presented to any creditor that is not related (within the meaning of Section 267) to the company or any significant (say, 5 percent) shareholder and that has extended credit to the company in excess of a set dollar amount, say $50 million, or a specified percentage, say 10 percent, of its paid-in capital contributions;

(v) the company has a net loss without taking into account any deductible expenses paid to any holder of, say, 5 percent or more of the outstanding shares; and

(vi) the absolute value of net loss reflected on the statement is equal to at least a specified percentage, say 25 percent, of the overall revenues reflected on the statement.

We also believe it would be appropriate to provide that an earnings statement shown to shareholders or creditors will not satisfy the indicia of reliability standard if it is inconsistent in any material respect with the company's books and records or any other statement of the company's performance (including a different profit and loss statement) shown to any other person. In addition, the earnings statement method would not be available if the PFIC computes its earnings using U.S. tax principles for any other purpose (*e.g.*, because it is a CFC).

Although we recognize that the principles used in preparing the company's earnings statement may not fully comport with U.S. tax principles, we believe that the earnings statement will be effective in accomplishing what is relevant in the deemed QEF context — determining whether the company is truly not making a profit. In addition,

this method has the added benefit that shareholders will, by definition, receive the company's earnings statement, and thus generally will know whether the deemed QEF election applies to their shares without further action by the company.[81]

While we believe that some of the other methods we have identified are viable alternatives, none of them has all of the advantages of the earnings statement method.

Most companies will follow local GAAP in preparing their earnings statement. However, using local GAAP as the required standard where it is not the method used in preparing the earnings statement would have disadvantages. First, requiring that the statement be prepared would raise the administrative and cost problems associated with the current QEF election requirements. In addition, this method, lacking the built-in checks and balances of the earnings statement method, could impose an audit burden on Service personnel who may have no familiarity with the local GAAP at issue.

While the Service is more familiar with U.S. GAAP, this method is likely to raise even greater administrative and expense problems for the foreign corporation and its U.S. shareholders. For example, converting the book numbers to U.S. GAAP is likely to be more costly and pose more practicable problems than converting the book numbers into local GAAP. In addition, U.S. GAAP still diverges from U.S. tax principles, once again without the checks and balances of the earnings statement method.

Another possible solution would be to employ principles similar to those used in Section 964 and the underlying Treasury Regulations to determine the earnings and profits (or deficits in earnings and profits) of a CFC for U.S. tax purposes. Although the general rule is that a CFC should compute its earnings and profits using the same rules as apply to a domestic corporation, the existing Treasury Regulations recognize that a non-U.S. corporation usually will not maintain its books using U.S. tax principles. Accordingly, the Section 964 Regulations provide that a CFC may compute its earnings and profits for U.S. tax purposes by: (1) starting with the profit and loss statement

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[81] See the discussion of the retroactive QEF election option in the case of a subsequent determination that the corporation was a PFIC (in Section VIE. below).

prepared from the corporation's regularly maintained books; (2) then making adjustments to take into account material departures in the profit and loss statement from certain aspects of U.S. GAAP; and (3) then making adjustments to take into account material departures from certain aspects of U.S. tax accounting practices.[82] While the "adjustments" are required only if they are material, this procedure is burdensome and may be essentially equivalent to requiring the corporation to prepare complete U.S. tax numbers. Accordingly, we believe it is an unwarranted burden on a non-CFC PFIC that is operating at a loss.

Thus, after consideration, we believe that the earnings statement method described above is the best method for purposes of determining the availability of the deemed QEF election. Under our proposal, if the statement satisfies the indicia of reliability standard (or whatever other safeguards are set forth in the regulations) at the time the statement is relied on by the shareholder in preparing and filing his or her return and reflects zero or negative net earnings, the deemed QEF should apply to that year, even if it is subsequently determined that under U.S. tax principles the corporation actually did have net earnings in that year.

We recognize that this raises a "leakage" issue that can best be described by an example:

Suppose a foreign corporation's earnings statement indicates that it had no net earnings for its first four years of operation. A U.S. shareholder who has held shares (with a $100x basis) since the company was formed and relied upon the deemed QEF election, sells his shares and recognizes $150 of long-term capital gain and is not subject to any interest charge. Although the earnings statements in the first four years satisfied all the "indicia of reliability" and were not manipulated to benefit the company's U.S. shareholders, had the company actually computed its U.S. tax numbers, it would have had $25x of U.S. earnings and profits in each of the four years. Thus, had the U.S. tax

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82 Treas. Regs. § 1.964-1(a).

numbers been known, the $100 of gain would have been taken into income over the four years pursuant to an actual QEF election, or the entire $150x of gain would be treated as an excess distribution. Thus, there is permanent "leakage" in that the shareholder has had the benefit of the deferral of $100x of ordinary income and its conversion to capital gain.

While the possibility of such leakage concerns all of us, some of our members believe that the potential costs are outweighed by the benefits of the proposal. Other members believe that the possibility of leakage casts serious doubt on the authority of Treasury and the Service to institute any such rule. The question of statutory authority is addressed in more detail in the next section. Here, we would like to describe some additional safeguards that we believe could be included in the regulations to decrease the likelihood of a material amount of leakage with respect to any one issuer:

(i) the deemed QEF election could be available only for the first 3 years the corporation was in existence or had gross receipts;

(ii) the deemed QEF election could be available only if the corporation's gross receipts did not exceed a specified dollar amount (such as $10 million); and/or

(iii) the validity of the deemed QEF election could be subject to challenge on the grounds that the earnings statement differed from U.S. tax numbers (although the burden of establishing this should be on the Service, not the taxpayer and the taxpayer should not be subject to a penalty if the Service's challenge is successful).

3. Is There Statutory Authority to Provide for the Deemed QEF Election by Regulations?

We believe the directive contained in Section 1298(f) that the Secretary "shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of" the PFIC rules provides sufficient statutory authority for the deemed QEF election we are proposing. Nevertheless, we recognize the fact that the deemed QEF could result in "leakage" (as described in the preceding section of this Report) may raise doubts as to the

authorization to promulgate such regulations under current law.[83] It might also be argued that the regulations would also conflict with the statute in that they would essentially change the definition of a PFIC by excluding any foreign corporation that does not have net income. While we are sympathetic to these concerns, we believe that the authorization in Section 1298(f) combined with the overwhelming need for a solution to the unintended and harmful consequences of the other provisions of the PFIC statute would fully support the proposed deemed QEF election.

We note that Congress has not objected in the past when the Secretary has used his or her discretion to promulgate regulations that stray from the specific terms of the underlying statutory rules but are easier to apply and are expected to get to the right result.

For example, Section 897(c)(2) defines a "United States real property holding corporation" ("USRPHC") as any corporation if at any time the fair market value of its U.S. real property interests equals or exceeds 50 percent of the fair market value of (a) its U.S. real property interests, (b) its interests in real property located outside the United States, plus (c) any other of its assets which are used or held for use in a trade or business (its "aggregate assets"). Treasury Regulations § 1.897-2(b)(2) provides, however, that the asset values need to be measured only at certain times or upon certain events; and, responding to the fact that making these determinations may be time consuming and costly, the Regulations also provide an "alternate test" under which "it shall be presumed" that less than 50 percent of the corporation's aggregate assets consist of U.S. real property interests if 25 percent or less of the U.S. GAAP book value of its aggregate

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[83] Authority for such prospective treatment can be found in Treasury Regulations § 1.897-2(b)(2) which provides generally that if a corporation determines, using the alternative test prescribed by such Treasury Regulations, that it is not a U.S. real property holding corporation but the Service determines that the corporation in fact is a U.S. real property holding corporation, then the corporation will be treated as a U.S. real property holding corporation on a *prospective* basis only. Treas. Regs. § 1.897-2(b)(2)(iii). *See also infra* Section IIIB3 (discussing Treasury Regulations § 1.897-2(b)(2) as analogous authority for proposition that Treasury has authority to issue Regulations which seemingly expand the scope of the statute to which such Regulations relate).

assets consist of real property interests. The corporation can rely on this presumption unless it knows that the book value of its assets is substantially higher or lower than the fair market value of those assets and, it therefore has reason to believe it would probably be a USRPHC under the 50 percent test.

The Preamble to the Proposed Regulations that introduced this "alternative test" explained that the alternative test was provided "in response to several comments" and was aimed at "certain corporations that are unlikely to be U.S. real property holding corporations."[84] We note that there was no specific, or even general, grant of authority under Section 897 to issue any such regulations.

We suggest that the election terminate at that time primarily because we believe that the existing PFIC rules should apply once it is determined that the corporation has net earnings and is a PFIC. This raises the question, however, of whether our proposal allows a shareholder to revoke a QEF election (without consent) by relying on the deemed QEF and then failing to make an affirmative QEF election.

We believe, however, that there is no conflict between our proposal that the deemed QEF election terminates automatically and the PFIC statute because by issuing the regulations, the Secretary would be consenting in advance to an automatic revocation of the QEF election.[85]

4. Summary

The deemed QEF election, because it is based on the company having no net earnings, would not be helpful for a company that had minimal earnings (*e.g.*, a company classified as a PFIC because it has three times as much passive income as other gross

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84 48 F.R. 50751 (Nov. 3, 1983) (Preamble to Proposed Regulations). If, however, Treasury nonetheless decided that issuing regulations providing a deemed QEF election was beyond the scope of its regulatory authority, we would be more than willing to work with Treasury to develop a legislative proposal.

85 *Compare* Section 897(i)(2) (revocation of election to be treated a U.S. corporation may be made only with consent of the Secretary) *with* Treas. Regs. § 1.897-3(f) (outlining circumstances under which Commissioner will generally consent to a revocation).

income) or received a substantial capital infusion triggering PFIC status. Accordingly, we propose the adoption of both the deemed QEF election proposal and the proposed modification of the Cash Rule described in Section A.

Section IV. Difficulties That Arise With Respect to Businesses Earning Active Commodities Income, Rents or Royalties or Gain from the Sale of an Interest in a Subsidiary

A. Introduction

As discussed above, the PFIC rules define passive income (and thus, passive assets) by cross-reference to the definition of "foreign personal holding company income" ("FPHCI") found in Section 954(c), which is part of the subpart F rules applicable to CFCs.[86] While some of the policy objectives of the PFIC and CFC anti-deferral regimes are similar, they are not identical, and the mechanics of the two regimes differ in many respects. In this Section, we discuss some of the differences between these two regimes and how a direct and wholesale importation of the subpart F rules, without refinements appropriate to the PFIC context, may lead to the inappropriate classification of certain active businesses as PFICs. Certain aspects of these subpart F rules are also inconsistent with the 25 percent and 50 percent look-through rules that apply in the PFIC context (but not in the subpart F context). We believe these problems can and should be eliminated by Treasury pursuant to its authority, under Section 1298(f), to prescribe regulations appropriate to carry out the purposes of the PFIC provisions.

B. How the PFIC Rules and the Definition of FPHCI Apply to Businesses Earning Gains from Commodities, Rental or Licensing Activities or from a Sale of an Interest in a Subsidiary or Partnership

1. The PFIC Rules: Definition of PFIC "Passive Income" and the 25 Percent and 50 Percent PFIC Look-Through Rules

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[86] Sections 951 through 964 (*i.e.*, Chapter 1, Subchapter N, Part III, Subpart F of the Code).

a. Passive Income

"Passive income" is defined in Section 1297(b) as "any income which is of a kind which would be foreign personal holding company income as defined in Section 954(c)" (subject to exceptions for certain income of banks, insurance companies, FSCs and export trade companies, none of which are addressed in this Report).

b. The 25 Percent and 50 Percent PFIC Look-Through Rules

Section 1297 also provides two look-through rules:

(1) if a foreign corporation owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation, for purposes of determining if the foreign corporation is a PFIC, the foreign corporation is treated as if it held its proportionate share of the subsidiary corporation's assets and "received directly its proportionate share of" the subsidiary corporation's income (the "vertical look-through rule");[87] and

(2) any interest, dividend, rent or royalty received from a related person (within the meaning of Section 954(d)(3)) is not passive income to the extent it is allocable (under regulations) to non-passive income of the related person (the "horizontal look-through rule").[88]

A "related person" is defined in Section 954(d)(3) as any individual, corporation, partnership, trust or estate which owns more than 50 percent of the foreign corporation, is more than 50 percent owned by the foreign corporation or is more than 50 percent owned by one or more persons who also own more than 50 percent of the foreign corporation. Ownership for this purpose is measured by vote or value, and includes indirect ownership under the rules of Section 958.[89]

2. Definition of FPHCI For Subpart F Purposes

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87 Section 1297(c).

88 Section 1297(b)(2)(c).

89 Section 954(d)(3).

a. In General

FPHCI is a term used in subpart F to define one component in a CFC's "subpart F income," all of which generally must be included in income on an annual basis by U.S. persons actually and constructively holding 10 percent or more of the CFC's voting shares.[90] Over the years, the definition of FPHCI set forth in the Code and the Treasury Regulations under Section 954 has become extremely complicated. To the extent relevant to this Report, FPHCI is defined in the Code as including the following:

(1) dividends, interest, rents, royalties and annuities, other than

(a) rents and royalties derived in the active conduct of a trade or business and which are received from a person that is not a related person (as defined in Section 954(d)(3));[91]

(2) the excess of gains over losses from transactions in commodities, other than

(a) "active business gains or losses from the sale of commodities, but only if substantially all of the [CFC's] business is as an active producer, processor, merchant, or handler of commodities,"

(b) gains or losses arising out of "bona fide hedging transactions reasonably necessary to the conduct of any business by a producer, processor, merchant, or handler of a commodity in the manner in which such business is customarily and usually conducted by others," or

(c) foreign currency gains or losses attributable to any "section 988 transactions;"[92] and

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90 Sections 951(a), 952(a)(2) and 954(a)(1) and (c).

91 Sections 954(c)(1)(A) and (2)(A).

(3) the excess of gains over losses from the sale or exchange of property (other than inventory) which

(a) gives rise to income described in clause (1) above,

(b) is an interest in a trust, partnership or REMIC, or

(c) does not give rise to any income.[93]

b. The Subpart F 50 Percent "Same Country" Look-Through Rule

The statutory definition of FPHCI also includes a look-through rule, although this look-through rule is narrower than the two PFIC look-through rules. Specifically, under the subpart F look-through rule, FPHCI does not include

(1) dividends and interest received from a related person (*i.e.*, a person with a greater than 50 percent ownership link to the CFC) organized in the same foreign country as the CFC, and which has a substantial part of its assets used in its trade or business in that country; and

(2) rents and royalties received from a related person in exchange for the use of property within the country in which the CFC is organized;

except, in the case of interest, rents and royalties, to the extent the payment reduces the payor's subpart F income.[94]

This look-through rule is more limited than the two PFIC look-through rules in that it provides for look-through attribution only when (1) the CFC receives an actual payment from the related person (whereas the PFIC 25 percent vertical look-through rule applies whether or not the subsidiary makes payments to its parent), and (2) certain additional conditions are met — namely, that the related payor is organized in, and has a

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92 Section 954(c)(1)(C). "Commodities" is defined in the Treasury Regulations as tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded. Treas. Regs. § 1.954-2(f)(2)(i).

93 Section 954(c)(1)(B).

94 Sections 954(c)(3) and (d)(3).

substantial part of its trade or business assets in, the same country as the CFC or the property leased or licensed by the CFC to the payor is used in the CFC's country of organization. The legislative history to the PFIC rules confirms that the broader scope of the PFIC look-through rules was intentional.[95] Under the PFIC vertical look-through the attribution is also more extensive in that a proportionate share of the subsidiary's *assets* are attributed to the parent, and the parent is also treated as if it *received directly* its proportionate share of the subsidiary's income.

c. Subpart F Exceptions For Active Commodities Gains, Rents and Royalties

The Treasury Regulations under Section 954 provide specific rules for determining whether the statutory exceptions from FPHCI for active commodities gains, rents and royalties apply.

i. The Exception For Active Commodities Gains

For purposes of the active commodities gains exception, the Regulations provide that the statute's "active business" and "substantially all" requirements are met only if the CFC's gross receipts from "qualified active sales" and "qualified hedging transactions" equals or exceeds 85 percent of its gross receipts.[96] This test is applicable on an annual basis. A qualified active sale is defined in Treasury Regulations § 1.954-2(f)(2)(iii) as a sale of commodities,

(a) which the CFC holds directly (and not through an agent or independent contractor) as inventory or similar property or as dealer property (*i.e.*, not for investment or speculation); and

(b) only if the CFC incurs "substantial expenses" in the ordinary course of a commodities business from engaging directly (and not

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95 *See* S. Rep. No. 100-445, at 281-286 (1988); Staff of the Joint Comm. on Taxation, 100th Cong., *Description of the Technical Corrections Act of 1988*, at 293-94 (Comm. Print 1988) (the "1988 Bluebook").

96 Treas. Regs. § 1.954-2(f)(2)(iii)(C).

through an independent contractor) in one or more of the following activities with respect to the commodities sold —

(i) substantial production activities (such as planting, tending, harvesting, extracting, raising or slaughtering),

(ii) substantial processing activities (such as blending and drying, concentrating, refining, mixing, crushing, aerating or milling), or

(iii) significant activities with respect to the physical movement, handling and storage of the commodities (including preparing necessary documents, arranging for transfer or storage and dealing with quality claims); or owning and/or operating storage facilities or transportation vehicles.[97]

In determining if the CFC conducts the activities directly, employees of a related entity are treated as employees of the CFC only if the employees are made available to and supervised on a day-to-day basis by the CFC and the CFC pays their salaries directly or by reimbursing the related entity.[98]

A "qualified hedging transaction" is generally a hedging transaction (as defined in Treasury Regulations under Section 1221) with respect to qualified active sales, provided it is identified as such on the day the hedge is acquired.[99]

ii. The Exceptions For Active Rents and Royalties

Under the Regulations, rents are considered to be "derived in the active conduct of a trade or business" for purposes of the active rents exception only if the rents are derived from leasing:

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97 Treas. Regs. § 1.954-2(f)(2)(iii)(B).

98 Treas. Regs. § 1.954-2(f)(2)(iii)(D).

99 Treas. Regs. §§ 1.954-2(a)(4)(ii) and (b)(2)(iv).

(a) property that the CFC has manufactured or produced, or has acquired and added substantial value to, but only if the CFC is regularly engaged in the manufacture or production of, or acquisition and addition of substantial value to, property of such kind;

(b) real property with respect to which the CFC "through its own officers or staff of employees" regularly performs active and substantial management and operational functions while the property is leased;

(c) property that is leased as a result of the performance of marketing functions by the CFC if the CFC "through its own officers or staff of employees located in a foreign country" maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is "substantial" in relation to the amount of rents derived from the leasing of such property; or

(d) personal property ordinarily used by the CFC in the active conduct of a trade or business, leased temporarily during a period when the property would otherwise be idle.[100]

Under the Regulations, the exception for active royalties applies only if the royalties are derived from licensing

(a) property that the CFC has developed, created or produced, or has acquired and added substantial value to, but only if the CFC is regularly engaged in the development, creation or production of, or in the acquisition and addition of substantial value to, property of such kind; or

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100 Treas. Regs. § 1.954-2(c)(1).

(b) property that is licensed as a result of the performance of marketing functions by the CFC if the CFC "through its own officers or staff of employees located in a foreign country" maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is "substantial" in relation to the amount of royalties derived from licensing of such property.[101]

For purposes of the rents and royalties exceptions, whether an organization in a foreign country is "substantial" in relation to the amount of rents or royalties is determined "based on all the facts and circumstances." Under a safe harbor, the organization will be considered substantial if, respectively, the "active leasing expenses" or "active rental expenses" of the CFC equal or exceed 25 percent of the "adjusted leasing profit" or "adjusted licensing profit of the CFC (tested on an annual basis)."[102]

Generally, "active leasing expenses" and "active licensing expenses" means the Section 162 expenses of the CFC allocable to the rental or royalty income, other than

(a) compensation for personal services rendered by shareholders or "related persons" of the CFC;

(b) deductions for rents or royalties (respectively);

(c) Section 162 expenses that would also be *specifically* allowable under a Code Section other than Section 162; and

(d) deductions for payments made to agents or independent contractors with respect to the leased property (other than payments for

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101 Treas. Regs. § 1.954-2(d)(1).

102 Treas. Regs. §§ 1.954-2(c)(2)(ii) and (d)(2)(ii).

insurance, utilities or the like, or for capitalized repairs) or the licensed property, respectively.[103]

"Adjusted leasing profit" and "adjusted licensing profit" means the gross income from rents or royalties (respectively), reduced by the amounts described in clauses (b), (c) and (d) of the preceding paragraph.[104]

d. Sales of Interests in Corporations and Partnerships

As noted above, the subpart F look-through rule does not attribute the assets of a subsidiary to a parent corporation, unlike the PFIC 25 percent vertical look-through rule which attributes a proportionate share of the assets of any 25 percent directly or indirectly owned corporate subsidiary to the foreign corporate parent. Thus, under Section 954 FPHCI includes net gains from the sale of stock (*i.e.,* property that gives rise to dividends) and from the sale of an interest in a partnership (unless the stock or partnership interest is inventory to the CFC). Thus, while it is clear that for subpart F purposes gain from the sale of stock of a 25 percent owned subsidiary or from a partnership interest is automatically FPHCI, as discussed below, the appropriate treatment of such gains for PFIC purposes is not clear.

C. The Differences Between the Policies Behind the Subpart F and PFIC Rules

Before describing how these very specific FPHCI definitions create problems in the PFIC context, we want to address the differences in the policies behind the two anti-deferral regimes, because we believe these differences demonstrate why certain aspects of the subpart F definitions should not apply in the PFIC context.

The subpart F rules, enacted in 1962, sought to foreclose the deferral advantages of sheltering foreign investment income or certain types of active overseas income thought to be easily moveable from a company organized in the country in which the

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103 Treas. Regs. §§ 1.954-2(c)(2)(iii) and (d)(2)(iii).

104 Treas. Regs. §§ 1.954-2(c)(iv) and (d)(iv).

activities were conducted into a company situated in a "tax haven."[105] The rules apply only if the foreign corporation is a CFC, that is, if more than 50 percent of the foreign corporation's stock, by vote or value, is owned by U.S. persons, counting only persons owning 10 percent or more of the voting stock. Congress concluded that where five or fewer U.S. shareholders control an entity, tax haven deferral can be arranged easily.

Consistent with the intent of targeting income moved into a tax haven jurisdiction, the subpart F rules apply separately to each foreign corporation in a chain of entities. And, consistent with the intent of targeting easily moveable income, the subpart F rules apply only to the extent of the CFC's income that fits within the definition of FPHCI. Subject to a limited "full inclusion" exception, the CFC's non-FPHCI income is not required to be included in the U.S. shareholders' income (until distributed) and any appreciation in the value of the shares of the CFC is not taken into income until recognized under the normal U.S. tax rules.[106]

Based upon these policy objectives, it made sense not to look through to the active nature of the income of operating affiliates, unless that income was actually paid to the foreign company under examination and the income was derived with respect to activities conducted by both companies in the jurisdiction in which they were organized

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105 While the prevention of tax haven abuse seems to have been the primary objective of the enactment of subpart F, the recent Treasury Department study of CFC policy has identified in the relevant legislative history additional important objectives. These include: promoting equity between U.S. taxpayers doing business overseas and doing business exclusively within the United States; promoting an economically efficient – as opposed to an artificial, purely tax-motivated – allocation of resources; avoiding undue harm to the competitiveness of U.S. multinationals (an objective that gave rise to the exceptions to subpart F income); and preventing passive income from escaping current U.S. taxation, without regard to the impact on U.S. multinationals' competitiveness with respect to this kind of income. Office of Tax Policy, Department of the Treasury, *Treasury Department Policy Study On Deferral of Income Earned Through U.S. Controlled Foreign Corporations*, (December 2000), Daily Tax Rep. (BNA), Jan. 3, 2001, S-1.

106 *See* Section 954(b)(3)(B) (the full inclusion rule); *see also* Section 954(b)(3)(A) (the de minimis rule).

(or, in certain cases, operated). This is the reason for the restrictions in the 50 percent same-country look-through rule.

By contrast, Congress intended the PFIC rules to apply whenever a U.S. investor invests in a passive venture — that is, a venture that is, as a whole, *primarily* a collection of passive income and assets. If the U.S. investor invests in a corporation that operates one or more active ventures through one or more operating companies, Congress considered that to be an active venture to which the PFIC rules should *not* apply. Indeed, the Conference Committee Report to the 1986 enactment of the PFIC rules and the 1986 Bluebook explain that this was the reason for the 25 percent vertical look-through rule (attributing a proportionate part of any 25 percent-owned corporate subsidiary's assets and income to its parent).[107] Congress also included in the PFIC rules the 50 percent horizontal look-through rule which treats income received from a 50 percent related company (and which would otherwise be passive) as active to the extent allocable to active income of the payor, furthering the intent to look at a related group of entities as a single business for PFIC purposes (without regard to the rigid "same country" requirements used in the CFC look-through rule).

D. How the Subpart F Active Commodities "Substantially All"/"85 Percent" Test Developed

Prior to 1986, the only commodity transaction gains included in FPHCI were gains from futures transactions in commodities traded on or governed by the rules of a board of trade or commodity exchange.[108] Congress soon recognized that passive income could be earned from commodities in off-exchange and other transactions. Accordingly, the Tax Reform Act of 1986 significantly expanded the scope of the types of commodity gains and losses included within FPHCI, and then attempted to address the true active

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107 *See* H.R. Conf. Rep. No. 99-841, at II-644 (1986); 1986 Bluebook ("Congress did not intend that foreign corporations that own subsidiaries primarily engaged in active business operations be treated as PFICs").

108 Section 954(c)(1) (cross-referencing Section 553(a)(3)), prior to amendment by Section 1221(a)(1) of the Tax Reform Act of 1986.

commodities businesses with an exception that includes a "substantially all" requirement.[109] As described above, the Regulations elaborated on the statutory language by providing that the "substantially all" requirement is met only if gross receipts from sales in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities, and from bona fide hedging transactions with respect to such sales, represent 85 percent or more of the individual foreign corporation's gross receipts. While this narrow exception arguably works, somewhat imperfectly, in the subpart F context, in the PFIC area its application is not only unclear but it may often lead to wildly inappropriate results.

E. The Application of the Active Commodities "Substantially All"/"85 Percent" Test Often Leads to Inappropriate Results and Is Not Clear

1. How the 85 Percent Test May Cause a Single Entity that Conducts More Than One Active Business to be Classified as a PFIC

In the PFIC context, the 85 percent test actually discourages U.S. investment in a foreign commodities producer if that producer has diversified into other active businesses. The simplest case, and one that is by no means rare, is that of a single corporate entity engaged in two types of business, one of which involves the active handling, processing, etc. of commodities, the other being an active business of a different kind. For example, suppose a stand-alone corporation derives 55 percent of its revenue from active sales of iron ore (a "commodity"), and 45 percent from non-commodity activities, such as selling steel products it manufactures. If the value of the two divisions is in proportion to their revenues, application of the 85 percent test would cause this corporation to be a PFIC: it would fail the 85 percent test so all of its commodity income would be treated as FPHCI and, thus, the assets that produce that income (*i.e.*, 55 percent of its total assets) would be treated as passive for purposes of the Asset Test.

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[109] *See* Section 1221(a)(1) of the Tax Reform Act of 1986.

2. How the Application of the 85 Percent Test in the PFIC Context is Not Clear

Another aspect of the 85 percent test that is problematic in the PFIC context is that it is not clear how to apply the test where a top-tier corporation owns a 25 percent or greater interest in one or more corporate subsidiaries. Should the 85 percent test be applied to each member of the look-through group prior to attribution of the income and assets of each to the parent (the "entity-by-entity" approach); or should the attribution of the income and assets be applied prior to the 85 percent test (the "aggregate" approach)? The PFIC Code provisions do not answer this question, although they tend to support the aggregate approach, since the vertical look-through rule treats the parent as if it held and derived its proportionate share of the subsidiary's assets and income. The subpart F Regulations do not address the matter because the PFIC look-through rules are not applicable under Section 954. Arguably, the subpart F Regulations could be said to suggest the entity-by-entity approach in that they are written in those terms.[110]

Two examples illustrate the differences between the entity-by-entity and aggregate approaches:

Example 1: A parent holding company derives all its income from two operating subsidiaries. Sub 1 has 80 percent of its revenues from qualified active sales of commodities and 20 percent from manufacturing, and in total represents 75 percent of the group's gross income and income-generating assets. Sub 2 has 100 percent active commodity sales and represents the remaining 25 percent of the group's income and income-generating assets.

Under an entity-by-entity approach, all of Sub 1's income and income-generating assets involved in the active commodities operation would be passive, because the

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110 For example, the subpart F Regulations do *not* provide that where the subpart F 50 percent same-country related person look-through rule applies a proportionate share of the 50 percent related payor's active commodities gains should be treated as active commodities gains of the CFC payee. Instead, the look-through income is, in the hands of the payee, simply, "not FPHCI."

85 percent requirement is not met; applying the look-through rule next, 60 percent of the parent corporation's assets (75 percent times 80 percent) would be passive and so it would be a PFIC.

If the aggregate approach is used instead, all of the income and assets of the subsidiaries would be attributed to the parent company, whose income would then consist of more than 85 percent qualified active sales income. Therefore, the parent would not be a PFIC.

In the example above, the aggregate approach leads to non-PFIC classification and the entity-by-entity approach leads to PFIC classification. In a second example, the reverse is true.

Example 2: Again, a parent holding company derives all its income from two operating subsidiaries. Sub 1 has 100 percent active commodity sales and in total represents 60 percent of the group's income and income-generating assets. Sub 2 has 100 percent active business income from manufacturing and represents the remaining 40 percent of the group's income and income-generating assets.

Under the aggregate approach, the parent corporation would be a PFIC because it fails the 85 percent test. However, analyzed entity by entity, both subsidiaries earn 100 percent non-passive income and so, applying the look-through rule, the parent would not be a PFIC.

Under current law, neither parent company can be absolutely sure that it is not a PFIC, even though all its direct (and constructive) income is from active operations. As a policy matter, of course, neither should need to worry about the PFIC rules

3. Why the Substantially All Test Is Simply Inappropriate in the PFIC Context As a Policy Matter

Thus, the substantially all/85 percent test achieves its intended purpose in the PFIC context only where a *single* corporate entity is engaged *solely* in business as an active producer, processor, merchant or handler of commodities. It is extremely common, however, for a corporation that engages in such activities to also conduct (itself, or together with subsidiaries) other active businesses. For instance, some mining

companies supplement their mineral extraction and processing revenues with income derived from providing drilling and exploration services to third parties; some vertically integrated mining companies that process and sell commodities (*e.g.*, iron ore) also manufacture and sell finished products (*e.g.*, steel); and some active natural resource businesses are simply part of diversified conglomerates. Under the 85 percent test, a stand-alone foreign entity or any member of a foreign group may be classified as a PFIC, even though the corporation (or the group as a whole) is operating an active commodities business that is substantial. There is no policy reason for this result. These rules make it more difficult to invest in a diversified business with an active commodities component than in a business devoted solely to commodities. This result was clearly not the intent of the PFIC regime.[111]

In the subpart F area, the rationale for the substantially all test appears to have been to prevent a corporation from combining commodities gains from an active business as a producer, processor, merchant or handler with gains from speculative trading or investment transactions in commodities. Arguably, the rule is less problematic for the 10 percent U.S. shareholders of a CFC because they will often be able to cause the CFC to structure its operations so as to meet the substantially all test (*i.e.*, by moving non-qualified sales activities to a different entity). CFC status, by definition, means that there is sufficient U.S. investor influence to cause the corporation to make U.S. tax-sensitive choices (particularly since the U.S. investors will often control the CFC from its formation — *i.e.*, before a specific structure has been adopted). In contrast, in the PFIC context, widely dispersed U.S. investors with minority stakes (and investing in an already-established business) typically will not be able to wield such influence, particularly given the likely complexities of any required restructuring, including

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[111] Indeed, the 1993 legislative history specifically provided that a corporation should be able to combine an "exempt" securities business with another active business without being a PFIC. H.R. Conf. Rep. No. 103-213, at 640-641 (1993). An intent to permit diversification is also reflected in the administrative interpretations of the active banking exception, which allow both an "active bank" *and* its "qualified banking affiliates" to qualify for the exception. *See* Prop. Treas. Regs. § 1.1296-4 and Notice 89-81, 1989-2 C.B. 399.

constraints imposed by foreign tax and corporate law, the need to obtain consents from lessors, creditors and other persons, and regulatory matters such as the ability to register or qualify a new entity or move existing permits or tax concessions to a new entity. Moreover, as discussed above, the consequences of PFIC classification for U.S. shareholders of an active foreign business are generally far more costly than the classification of certain items of income of a CFC as FPHCI for its 10 percent shareholders. For example, if the shareholder is a U.S. corporation, it may be entitled to a Section 902 deemed paid foreign tax credit with respect to any subpart F inclusions (under Section 960). In addition, active commodities gains that are classified as FPHCI may be excluded from subpart F income under the high tax kick-out of Section 954(b)(4).

The FPHCI definition was used in the PFIC context because Congress wanted to impose the equivalent of current taxation on gains from speculative and investment transactions in commodities. As indicated above, Congress did not intend that differences in corporate structure or diversification would cause PFIC status to apply to businesses that are predominantly active. It is highly doubtful that Congress foresaw the full consequences of incorporating the "substantially all" rule. Because these results seem to be inadvertent and are so clearly in conflict with the purposes of the PFIC rules overall (not to target active business), and the two PFIC look-through rules in particular (to facilitate diversified operations), we believe Treasury can provide a remedy, and give effect to the legislative purpose of the PFIC rules, by issuing regulations under Section 1298(f) that eliminate the substantially all test in the PFIC context. (Our proposal is described in more detail below in Section V.)

F. How the "Own Employees" Requirements for Commodities Gains, Rents and Royalties is Unclear and Potentially Problematic in the PFIC Context

The second aspect of the subpart F Regulations that could result in inappropriate PFIC classification of active businesses conducted within a foreign corporate group is the "own employees" requirements that apply in determining when rents, royalties, and commodities gains are "active" and therefore not FPHCI. It is unclear how these requirements apply in determining whether a corporation is a PFIC. We believe that the

most appropriate reading of these requirements is that they should be applied to a corporation that may be a PFIC and its 25 percent owned subsidiaries as an aggregate group. A more restrictive reading of the own employees requirements — treating employees of subsidiaries as not the parent's "own employees" — could distort the PFIC analysis.

As described above, under the subpart F Regulations, a CFC may take into account employees only as follows:

(1) in determining if the CFC is engaged in an active commodities business generating qualified active sales, it must conduct the commodities production, processing, merchanting or handling through its own employees and not employees of a related entity (unless those employees are made available to, supervised and compensated by the CFC on a day-to-day basis), and

(2) in determining if the CFC's rents or royalties are derived in the active conduct of a trade or business,

  (a) management, operational and marketing functions are taken into account only if conducted through the CFC's own employees (not employees of a related person), and

  (b) in determining if its "active leasing" or "active rental" expenses constitute at least 25 percent of its "adjusted leasing" or "adjusted licensing" profit, compensation for services of employees of related persons may not be taken into account.

If these "own employees" rules applied in the PFIC context, they would create adverse consequences for a wide range of commonplace, economically sound arrangements for employee-sharing within foreign corporate groups. For non-tax business reasons (*e.g.*, limiting liabilities associated with distinct properties or projects, or consolidating employee payroll and benefit plans), many rental or leasing operations hold their individual properties through separate entities and concentrate their management, operational, marketing and administrative functions in another entity; commodities

operations often enter into similar employee and corporate structure arrangements for similar business reasons. Under the "own employees" rules, these types of arrangements can result in the income from the property being classified as FPHCI simply because certain operational functions are being conducted by employees of a related entity rather than the entity holding the property or the entity to which rental income is imputed. If the corporate entities were merged together, the income would not be FPHCI. Again, this unfortunate result is an accident of a form that is usually adopted for business reasons and cannot be changed by U.S. shareholder pressure.[112]

The application of the "own employees" rules is particularly uncertain where, as may often be the case, certain assets are held, or certain activities are conducted, through a partnership. Generally, a foreign corporation that conducts an active business through a partnership should not be a PFIC solely because the individuals that run the business are employed by a separate but related entity. While the proposed so-called "*Brown Group*" regulations have sought, for subpart F purposes, to provide a measure of aggregate treatment in respect of the income and activities of a partnership, those regulations do not address this issue. Those regulations were proposed to address a different problem and they require that, in applying the exceptions from FPHCI, *only* the activities and property of the partnership be taken into account.[113]

While the "own employees" rules might have some rationality in the context of the CFC rules, where the crucial issue is whether income is being diverted from the country where the underlying assets are located to a tax haven, they would frustrate the intention of the PFIC rules, which is to distinguish active operations from passive investment activities. In addition, these own employee rules are inconsistent with *both* PFIC look-through rules and the policy behind them, which is to treat a group of related

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112 For further discussion of this problem, *see* Mary C. Bennett, *U.S. Definition of "Active Rents" For PFIC Purposes Creates Problems*, 14 TAX NOTES INT'L 1437; *see also* Thomas D. Fuller, *The Pfickle Finger of Fate: Many Questions, Few Answers*, 17 TAX NOTES INT'L 1617, 1624.

113 Prop. Treas. Regs. § 1.954-2(a)(5)(ii).

operating entities (whether connected by an operating parent or a holding company) as an active venture.

A failure to take into account activities of related entities' employees in the PFIC context would be all the more unfortunate in that the legislative history makes it clear that such a result was not intended (at least in the rents and royalties contexts). PFIC "passive income" was initially defined, not by direct cross-reference to Section 954(c), but rather to Section 904(d), which provides for a foreign tax credit limitation basket for "passive income," which it defines as "income . . . which is of a kind which would be foreign personal holding company income (as defined in Section 954(c))." Evolving Regulations under Section 904(d) have adapted the Section 954(c) definitions to the foreign tax credit context by providing that the determination of whether rents or royalties are active is to be made by taking into account the activities of all members of the recipient's affiliated group.[114] Months after this regulation was issued, however, Congress amended the PFIC "passive income" definition so that it would refer directly to Section 954(c) and no longer to Section 904(d).[115] The stated reason for the amendment was the need to eliminate confusion concerning the relation between Section 904(d)'s related person look-through rule and the PFIC subsidiary look-through rule.[116] There is no evidence, however, that Congress intended a substantive change to whether rental or royalty income is classified on a group-wide or entity-by-entity basis for PFIC purposes.

This history teaches two important lessons. One is that, if not for a technical need to remove confusion created by the co-existence of two different look-through rules in different parts of the Code, it is likely that today the PFIC rules would incorporate the more consistent and sensible approach to related company employees found in the Section 904(d) Regulations. The second is that, in issuing the Section 904(d) Regulations, Treasury showed that it believed it had the authority to adapt the Section

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114 Treas. Regs. § 1.904-4(b)(2)(ii), T.D. 8214, July 15, 1988.

115 Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, 102 Stat. 3342.

116 *See* 1988 Bluebook at 289, 290, 293.

954(c) standards when appropriate, despite the fact the Section 904(d) cross-reference to Section 954(c) contained no explicit regulatory authority to modify the FPHCI definition.[117]

G. Why the Treatment of Sales of Interests in Corporate Subsidiaries and Partnerships as Passive Income is Inappropriate in the PFIC Context

As indicated above, under the subpart F rules it is clear that the sale of stock or a partnership interest gives rise to FPHCI, regardless of the percentage of the issuer's equity owned by the CFC. It seems that these rules do not apply in the PFIC context, but it is not entirely clear.

Under the PFIC 25 percent vertical look-through rule, where a foreign corporation owns at least 25 percent of the stock of a subsidiary, for PFIC purposes the stock is ignored and instead the shareholder is treated as owning its proportionate share of the subsidiary corporation's assets. Because there is no such rule in the subpart F context, the subpart F characterization of gain from the sale of stock would appear to be irrelevant in the PFIC context if the selling shareholder owns at least 25 percent of the corporation being sold. This appears to be the logical reading of the statute and it is also consistent with the general intent of the PFIC rules to treat a foreign corporation that is a holding company for active subsidiaries in the same manner as a foreign corporation that conducts active operations directly.

Indeed, a recent private letter ruling, Priv. Ltr. Ruling 200015028 (Jan. 12, 2000), treated a sale of shares of a 100 percent owned corporate subsidiary as a direct sale of the subsidiary's assets. The ruling appears to have reached that conclusion based on a combination of the 25 percent vertical look-through rule and the rule in Section

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[117] *See* Bennett, *supra* at 1439. Moreover, because the QEF inclusions in respect of a mature business earning active commodities, leasing and/or royalty income are likely to include substantial amounts of active income, it is all the more important to limit inappropriate PFIC classification of such businesses.

1298(b)(3) that a corporation will not be a PFIC in a taxable year as a result of passive income attributable to the proceeds from the disposition of one or more active trades or businesses if it will not be a PFIC for either of the following two years. The ruling, thus, appears to have interpreted the sale of the shares as a sale of the business and assets of the subsidiary, pursuant to the 25 percent look-through rule.

While there is no specific guidance in the PFIC context as to a sale of an interest in an operating partnership, we believe the same look-through principle should apply, provided the corporation holds a 25 percent interest in the partnership. Thus, when a corporation sells an interest in a 25 percent owned partnership, the gain should be characterized as if the corporation had held and sold directly its proportionate share of the assets of the partnership. This would be consistent with the 25 percent look-through rule for corporate subsidiaries and the intent of the PFIC rules, since many foreign corporations conduct operating businesses through joint ventures taxable as partnerships rather than as corporations. It would also be consistent with Revenue Ruling 91-32, which treats the gain on sale by a foreign person of a partnership interest as effectively connected income to the extent that a sale of partnership assets would have given rise to effectively connected income (regardless of how small the foreign partner's interest was).[118]

Section V. Proposed Solutions to the Issues Raised by the Substantially All Test, the Own Employees Requirements and Sales of Interests in Operating Subsidiaries and Partnerships

We believe that all three aspects of the subpart F definition of FPHCI described above — that is, (1) the substantially all/85 percent test for commodities gains, (2) the "own employees" requirements for commodities gains, rents and royalties, and (3) the classification of gain from the sale of stock of a 25 percent owned corporate subsidiary or of an interest in a partnership as FPHCI without looking-through to the character of the entity's assets — are inconsistent with the policy of the PFIC rules and may improperly

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[118] *See* Rev. Rul. 91-32, 1991-1 C.B. 107.

result in an interest in an active venture being treated as FPHCI. Accordingly, we believe that Treasury clearly has and should exercise regulatory authority under Section 1298(f) to provide for the following refinements and clarifications as to how those aspects of the FPHCI definition will be applied in the PFIC context:

(1) the "substantially all" requirement will not apply for purposes of the PFIC rules;

(2) in determining if any foreign corporation is a PFIC with respect to any direct or indirect shareholder, the "own employees" test used to determine the character of commodities gains, rents and royalties (including the active leasing/active rental 25-percent-of-adjusted-profit tests) will be applied by (i) attributing to the foreign corporation the relevant employee activities (and employee compensation expenses) of any person (whether a corporation or a partnership) whose income is attributed to the foreign corporation under either PFIC look-through rule or under the 10 percent partnership income look-through rule we propose below (see Section VI D), and (ii) by treating any income to which the 50 percent PFIC horizontal look-through rule applies as having been derived directly by the payee in the same manner as it was derived by the payor;[119] and

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[119] There are some employee arrangements that may not be addressed adequately by our proposal and arguably should receive similar relief. For example, because our proposal makes employee aggregation dependent on an ownership threshold (25 percent in the case of subsidiary stock and either 10 or 25 percent in the case of partnership interests), it will not relieve all problems that arise in connection with the "own employees" active commodities sales requirement, under which attribution depends in part on employees working for a "related" person.

For example, a foreign corporation ("FC") participates in a mining joint venture (the "partnership") from which it receives 10 percent of the mined ore, which it refines and sells. The employees who mine and refine the gold are employed by a foreign cost corporation ("CC"), owned by the partners in the same proportion as they receive of the mine's output. Each partner/shareholder has personnel on the board of CC supervising the employees on a daily basis; and each pays its share of CC's expenses, including salaries. Under our "employees" proposal as well as under the current PFIC rules, FC's income from the partnership would be passive income: the employees of CC cannot be attributed to FC because, although FC satisfies the supervisory and salary criteria of the

(3) when a corporation sells or disposes of an interest in a 25 percent owned corporate subsidiary or 25 percent owned partnership, any gain that is recognized is characterized as if the corporation had held and sold directly its proportionate share of the assets of the subsidiary or partnership.

With respect to proposal (1) above, regulations might provide simply that, for purposes of defining PFIC passive income, Treasury Regulations § 1.954-2(f)(2)(iii) will be applied without regard to the requirement that "substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities." Thus, the exception would still apply only to gains from "qualified active sales," which would be defined for PFIC purposes as "sale[s] of commodities in the active conduct of a commodities business as a producer, processor, merchant or handler of commodities" (*i.e.*, the definition in Treasury Regulations § 1.954-2(f)(2)(iii), minus the substantially all requirement). [120]

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commodities "own employees" requirement, FC owns only 10 percent of CC and hence the two companies are simply not "related" within the meaning of Section 954(d)(3). One possible solution would be to extend the concept of a "related person" to cover the employees of any corporation formed or availed of principally to assist in carrying on the business of the foreign corporation or partnership which deals in commodities and which is owned by such corporation or partnership, or by its shareholders or partners, as the case may be. Another possibility is to eliminate, for PFIC purposes, the requirements relating to employees and instead focus on whether the foreign corporation is subject to the risks and rewards of carrying on an active business as a producer, processor, merchant or handler of commodities. Treasury could here follow the example laid down in Treasury Regulations § 1.179-2(c)(6)(ii), where the definition of active conduct of a trade or business has no employees requirement and a taxpayer is instead considered to actively conduct a trade or business if the taxpayer "meaningfully participates" in the management or operations of the trade or business (a more substance-oriented approach that could benefit companies like FC in the above example). *See also* Treasury Regulations § 1.864-5(b)(l)(iii) (facts and circumstances active business test). However, we are aware that in other areas outside subpart F, actively conducting a business means directly carrying out operational and management functions. *See, e.g.*, Treasury Regulations §§ 1.355-3(b), 1.367(a)-2T(b)(3) and 1.367(a)-4T(c)(1).

120 In the event that Treasury believes that it lacks the authority to eliminate the "substantially all" requirement in the commodities context, because this is provided for in the statute (rather than in the regulations as the "own employees" requirements are), we urge Treasury to dispel the uncertainty as to the sequence in which to apply the "substantially all" test and the PFIC look-through rules. Because application of either the

With respect to the "own employees" look-through rules proposed in item (2) above, these rules would apply only in determining whether a foreign parent corporation is a PFIC for a U.S. shareholder of the parent corporation. If the PFIC is also a CFC, these rules would not apply in determining its subpart F income for purposes of its direct or indirect 10 percent U.S. shareholders subject to subpart F. In addition, there would be no downstream attribution for purposes of determining if a subsidiary that is 25 percent owned by another entity is a PFIC with respect to a direct U.S shareholder of the subsidiary.

Proposal (3), which would clarify when there is look-through treatment in the case of a sale of an interest in a subsidiary or partnership, would apply not just to actual sales but to any other disposition or deemed disposition in which income must be recognized as if the shares or partnership interest had been sold. For example, if a foreign corporation recognizes gain under Section 311(b) on a distribution of appreciated subsidiary shares (or partnership interests), then look-through treatment would apply to that gain.

We believe these rules would not result in passive commodities gains, rents or royalties escaping classification as "passive income" for PFIC purposes. Gains that are not directly attributable to the foreign venture's active commodities operations (as a

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entity-by-entity approach or the aggregate approach can, depending on the circumstances, result in treating certain members of a corporate group that engages in an active commodities business as PFICs, we believe that, in the absence of elimination of the rule, Treasury should promulgate regulations providing domestic shareholders (or the foreign company) the option of applying either approach. We believe that providing for an election would further the purposes of the PFIC rules more than mandating one of the two approaches used because an election would reduce the number of foreign corporations that fail the 85 percent requirement even though a substantial part of their operations consists of active commodities businesses. Because the Code states two sets of rules — the subpart F "substantially all" and the PFIC look-through rules — without providing adequate guidance as to the crucial question of the sequence in which they are to be applied, Treasury is unconstrained with regard to answering this question.

If, however, no election as to which approach is followed is to be permitted, then at least there should be clarification as to the proper approach so foreign issuers and U.S. investors can understand and fulfill their U.S. tax reporting and payment obligations.

producer, processor, merchant or handler) or active rental or licensing operations would still be considered passive.

Such rules would not be an unprecedented exercise of regulatory authority, as Treasury has already on two previous occasions, "modified" the Section 954(c) definition of FPHCI in order to better meet the needs of a non-subpart F set of rules where there was no prior specific Congressional direction to do so. For purposes of the foreign tax credit Section 904(d) "basketing" rules, "passive income" is defined (as it is in the PFIC rules) by reference to the Section 954(c) definition of FPHCI. However, where that statutory definition has been found to be inadequate for Section 904 purposes, regulatory modifications have been adopted. Regulations under Section 904 have both added to and subtracted from the Code's definition of FPHCI: under Treasury Regulations. § 1.904-4(b)(2)(ii), in determining whether rents or royalties are active, the activities of all members of a recipient's affiliated group are taken into account (not just, as in subpart F, the activities of the company being tested for the active rents and royalties exception); and, very recently, Proposed Treasury Regulations § 1.904-4(b)(2)(i) has essentially read out of the active rents and royalties exception the requirement (found in Section 954(c)(2)(A)) that the payments must come from an unrelated person.[121] In each of these cases, notwithstanding the absence of any specific authorization from Congress to adapt the Code's definition of FPHCI, Treasury eliminated elements of the definition that it determined were inappropriate in the Section 904 context.[122]

We believe that such regulatory modifications would be particularly appropriate in the PFIC context. In addition, the "own employees" rules, were created entirely by the subpart F Regulations and thus Regulations under Section 1298(f) could, without question provide that these rules do not apply in the PFIC context.

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121 (REG-104683-00) (3 January 2001).

122 *See* T.D. 8214, 1988-2 C.B. 220 and Preamble to Proposed Regs., Fed. Reg. Vol. 66, No. 2, p. 319.

Section VI. Other Regulatory Proposals

A. Proposal for Regulations Making a QEF Election Available to Optionholders.

While we believe that the other proposals we are making will resolve many of the problems for active companies, we recognize that some active companies may fall through the cracks and end up being classified as PFICs. Therefore, we believe that the problem that exists for holders of options on stock of such corporations should be addressed by allowing optionholders to make a QEF election.[123]

Under Proposed Regulations, an option on stock in a PFIC (including debt convertible into stock) is treated as PFIC stock.[124] If the option is sold, the gain is subject to the excess distribution tax and interest charge (based upon the number of years the option was held). If the option is exercised, the excess distribution tax is not triggered at that time, but, for purposes of computing the interest charge on any subsequent excess distribution, the holding period of the stock received upon exercise includes the holding period of the option.[125] These rules are authorized by Section 1298(a)(4) and are premised on the fact that a PFIC optionholder may participate in corporate growth in the same manner as a stockholder and that, like a stockholder, the optionholder should be required to disgorge the value of the tax deferral.

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123 Of course, the option election would apply to all optionholders, even those holding options on "classic" PFICs.

124 Prop. Treas. Regs. §§ 1.1291-1(d) and (h)(3) *Example* (proposed to be effective generally on April 11, 1992).

125 Treas. Regs. §§ 1.1291-1(d) and (h)(3). If the shareholder elects to treat the PFIC stock as QEF stock after exercise, the PFIC will be an unpedigreed QEF because of the PFIC years in the shareholder's holding period attributable to the period the option was held. While the shareholder may elect to purge the PFIC taint by recognizing the gain and paying the excess distribution charge pursuant to Section 1298(b)(1) and Treas. Regs. § 1.1297-3, this is likely to be more costly than a current annual accrual of the gain and payment of tax while the option was held.

Regulations finalized last year provide, however, that an optionholder may *not* make a QEF election.[126] Treasury and the Service have explained that the QEF regime election was not made available to an optionholder because of the difficulties in determining how to properly compute the QEF inclusions for an optionholder.[127] Acknowledging the problem this creates for PFIC optionholders, they called for suggestions of administratively feasible mechanisms that would permit an optionholder to make a QEF election.[128]

We also note that Congress appears to have recognized the unfairness of rules that trap PFIC optionholders in the excess distribution regime when it enacted Section 1296 in 1998. Section 1296, which offers a mark-to-market alternative for marketable PFIC stock, explicitly provides that the mark-to-market regime will be available for any option on marketable stock "to the extent provided in regulations."[129]

The unavailability of the QEF election for an optionholder is of particular concern to potential investors in foreign startups and other speculative ventures. As noted above, such unproven companies often raise funds by giving investors options to acquire additional shares or offering convertible debt. This provides some downside protection and upside potential to the investor and often allows the issuer to obtain financing on more favorable terms.

Accordingly, we have developed a proposal for allowing an optionholder to make a QEF election. We recognize the difficulties of devising a method for computing the QEF inclusions for an optionholder that is administratively feasible and reflects an appropriate measure of the gain on the option. We believe our proposal accomplishes the

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126 Treas. Regs. § 1.1295-1(d)(5).

127 *See* T.D. 8750 (Dec. 31, 1997) (Preamble to Regulations when issued in temporary form).

128 *Id.*

129 Section 1296(c)(1)(C). Regulations finalized in January 2000 reserve on this issue. Treas. Regs. § 1.1296(e)-1(e).

first goal and, as to the second, most likely will err on the side of inflating the inclusion. We believe, therefore, that the Government's interests are protected and that, while the solution is not ideal for optionholders, optionholders may find it more attractive than the current situation and they should at least be given this alternative.

1. Proposal: Inclusion of Current Earnings by Optionholder as If Optionholder Held the Stock Directly

Under our proposal, the optionholder would apply the existing QEF regime as if the optionholder had exercised the option or converted the bond. Thus, the optionholder would compute her pro rata share of the issuer's earnings by assuming that she held the shares subject to the option and that the total number of outstanding shares equaled the shares actually outstanding plus the shares subject to the option. For purposes of this computation, the optionholder would not treat any other outstanding options as having been exercised. Nor could any person holding stock (or an option) and who had made a QEF election treat any of the optioned shares held by any other person as outstanding in computing that shareholder's QEF inclusion. If the optionholder also holds shares of the PFIC for which a QEF election has been made, the shareholder/optionholder would compute a combined QEF inclusion assuming that he or she held both the shares actually held and the shares subject to the option. The optionholder would then include this pro rata share in income as ordinary income and capital gain, just as if she held the optioned shares.[130]

To illustrate, assume a PFIC has 100 shares of common stock outstanding. One U.S. person holds 10 shares of stock, a second U.S. person holds an option issued by the PFIC to acquire 20 shares of stock, and a third U.S. person holds debt of the PFIC that is convertible into 20 shares.[131] The PFIC has $120 of net earnings and all three U.S.

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130 As with a shareholder who makes a QEF election, amounts included in the optionholder's taxable income under Section 1293 would increase the optionholder's tax basis in the options. Section 1293(d).

131 The remaining 90 outstanding shares are owned by non-U.S. persons or U.S. persons who do not make QEF elections.

persons make QEF elections. The shareholder takes into income 1/10 of the $120 of earnings ($12); and the optionholder and the debtholder each take into income 1/6 (or, 20 shares divided by 120 shares) of the $120 of earnings ($20 each).

The theory behind computing the QEF inclusion in this way is that if the optionholder or the debtholder exercised the option he or she would receive shares whose value reflected 1/6th of the $120 of earnings. Of course, this methods results in the same earnings being imputed to all three U.S. persons; (1) the shareholder has to recognize 1/10th of the $120, even though if both options are exercised, the shareholder would have an interest in only 1/14th (or 10 divided by 140) of the $120; and (2) each optionholder recognizes 1/6th, even though if both options are exercised, each would have only 1/7th of the outstanding shares. Accordingly, the election may inflate the inclusions that any optionholder would have had if the optionholder had instead actually held the stock. While this is not ideal, it has the benefits of being straightforward and easily administered, it will not jeopardize the Government's interests, and an optionholder may find it preferable to the excess distribution regime.

The amount of double-counting is reduced, however, to the extent the same U.S. person owns both QEF shares and QEF options. Consider the example above: if it is the same U.S. person who holds the 10 shares and the option on 20 shares, that person takes into income 30/120 or 1/4 of $120 ($30), rather than $12 (as a shareholder) plus $20 (as an optionholder).

There is also a slight variation on this approach, which is more complex but more precise. Under this variation, the optionholder's annual QEF inclusion would be reduced by distributions actually made during that year on the stock for which the option is exercisable (to the extent made out of that year's current earnings and profits). The rationale for this adjustment is that the optionholder will, in fact, never share in the earnings that were distributed to the actual stockholder. The adjustment would not apply, however, if the optionholder received an anti-dilution adjustment (including an exercise price adjustment) to compensate for the distribution. While this involves a two-step

approach in place of the first proposal's one-step approach, we believe it is far more precise without being significantly more difficult to apply, and thus is preferable.

2. QEF Election for Options Should be Separate From QEF Election for Shares Held Concurrently

Under the existing Regulations, a QEF election made by a shareholder for shares of a PFIC applies to all shares of the PFIC held or subsequently acquired by the shareholder.[132] This raises a number of questions: (i) Should a QEF election made with respect to shares apply to options held or subsequently acquired by the shareholder? (ii) Should a QEF election made with respect to options continue to apply once the option has been converted into shares? and (iii) Should a QEF election on options apply to any options subsequently acquired?

We believe a QEF election made on options should apply to the shares received upon conversion and should apply to any subsequently-acquired options for shares of the same foreign corporation. We do not believe, however, that a QEF election on shares should carry over to options on shares of the same corporation. Because of the double-counting and the possibility that the options may never be exercised, shareholders should have the choice as to whether or not to make the option election.[133] This would also be consistent with the principle of Proposed Treasury Regulations § 1.1295-2(d), which permits a holder of preferred shares to make a special preferred QEF election for the shares on a share-by-share basis.

It also is necessary to address the case of an optionholder who makes a QEF option election at a time when he or she already holds shares of the same foreign corporation for which no ordinary QEF election was made. We believe that a QEF election for options should, in the year the option is exercised, automatically cause a QEF election to be made for shares already held by the optionholder, but not vice versa.

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132 Treas. Regs. § 1.1295-1(b)(2)(i).

133 Alternatively, the share election should apply to options only if the options are in-the-money when acquired.

B. Compensatory Stock Options Should Not be Treated as PFIC Stock

It is not whether under the proposed Regulations treating options on PFIC stock *as* PFIC stock would apply to compensatory stock options. We think they should not.

The use of options as a compensation device is widespread and serves legitimate business purposes that have nothing to do with the mischief the PFIC rules were designed to eliminate. For example, compensatory stock options enable corporate employers to reinvest more cash in the business, retain key personnel, incentivize the workforce, tie employee compensation to the creation of shareholder value and contribute to third party's confidence in management. Options are intended and expected to have a net compensatory effect. Because compensatory stock options are, by definition, granted only to actual officers and employees and usually with restrictive conditions on exercise and vesting, they simply do not lend themselves to use as a tax saving device with which to abuse the PFIC rules. This is especially true in the case of so-called "non-qualified stock options" (*i.e.*, options subject to Section 83) since, upon exercise, generally the entire spread is taxed as ordinary compensation income. There is no policy need for adding an interest charge to this income solely because the individual was employed by a corporation that was classified as a PFIC. Similarly, because the employee has recognized the entire gain as ordinary income at that time, there is no policy justification to tack the option holding period onto the stock ownership period for purposes of applying the PFIC rules to the shares received upon exercise. As a policy matter, the United States should not make compensating U.S. employees with stock more difficult for foreign corporations than it is for U.S. corporations.

In other regulations that deem options to be stock, employee stock options are often excluded. Congress in the PFIC provisions provided Treasury the authority to draft regulations treating options as stock;[134] where Treasury has received this authority

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[134] Section 1298(a)(4) (to "the extent provided in regulations" ownership of an option is to be treated as ownership of stock).

elsewhere, it has declined to extend such treatment to compensatory stock options. For instance, for purposes of determining when a Section 382 ownership change has occurred, regulations treat certain option holders as constructively holding the underlying stock but exclude holders of compensatory stock options.[135] Similarly, in the S corporation rules, in-the-money call options are classified as a second class of stock, but an exception is made for compensatory stock options.[136] While there is no carve-out for employee stock options under the constructive ownership rules of Section 318, Congress in that provision drafted a clear blanket rule intending to cover all types of options, without any call for regulations that might modify the general rule, as is the case in Section 1298(a)(4).

We recognize that there are significant counter arguments: first, a compensatory stock option presents the same opportunities for tax deferral as a non-compensatory option, and therefore ought to be caught within the PFIC rules; and second, if the corporation is properly characterized as a PFIC, a "compensatory" option is more likely to represent a passive investment in a passive vehicle than the typical compensatory option issued to an active employee in an active corporation.

Our response to the first argument is that this is true of all compensatory options, yet Congress has, when faced with this issue, concluded that compensatory options should generally be governed by special rules dictating the timing and character of gains for employee/holders and deductions for employer/issuers. It does not make sense to deviate from these rules to address an unrelated means of deferral being pursued by passive investors. However, we leave it to Treasury to decide as to whether the goal of combating deferral through foreign investment should be pursued in every possible instance, including where the tax deferral in question may to an extent be justified by non-tax policy reasons

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135 See Section 382(1)(3)(A)(iv) ("except to the extent provided in regulations", options to be treated as exercised) and Treas. Regs. §§ 1.382-4(d)(2) and (d)(7)(iii).

136 Treas. Regs. § 1.1361-1(1)(4)(iii)(A) and (1)(4)(iii)(B)(2).

Our response to the second argument is that if an option is compensatory it is, by definition, granted in exchange for services and services should not be differentiated because they relate to a business that produces so-called "passive income" rather than one that produces a tangible product.

C. The Consequences of Making a "Regular" QEF Election for Preferred Stock Should be Clarified

We also request that regulations clarify the consequences of making a "regular" QEF election for preferred shares that are convertible into common shares. By "regular" QEF election, we mean an election other than a "special preferred QEF election" under Proposed Treasury Regulations § 1.1295-2. Assuming the special preferred QEF election is not available, it would seem that the shareholder should compute the preferred share inclusions on an as-converted basis (but perhaps net of any actual distributions on the common, as proposed above with respect to QEF options inclusions). The preferred QEF inclusion would be in addition to any income required to be recognized with respect to stated dividends and any other amounts on the preferred stock itself.[137] In the event of a conversion into common shares, the pedigreed or unpedigreed QEF status of the preferred shares would carry over to the common shares (consistent with Treasury Regulations § 1.1291-1(h)(7)). We believe that this should be clarified, however.[138]

D. Clarification of Treatment of Partnerships for Purposes of the Income Test

We also believe that the treatment of interests in partnerships for purposes of the PFIC Income and Asset Tests should be clarified.

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137 Under the QEF regime, all or a portion of these amounts would technically be includible as a pro rata share of ordinary earnings and net capital gain under Section 1293(a), with the corresponding actual dividend distribution excludible under Section 1293(c).

138 We request clarification in particular because the interaction of Treasury Regulations § 1.1291-1(h)(7) and Treasury Regulations § 1.1295-1(b)(2)(ii) *Example* is somewhat unclear.

First, how is a corporate partner's distributive share of partnership income characterized in applying the Income Test? Without any rule to the contrary, arguably the character of the income is passed through automatically under Section 702(b).[139] We believe, however, that partnership look-through treatment should be available only to corporate partners that satisfy a specified ownership threshold. If a foreign corporation has a relatively small percentage interest in a partnership, it does not seem appropriate to characterize the partnership's income as active to the corporation. We considered two percentage levels for such a partnership look-through rule, either of which we believe would be suitable in the PFIC context.

First, a PFIC look-through rule for partnerships could adopt the 10 percent threshold used in the Section 904 foreign tax credit basketing Regulations. Under these Regulations, generally, all partnership name is passive, unless the partner owns 10 percent or more of the partnership's capital and profits interests, in which case look-through treatment applies. This seems to us to be an appropriate analogy and a reasonable way to distinguish between a passive investment and a business asset that may generate active income.[140]

Alternatively, to provide a greater degree of consistency in the treatment of corporate and partnership subsidiaries, a 25 percent partnership ownership threshold might be employed.

Although there was not a complete consensus on this point, a majority of our members favored 10 percent. These members felt that it was not necessary to use the same ownership threshold for income attribution from corporate and partnership subsidiaries since partnership income is taken into account in computing gross income

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139 With respect to assets, such treatment not only parallels the general treatment of partnerships under the Code, but also reflects the preference for an aggregate approach in the PFIC rules and allows foreign corporations to conduct active operations through both corporate and partnership ventures.

140 Treas. Regs. §§ 1.904-5(h)(2)(i) and (h)(4).

regardless of the partner's ownership interest and since, without a specific rule to the contrary, Section 702 would appear to support look through in *all* cases.

With respect to the Asset Test, there is currently no guidance, other than perhaps the rule that an asset is characterized by reference to the character of income it generates. Whether this rule applies to a partnership interest is not clear. If it were clear that that rule does apply, no additional rules would be necessary -- essentially, asset look through would be available only where income look through is available. Alternatively, a specific rule could be utilized that would conform the treatment of subsidiary corporations and partnerships for the Asset Test by providing partnership look through only where the corporate partner had a 25 percent or greater interest in the partnership. While this would be a deviation from the general rule that asset-character-is-dictated-by-income-character, we think it is an appropriate threshold to use since it matches the 25 percent corporate subsidiary rule.

E. Modification of Requirements for Making a Retroactive QEF Election

We propose that the rules governing when a shareholder may make a retroactive QEF election (set forth in Treasury Regulations § 1.1295-3), be revised to simplify the filing of a "Protective Statement" and to increase the stock ownership percentage limitation for qualifying as a "qualified shareholder" (and thus being excepted from having to file a Protective Statement), both as discussed below.

Under the current rules, if for any reason, a holder of PFIC shares fails to file a valid and timely QEF election for a taxable year, the shareholder may make the QEF election *retroactively* only if the shareholder satisfies one of the following tests:

1. (a) the shareholder had a "reasonable belief", as of the due date for the filing of the QEF election, that the foreign corporation was not a PFIC for the year in question (after taking into account the relevant

facts and circumstances and making "a good faith effort to apply the Code, regulations, and related administrative guidance")[141] and

(b) the shareholder filed, with the shareholder's U.S. federal income tax return for that taxable year, a "Protective Statement" that included a "reasonable belief" statement describing the basis for the shareholder's reasonable belief that the corporation was not a PFIC (including a discussion of the application of the Income and Asset Tests and the factors that affect the results of those tests);[142]

2. the shareholder was a "qualified shareholder" for that taxable year, meaning that:

(a) the shareholder did not file a Protective Statement applicable to any earlier taxable year,

(b) at all times during the taxable year in question, the shareholder owned less than 2 percent of the vote and value of each class of stock of the corporation, and

(c) the corporation or its U.S. counsel "indicated in a public filing, disclosure statement or other notice provided to U.S. persons" that the corporation

(i) reasonably believes that it is not or should not constitute a PFIC for that year or

(ii) is unable to make that conclusion, but reasonably believes that, more likely than not, it "ultimately will not be a PFIC" for that year; or[143]

3. (a) the shareholder reasonably relied on a qualified tax professional

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141 Treas. Regs. § 1.1295-3(d) and (e).

142 Treas. Regs. §§ 1.1295-3(c)(1), (2) and (4).

143 Treas. Regs. § 1.1295-3(e)(2).

(who the shareholder reasonably believed had access to all the relevant facts and circumstances) who failed to identify the corporation as a PFIC or inform the shareholder about the QEF election and

(b) the shareholder satisfies various other factual and procedural requirements (some of which are quite onerous and may be impossible to satisfy) and requests an individual private letter ruling from the Commissioner for special consent to make a retroactive QEF election.

We believe these tests are unduly burdensome and complex. Specifically, in order to make a retroactive QEF election, the shareholder must have (1) foreseen the issue prior to filing his or her tax return for the year, undertaken a detailed legal and factual analysis of the application of the PFIC rules, and made a protective filing in lieu of the actual QEF election, (2) failed to foresee the issue after consulting a qualified professional who had access to all the relevant facts and circumstances, or (3) have had a less than 2 percent interest and reasonably relied on the corporation's determination that it was not a PFIC.

Thus, there is essentially no relief for a shareholder who fails to undertake a full-blown analysis and make a Protective Statement filing prior to the due date for the return *unless* the shareholder (a) owns less than 2 percent of the shares and relies upon a statement from the corporation or (b) consulted a qualified tax professional who had all the facts necessary to identify the issue but failed to do so (and otherwise is able to qualify for a private ruling granting special relief).

In other words, there is essentially no relief where the U.S. shareholder and the foreign corporation completely "missed" the issue, even though this is quite possible when an active foreign company is technically classified as a PFIC. And, even if the foreign corporation or the shareholder does identify the issue, if the shareholder owns 2 percent or more of the shares, the shareholder must engage its own sophisticated tax advisor to make this analysis and prepare the Protective Statement filing. Where the

shareholder may qualify for a ruling, the process is both expensive and time-consuming for the taxpayer and the Service.

Accordingly, we recommend that Treasury Regulations § 1.1295-3 be modified to provide (i) that a shareholder who files a Protective Statement may do so in reliance on statements furnished by the corporation and without setting forth a detailed legal analysis and (ii) that a shareholder who owns 5 percent or less may qualify as a "qualified shareholder."

1. Modify Requirements for Protective Statement

Specifically, we propose that Treasury Regulations § 1.1295-3(c)(1) and (2) be amended to provide that a shareholder is not required to discuss the Income or Asset Tests or apply the Code, Regulations and administrative guidance in its "reasonable basis" statement included in the Protective Statement. Instead, a shareholder should be able to rely on the corporation's statements and materials showing it has no net earnings (as discussed in Section III.B.); or where the modified Cash Rule is relevant (as discussed in Section III.A.), the prospectus, offering memorandum and any other materials showing that the corporation's liquid assets are held for the reasonable needs of the business.

2. Increase Ownership Percentage Limitations Under Qualified Shareholder Rules

In addition, we propose that Treasury Regulations § 1.1295-3(e)(1) and (2) be modified to increase the maximum percentage of shares a "qualified shareholder" may hold 5 percent of the vote and value of each class of stock of the corporation. In addition, we believe a qualified shareholder should be permitted to rely on the same statements and materials provided by the corporation as would be allowed for purposes of setting forth a shareholder's "reasonable basis" (*e.g.*, that the corporation has no net earnings) in lieu of an explicit statement from the corporation or its U.S. counsel that the corporation reasonably believes it will not be a PFIC. We believe these changes would be appropriate because a shareholder holding 5 percent or less of the corporation should not have to go through the trouble of prepaying and filing a Protective Statement but should instead be permitted to reasonably rely on the corporation's earnings statement in

determining that the corporation is not a PFIC or that the deemed QEF election applies. If the corporation's statements are later determined to be unreliable, the shareholder should not be punished by not being permitted to make a retroactive QEF election.

3. Summary

Allowing a shareholder to rely on statements and materials provided by the corporation in the shareholder's "reasonable belief" statement for purposes of the Protective Statement and for purposes of complying with the requirements of a "qualified shareholder" will allow a shareholder to be less dependent on the corporation in making a retroactive QEF election and, in addition, will round out the deemed QEF and Cash Rule proposals by explicitly providing a mechanism by which shareholders may retroactively apply the QEF rules if a corporation is classified as a PFIC in spite of these modified rules.

F. Allow Protective QEF for PFIC Debtholders

A problem similar to that faced by option holders (discussed in subsection A. above), namely the unavailability of a QEF election for the first year the corporation is classified as a PFIC, exists for U.S. persons who hold debt of a PFIC which debt is later characterized as equity for whatever reason. In this case, the debtholder, now a shareholder, will be subject to the excess distribution regime without having had the opportunity to make a QEF election.

We therefore propose that regulations be issued providing either that debtholders may make "protective" QEF elections for the first year in the debtholder's holding period in which the corporation is classified as a PFIC, or alternatively, that in any case in which debt of a PFIC is recharacterized as equity such holder may at that time make a QEF election retroactive to the first year in such investor's holding period in which the corporation was classified as a PFIC. We think such rules would be appropriate given the complexity of the debt/equity question, particularly when certain unusual foreign securities are involved. We do not think this rule would be subject to abuse, and, as suggested in the next Section, a general anti-abuse rule could be used in such cases.

Section VII. General Anti-Abuse Rule

While the majority of this Report focuses on active companies that have been inappropriately classed as PFICs and various proposals to ameliorate this problem, we believe there are also passive investment vehicles that are attempting to manipulate the existing rules and regulations to inappropriately avoid PFIC classification. And we recognize, of course, that some of our proposals may open up additional avenues for manipulation. Simple examples might include a company that creates a business plan using inflated estimates of the amount of cash it will need to execute the plan. Or a company might attempt to qualify its shareholders to use the deemed QEF election by manipulating its income and deductions through derivatives transactions or transactions with related parties.

We believe that the best way to combat the current and any future abuse is to provide a broad, general anti-abuse rule, perhaps along the lines of what has been used in Treasury Regulations § 1.701-2 in the case of partnerships. Treasury Regulations § 1.701-2 begins with a broad statement of the intent of subchapter K, namely, to allow taxpayers to conduct a joint business without incurring an entity-level tax. The Regulation then explains that the provisions of subchapter K must be applied consistently with such intent. The Commissioner is given broad authority to recast a transaction to effectuate such intent.[144] Additionally, specific examples are given that illustrate the principles of the anti-abuse regulations.[145]

In particular, the Secretary should have broad authority under the PFIC anti-abuse rules to disallow use of the deemed QEF election or modified Cash Rule, in whole or in part, if those provisions are being used to achieve a result that is inconsistent with the intent of the PFIC rules. In addition, the anti-abuse rule might specify certain facts which would evidence an intention to avoid the intent of the PFIC rules, such as marketing that

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144 *See* Treas. Regs. § 1.701-2 (a) and (b).

145 *See* Treas. Regs. §1.701-2(d).

indicates that the foreign corporation is not likely to be treated as a PFIC while also indicating that the shares will provide a return which is likely to be or is intended to be based upon the performance of investment or other non-active trade or business assets.

Section VIII. Proposed Statutory Amendment: Amend Section 1291 to Replace Ratable Accrual with Accrual Based Upon a Constant Yield to Maturity.

We believe that the use of ratable accrual in Section 1291's excess distribution rules is a serious flaw in the statute that should be revised by Congress as soon as possible.[146] As discussed in Section II.B. above, when a shareholder receives an "excess distribution" (which includes certain distributions and *all* gains on disposition), the tax and interest charge is computed by allocating the excess distribution ratably to each year in the shareholder's holding period.[147] Accordingly, the excess distribution is treated as if it were earned in equal portions in each of the years the shareholder held the PFIC stock.

The problem with the use of ratable accrual is that it makes the PFIC regime punitive, rather than a proxy for current taxation of the PFIC's earnings, and we believe this was not Congress' intent. For example, both the 1986 Conference Committee Report and the 1986 Blue Book explain that the new Section 1291 requires a shareholder to pay "tax plus an interest charge based on the value of tax deferral" upon a disposition or receipt of an excess distribution.[148] Thus, the intent was to discourage such deferral by imposing an equivalent charge, not by adding on a penalty:

> The conferees believe that eliminating the economic benefit of deferral is necessary to eliminate the tax advantages that U.S.

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146 We do not mean to suggest, however, that in our view this is the only flaw in the statutory regime. We focus on this because we believe the consequences of this rule were not intended and a revision would be neither complicated nor controversial.

147 Sections 1291(a)(1)(4) and (c).

148 H.R. Conf. Rep. No. 99-841, at II-641; 1986 Bluebook at 1027.

> shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds.[149]

This intent is further demonstrated by a modification made by the Conference Committee to the Senate's version of Section 1291. As described in the Conference Committee Report,

> The excess distribution provision liberalizes the Senate amendment provision which treated all distributions as representing prior and current year earnings. This provision gives relief to investment funds which currently distribute all their ordinary earnings, for which there is no U.S. tax deferral.[150]

In the great majority of cases, ratable accrual will *inflate* the value of the deferral. Ratable accrual is based on the assumption that the PFIC's earnings were actually earned in equal annual increments. It is far more likely, however, that the amount of earnings increased each year as the retained earnings were reinvested. Therefore, under the current regime, excess income is allocated to the early part of the holding period, resulting in an accrual of interest on an unrealistically high amount of gain for a longer period. The distortion is magnified by the fact that additional interest accrues on the "unpaid" interest. The resulting tax bill may not only exceed the value of the deferral, it also may well exceed the shareholder's actual gain.

For example, assume that an individual shareholder buys PFIC stock for $1.00 and sells it 20 years later for $1,001.00, and that in all relevant years the maximum individual income tax rate was 39.6% and the interest rate on underpayments was

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149 H.R. Conf. Rep. No. 99-841, at II-641.

150 *Id.*, at II-642. *See also* 1986 Bluebook ("Because the Act's provisions approximate the economic equivalent of current taxation, Congress did not believe that a passive foreign investment company should be subject to two penalty provisions contained in the Code: the accumulated earnings tax provision and the personal holding company tax provision.").

9.00%.[151] If the gain is allocated ratably to each of the 20 years ($50.00 per year), upon disposition the total tax plus interest would be $1,061.50 — an amount that exceeds not only the gain, but also the gross proceeds. This is a punitive result that does not economically approximate current taxation.

Therefore, we recommend that ratable accrual be replaced by accrual based upon a constant yield-to-maturity, as is used in the case of debt instruments with original issue discount under Section 1272 and the Treasury Regulations thereunder.

Applied to the facts in the example above, this method would, instead of allocating an identical amount to each complete year, for example, allocate $0.41 of excess distribution to year 1 and $292.38 to year 20. The resulting tax under Section 1291 would be $396.00 in tax and $114.50 in interest.

This is far more likely to accurately reflect the issuer's accrual earnings history and thus the actual "value of tax deferral."

Section IX. Summary of Recommendations With Respect to Partnerships

We have made a number of recommendations with respect to the treatment of partnerships in this Report and we thought it would be helpful to summarize those all in one place. Those recommendations are the following:

1. It should be clarified that when a foreign corporation sells an interest in a partnership in which the foreign corporation owns a 25 percent interest, the gain will be characterized as if the foreign corporation had held and sold directly its proportionate share of the assets of the partnership (*see* Section V);

2. In determining whether commodities gains, rents and royalties are active or passive income, look-through rules should be applied so as to take into account the

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[151] The interest rate charged on the "deferred tax" is equal to the underpayment rate under Section 6621, which generally is the Federal short-term rate (reset quarterly) plus 3 percentage points, compounded daily. Sections 1291(c)(3), 6621 and 6622.

relevant employee activities of a partnership whose income is attributed to the foreign corporation (under the proposed 10 percent look-through rule) (*see* Section V); and

3. It should be clarified that in applying the Income Test a foreign corporation's proportionate share of a partnership's income will be treated as if derived by the corporation directly, if the corporation has at least a 10 percent interest in the partnership (*see* Section VI).

4. It should be clarified that in applying the Asset Test, a foreign corporation's interest in a partnership should be characterized on a look-through basis if the corporation holds at least a 25 percent interest in the partnership (*see* Section VI).

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