NEW YORK STATE BAR ASSOCIATION

REPORT COMMENTING ON SELECT ISSUES WITH RESPECT TO THE PASSIVE FOREIGN INVESTMENT COMPANY RULES

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REPORT COMMENTING ON SELECT ISSUES WITH RESPECT TO THE PASSIVE FOREIGN INVESTMENT COMPANY RULES

1. Introduction

We have prepared this report[1] on certain Passive Foreign Investment Company ("PFIC") issues in response to an informal request for comments from the Internal Revenue Service (the "Service"). We understand that you are considering finalizing Proposed Treasury Regulations § 1.1296-4[2] (the "Banking Regulations") and withdrawing Notice 89-81[3] (the "Banking Notice"), both of which deal with the characterization of the income of foreign banks for purposes of the exception to passive income for income derived in the active conduct of a banking business. We also understand that you are giving consideration to some other changes or clarifications to the PFIC regime.

We have previously commented on various aspects of the PFIC regime in particular in our report titled *Proposals for PFIC Guidance* [4] dated May 22, 2001 (the "2001

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1 The principal drafter of this report was Edward Gonzalez. Significant contributions were made by Kimberly Blanchard, Douglas Borisky, John Narducci, Erika Nijenhuis, Olivier Nolens, Michael Schler, and Hermann Schneeweiss. Helpful comments were received from Dale Collinson, Peter Connors, Abraham Leitner, Vadim Mahmoudov, David Miller, Stephen Mills, Andrew Needham, Chris Ocasal, David Sicular, Eric Sloan, and Kirk Wallace.

2 Unless otherwise indicated, all section and regulation references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

3 1989-2 C.B. 399, *modifying* Notice 88-22, 1988-1 C.B. 489.

4 N.Y. State Bar Ass'n, *Proposals for PFIC Guidance* (2001), *reprinted in* 91 Tax Notes 2211 (2001) [hereinafter *2001 Report*]. Unless otherwise indicated, all page references with respect to the 2001 Report refer to the reprinted version.

Report"). Rather than focusing on the technicalities of the existing PFIC regime, which were partly covered in the 2001 Report, this report focuses on the PFIC regime as applied to banking and financial institutions and on the changes that should be made to the Banking Regulations before they are finalized. We also address other issues that arise under the existing PFIC regime that we believe should also be addressed if you are making the effort to improve the operation of the PFIC regime. We have selected these issues because we believe that resolving these issues will provide guidance in situations that arise with greater regularity. We have tried to indicate the priority that should be given to the suggested changes by the order in which we discuss these issues. Although we recognize that the Service has issued some helpful private letter rulings with respect to some of the issues discussed in this report, we think that guidance should be available more generally.

The PFIC regime has been in place since 1986. Although we recognize that the PFIC regime serves a function in preventing United States taxpayers from deferring the recognition of ordinary income from passive assets and converting such income into capital gain, the regime captures many types of foreign corporations that are not passive investment companies.[5] The PFIC regime, moreover, is complex to administer and to comply with because

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[5] *See* Staff of J. Comm. on Taxation, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, at 1023 (Comm. Print 1987). The Joint Committee on Taxation described the purpose of the PFIC rules as follows:

> Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. Since current taxation generally is required for passive investments in the United States, 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. . . . Moreover, Congress recognized that U.S. persons who invested in passive assets through a foreign corporation obtained a substantial tax advantage vis-a-vis U.S. investors in domestic investment companies because they not only were able to avoid current taxation but also were able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income.

Id.

it is difficult to determine whether a particular foreign corporation is a PFIC. Furthermore, once it is determined that a foreign corporation may be a PFIC, it is difficult for many United States shareholders of such corporations to mitigate the draconian "excess inclusion" rules by making a Qualified Electing Fund ("QEF") election or a mark-to-market election under section 1296.

Accordingly, we believe that within the constraints of the applicable statutory provisions, the goal should be to narrow the entities that are unnecessarily treated as PFICs and to maximize the ability of holders to make QEF or mark-to-market elections. We believe that our recommendations, if implemented, will help to achieve that goal.

2. Summary of Recommendations

The suggested changes to the PFIC regime addressed in this report, which, we believe, should and can be implemented in the finalized Banking Regulations (the "Finalized Regulations") or by the issuance of Treasury regulations, are summarized below:

Banking and Finance:

- With respect to the deposit taking requirement, the Finalized Regulations should add a "safe harbor" to the existing substantiality test. Under the safe harbor, a foreign bank should satisfy the deposit taking requirement if the average of deposits determined as of the end of each quarter during the taxable year were equal to a least 30 percent of its total liabilities. The Treasury should also confirm that interbank deposits from other banks are treated as deposits for this purpose. In addition, for purposes of the substantiality test, the Finalized Regulations should remove as a fact or circumstance to be considered the comparison to the funding sources of other banks in the same jurisdiction. Finally, the Finalized Regulations should reconsider the requirement that only the deposits by residents

of the country or countries in which the foreign bank or its branches is licensed or authorized to engage in a banking business are considered for purposes of satisfying the deposit taking requirement.

- For purposes of satisfying the lending requirement, the Finalized Regulations should specify that interbank deposits with both related and unrelated parties are to be treated as loans. Also, the Finalized Regulations should permit debt instruments and other securities held by a foreign bank, as a result of its direct or indirect broker-dealer activities, to be treated as part of a lending business, at least for a certain period of time (*e.g.*, one year).
- Under the Banking Regulations, certain restricted reserves are viewed as a banking activity. The Finalized Regulations should eliminate this concept and allow a banking entity to maintain liquid assets in order to meet its liquidity needs.
- The Finalized Regulations should confirm the non-exhaustive character of the list of the banking activities that generate good banking income. The list of banking activities should be updated with activities such as investment banking activities as well as securities dealing.
- A majority of our Executive Committee believes that, if section 954(h) is not considered generally applicable for purposes of section 1297(b), then nevertheless, for periods while section 954(h) remains in effect, the license requirement should be relaxed by treating bank-like activities or services performed by foreign corporations that are not licensed or authorized to accept deposits as activities that give rise to active income under the Finalized Regulations, provided that the corporation satisfies requirements analogous to those under section 954(h). A

substantial minority would not relax the rules for such corporations even under such circumstances.

- The Finalized Regulations should clarify whether for purposes of section 1297(b), section 954(c) should be treated as incorporating all the exceptions to passive income that are not within section 954(c) itself.

Working Capital as Passive Asset:

- The Treasury regulations under the PFIC regime should treat working capital if held for use in an active trade or business as a nonpassive asset so long as the amount is reasonable. Such reasonableness could be tested under the "reasonable needs of the business" standard of the accumulated earnings tax. Less preferable, but possible alternatives to the reasonable needs test would be to cap the amount of assets that could be treated as held for the reasonable needs of the business to some percentage of aggregate assets, or to provide a further exception, similar to the start-up year exception, for foreign corporations engaged in an extensive capital expansion program.

Mark-to-Market Election:

- It should be made clear that if a mark-to-market election is made with respect to the stock of a top-tier PFIC in a tiered PFIC structure, the mark-to-market election covers all assets of the top-tier PFIC; no QEF election needs to be made with respect to any lower-tier PFIC, nor would the excess inclusion regime apply to such entities.
- The Treasury regulations should eliminate the uncertainty related to the concept of "qualified exchange or other market" by providing guidance with respect to

which foreign exchanges will be treated as "qualified exchange or other market" for purposes of the mark-to-market election. A potential starting point could be those foreign stock exchanges that are recognized under United States income tax treaties for purposes of applying the limitation of benefits provision.

The 25 Percent Look-Through Rule:

- In application of the look-through rule under section 1297(c) (the "25 percent look-through rule"), the character of income and assets should be tested at the level of the subsidiary. Exceptions to this general rule should be available to avoid inappropriate classifications resulting from the separation of business assets from a group's operations.
- For purposes of the Income Test and the Asset Test, transactions (i) between a parent and its 25 percent-owned subsidiaries and (ii) among such subsidiaries should be disregarded to the extent of the parent's direct or indirect ownership in the subsidiaries.
- When a corporation sells or disposes of an interest in a 25 percent-owned subsidiary, any gain that is recognized should be characterized as if the corporation had sold a proportionate share of the subsidiary's assets.

Tiered PFIC Structures:

- With respect to tiered PFIC structures, tax basis adjustments for corresponding QEF inclusions should be made available at the intermediate levels of such structures.
- Rules should be adopted to prevent inappropriate recognition of gain in tiered PFIC structures.

Own Employees Tests:

- In determining if any foreign corporation is a PFIC, the "own employees" tests provided for under Treasury regulations under section 954 should be applied by attributing to the foreign corporation the relevant employee activities (and employee compensation expenses) of any person whose income is attributed to the foreign corporation under the 25 percent look-through rule provided that such employees are actually performing functions for the related corporation.

Reorganizations:

- Proposed Treasury Regulations § 1.1291-6 should be finalized with the following additions: (i) an exception to gain recognition for the liquidation of a section 1291 fund into another section 1291 fund holding at least 80 percent of the liquidating corporation's stock; (ii) an exception to gain recognition for transfers of stock of section 1291 funds to partnerships under section 721 in cases where section 704(c) applies and a gain recognition election is made; and (iii) a clarification that "nonrecognition" transfers do not include securities lending transactions under section 1058.
- Guidance on the applicability and effect of section 1291(e) should be provided.

QEF Election:

- Before finalizing Proposed Treasury Regulations §§ 1.1293-2 and 1.1295-2, some of the requirements to make a "preferred" QEF election should be relaxed in order to make this election more widely available.
- A United States person owning less than a certain percentage of a PFIC’s stock (e.g., five percent) should be allowed to use Financial Statements of a foreign

corporation as the basis for making the determination of whether such corporation is a PFIC.

- A United States person that has made a QEF election should be allowed to compute its pro rata share of the income of a PFIC based on the Financial Statements of such PFIC.
- A person holding an option to acquire stock in a PFIC should be permitted to make a QEF election. Holders of options with respect to marketable stock should be permitted to make a mark-to-market election. Alternatively, an option holder should not be subject to the interest charge under section 1291 and/or should be allowed to make a purging election upon exercise of the option provided such options meet certain requirements.
- The term "option to acquire stock" should be defined for purposes of section 1298(a)(4) and should not include compensatory stock options.

3. Overview of the PFIC Regime

Under section 1297(a), a foreign corporation is a PFIC if either: (i) 75 percent or more of the gross income of such corporation for the taxable year is passive income (the "Income Test"); or (ii) 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 (the "Asset Test"). Under section 1297(b)(1), passive income means any income that would be characterized as foreign personal holding company income ("FPHCI") under section 954(c).

Unless the United States shareholder makes a QEF or mark-to-market election, such shareholder will be subject to the "excess inclusion" regime. Under section 1291(a)(1)(A),

any excess distributions received from the PFIC are allocated ratably over each day in the taxpayer's holding period for the stock.[6] The taxpayer includes in gross income the amount so allocated for the current year and for any taxable year beginning after December 31, 1986 for which the corporation was a PFIC. The tax for the current year is increased by the "deferred tax amount." Section 1291(c) defines "deferred tax amount" to include "aggregate increases in taxes," meaning the amount allocated under section 1291(a)(1)(A) multiplied by the highest rate of tax in effect for the tax year(s) to which the allocation is made. The deferred amount also includes interest charges on the deferred taxes for the period, beginning on the due date in the tax year for which the aggregate increase amount is measured, up until the due date of the return for the year in which the excess distribution is made. Similar treatment applies to dispositions of PFIC stock by United States persons.

To escape the excess inclusion regime, a taxpayer may make an election under section 1295 to have the PFIC treated as a QEF. The taxpayer can make this election with respect to any PFIC in which he or she owns stock for any taxable year, provided that the PFIC complies with requirements to furnish information specified by the Service with respect to determining the PFIC's ordinary earnings and net capital gain under United States federal income tax principles.[7] Under section 1293, every United States person who owns stock of a QEF at any time during the taxable year of such fund shall include in gross income: (i) as ordinary income, his or her pro rata share of the ordinary earnings of the QEF for that tax year; and (ii) as long-term capital gain, his or her pro rata share of the net capital gain of the QEF for that tax year.

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[6] "Excess distribution" is defined in section 1291(b) as the excess of the distributions received from the corporation during the taxable year over 125 percent of the average of the distributions received by the shareholder over the three preceding years (or, if shorter, the portion of the shareholder's holding period before the current year).

[7] *See* section 1295(a)(2).

There are certain exceptions designed to prevent double inclusion and to clarify this section's interaction with the controlled foreign corporation ("CFC") rules of Subpart F.[8]

A United States person owning stock in a PFIC that is "marketable stock" may also elect into the mark-to-market regime under section 1296. Under section 1296(e), "marketable stock" generally means: (i) any stock regularly traded on a national securities exchange registered with the Securities and Exchange Commission (the "SEC") or approved by the Secretary; or (ii) stock of a foreign corporation that is comparable to a regulated investment company which issues stock that is redeemable at net asset value. Under section 1296(a) a taxpayer who makes the mark-to-market election has certain annual inclusions in his or her income. The taxpayer includes the excess of the fair market value ("FMV") of such stock at the close of the taxable year over its adjusted tax basis in gross income. If the adjusted tax basis of such stock exceeds the FMV at the close of such tax year, the taxpayer may deduct the lesser of that excess or certain "unreversed inclusions" with respect to such stock.[9]

4. Banking and Finance

For purposes of the Income Test, section 1297(b)(2)(A) excludes from passive income any income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or any other corporation, to the extent provided in Treasury regulations). Since 1989, the Banking Notice has provided guidelines concerning the characterization of income derived in the banking business by a foreign bank that is not licensed as a bank in the United States. These guidelines were to be incorporated into future Treasury

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[8] *See* section 1293.

[9] In general under section 1296(d), "unreversed inclusions" are the excess of amounts included in gross income under section 1296(a)(1) with respect to such stock for prior taxable years over the amount allowed as a deduction under section 1296(a)(2).

regulations. In 1995, the Treasury issued the Banking Regulations, which are intended to provide guidance regarding the passive income exception applicable to foreign corporations conducting active banking activities.[10]

The existence of both the Banking Notice and the Banking Regulations makes it difficult to make determinations because when the two are in conflict it is not clear what United States taxpayers must regard as authoritative. Thus, withdrawing the Banking Notice and finalizing the Banking Regulations would help to provide greater certainty in this area. As part of finalizing the Banking Regulations, however, we believe that the Service should revise these regulations in five specific areas: (i) the deposit taking requirement; (ii) the lending requirement; (iii) the concept of restricted reserves; (iv) updating the list of banking activities; and (v) the license requirement.

A. The Deposit Taking Requirement

In order for a foreign corporation to be treated as an active bank, both the Banking Notice and the Banking Regulations require that such corporation accept deposits from its customers in the ordinary course of its business. In addition, this corporation must have, among other things, a certain amount of deposits accounted for as a liability on its balance sheet. Under the Banking Notice, a foreign bank meets the deposit taking requirement if the average of deposits accepted equals at least 50 percent of its total liabilities. In addition, the foreign bank must have at least 1,000 qualified depositors.[11] While the Banking Notice applies an objective

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[10] *See* Prop. Treas. Regs. § 1.1296-4. We note that no guidance has been issued regarding insurance companies and we think that this is also an area where guidance is needed. We would be happy to address the insurance issues if the Service and Treasury are planning to issue guidance in this area.

[11] Under the Banking Notice, a "qualified depositor" is defined as "a citizen or resident of the country in which the foreign corporation is licensed to accept the deposit who is unrelated to the foreign corporation." Notice 89-81, 1989-2 C.B. 399.

test in order for a foreign bank to qualify as an active bank under the deposit taking requirement, the Banking Regulations apply a subjective test. The Service and the Treasury recognized that "subjective tests will better accommodate the various types of banks that have developed as a result of different banking systems and regulatory frameworks."[12] Under the Banking Regulations, a foreign corporation will satisfy the active banking test if it regularly accepts, in the ordinary course of its trade or business, deposits from its customers who are residents of the country in which the foreign bank is licensed or authorized, and the amount of deposits shown on the foreign bank's balance sheet is "substantial."[13]

We believe that the deposit taking requirement under both the Banking Notice and the Banking Regulations presents two particular problems. The first problem relates to the amount of deposits that the foreign bank must have as a liability on its balance sheet. The second problem relates to the requirement that only deposits of residents of the country in which the foreign corporation is licensed or authorized to do business meet the deposit taking requirement.

(i) The Amount of Deposits on the Balance Sheet

Even if an entity is conducting significant traditional banking activities (*e.g.*, accepting customers' deposits and providing commercial, real estate and consumer loans), it is undeniable that there have been significant evolutions in the nature of banking transactions and in how banks raise funding. Banks that are not retail oriented may not rely on deposits to the same extent as other banks do to provide cash to carry out traditional banking businesses.

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[12] *See* 60 Fed. Reg. 20,922, 20,923 (Apr. 28, 1995) (preamble to the Banking Regulations).

[13] *See* Prop. Treas. Regs. § 1.1296-4(d)(1). The substantiality of deposits depends on all the facts and circumstances. *Id.* § 1.1296-4(d)(3).

Banking activities are financed in many diverse ways and not just through deposits. Some banks may, therefore, have a problem satisfying the 50 percent requirement of the Banking Notice. With the introduction of the "substantiality" test in the Banking Regulations, the Service and the Treasury addressed this concern and the adoption of a more subjective standard is helpful. As the Service and the Treasury recognized, such a standard is more flexible and allows for changes in the way banks conduct their business. Nevertheless, the criteria used by the Banking Regulations can be clarified in several respects.

As an initial matter, the Banking Regulations appear to require an unspecified quantum of deposits. The requirement for deposits appears to be related to the objective of distinguishing banks from other financial institutions.[14] Certainly in the United States regulatory scheme deposit taking has historically been a major distinction between banks and other institutions. One question is whether the right of a foreign entity to accept deposits should be sufficient in and of itself to enable such an entity to be classified as a bank, provided its other activities are traditional banking activities such as making loans. In other words, it is not clear why nature and quantum of deposits should be a major factor in determining whether a lending business generates nonpassive income for PFIC purposes. Assuming, however, that the basic framework of the Banking Regulations is not altered fundamentally, we offer the following suggestions.

To determine whether the deposit-taking requirement is satisfied, the Banking Regulations among other considerations list whether the funding sources are similar to that of

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[14] *See* 60 Fed. Reg. at 20,922 *et seq.* Note that in some other jurisdictions "banking" regulation is not based only on the activity of accepting deposits but also on the activity of lending. Also, the recent conversion of some traditional investment banks to "banks" in the United States illustrates the thinness of the separation between banks and certain institutions that are not licensed as banks.

other banks in the same jurisdiction.[15] Does this mean that if a bank in a small jurisdiction has more characteristics in common with large money center banks than with banks in its own jurisdiction it could have a problem satisfying this standard? Such a rule would not seem to us to make sense. As long as the funding sources are similar to those of banks in general, the deposits of a foreign entity should be accepted as such. In addition, the Service and the Treasury should consider adding a "safe harbor" to the substantiality test of the Banking Regulations. Such a safe harbor would provide that a foreign corporation satisfies the deposit taking requirement if the average of deposits determined as of the end of each quarter during the taxable year were equal to at least 30 percent of its total liabilities.[16] In addition, the Finalized Regulations would then still permit a foreign bank to determine whether or not it satisfies the deposit taking requirement based on an all facts and circumstances test.

(ii) Deposits by Residents of the Country in which the Foreign Bank is Licensed or Authorized

For purposes of the deposit taking requirement, both the Banking Notice and the Banking Regulations only take into account deposits made by residents of the country or countries in which the foreign bank (or branches thereof) is licensed or authorized. We believe that this limitation may unnecessarily create problems for foreign banks licensed or authorized in small countries, and also for multi-national banks. For example, a bank organized in Great Britain may receive deposits from residents of many jurisdictions. It is also not clear from the Banking Notice and the Banking Regulations how this requirement is to be satisfied when

[15] *See* Prop. Treas. Regs. § 1.1296-4(d)(3).

[16] Many large United States and foreign banks barely meet the 50 percent deposit taking requirement, and some fail to meet that requirement. According to their 2008 annual reports, the ratio of the deposits compared to the total liabilities was for Citi Group 43 percent, Bank of America 53.8 percent, JP Morgan Chase and Co 50.25 percent, BB&T 72.52 percent, Royal Bank of Scotland 27.55 percent, and BNP Paribas 20.53 percent.

applying the 25 percent look-through rule under section 1297(c).[17] Neither the Banking Notice nor the Banking Regulations specify whether the residency of the depositors has to be tested at the level of the deposit-taking entity or at the level of the top-tier corporation (*e.g.*, in the fact pattern of a bank holding company and one or more operating subsidiaries that are licensed as banks), though a reasonable conclusion is that the former suffices. Moreover, in the globalized economic environment customers do not limit themselves to opening bank accounts in their country of residence but also have bank accounts in different jurisdictions to facilitate their business transactions. We therefore suggest that this requirement be reconsidered in the Finalized Regulations. If this requirement is maintained in the Finalized Regulations, guidance should be provided regarding how section 1297(c) would apply in such circumstances.

Some members of the Executive Committee expressed concern that the relaxation of the deposit taking requirement could allow companies organized in tax havens to not be treated as PFICs even though they could be engaged in significant investment activities. We note that Proposed Treasury Regulations § 1.1296-4(c) contains an anti-abuse provision that could be used to prevent entities that obtain a banking license with the principal purpose of avoiding the PFIC rules from satisfying the licensing requirement. Consideration should also be given to requiring entities that satisfy the deposit taking requirement with deposits of non-residents to engage in substantial banking activities in their home jurisdictions.[18]

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[17] Under section 1297(c), if a foreign corporation owns 25 percent or more of the stock of another corporation, for purposes of determining whether the top-tier corporation is a PFIC, the top-tier corporation is treated as owning its proportionate share of the assets of such other corporation and receiving "directly" its proportionate share of the income of such other corporation. See discussion *infra* section 7 ("Application of the 25 Percent Look-through Rule") regarding this requirement.

[18] We note that the customer relationship provision also has an anti-abuse provision. *See* Prop. Treas. Regs. § 1.1296-4(h).

B. The Lending Requirement

In addition to the deposit taking requirement, a foreign corporation must, among other things, satisfy a lending requirement in order for the business conducted by the foreign corporation to be considered an active banking business. Different tests are used in the Banking Notice and in the Banking Regulations to determine whether the lending requirement is satisfied.

Under the Banking Notice, a foreign bank will be treated as being engaged in bona fide banking activities if, among other things, it makes or participates in loans or advances to unrelated parties, including banks, and services such loans. For this purpose, at least 50 percent of the average principal for the taxable year of all loans outstanding during the foreign bank's taxable year must be owed by unrelated parties. The Banking Notice further specifies that interbank deposits will be treated as loans for this lending requirement only if the interbank deposits are placed with a related person that is a corporation engaged in bona fide banking activities.

Under the Banking Regulations, the lending requirements are more lenient than under the Banking Notice, but similar to the deposit taking requirement, the Banking Regulations do not give the foreign corporation helpful thresholds to determine whether this requirement is met. The Banking Regulations simply require that the foreign bank regularly make loans to customers in the ordinary course of its trade or business.[19] The Banking Regulations further specify the meaning of a loan as being "[a] note, bond, debenture or other evidence of indebtedness . . . if the debt instrument is received by the corporation on an extension of credit made pursuant to a loan agreement entered into in the ordinary course of the corporation's

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[19] *See* Prop. Treas. Regs. § 1.1296-4(e).

banking business."[20] In the Banking Regulations, the Service and the Treasury did not initially provide for special treatment of interbank deposits. In the preamble to the Banking Regulations, however, the Service and the Treasury specified that the interbank deposits are to be treated like any other deposit, regardless of whether such interbank deposits are received from persons who are members of a related group.[21]

We believe that any Finalized Regulations should modify the lending requirement under the Banking Notice and the Banking Regulations to reflect current business practice. First, the Finalized Regulations should adopt the proposed amendment to the Banking Regulations that interbank deposits with both related and unrelated parties are to be treated as loans that can be used to satisfy the lending requirement. In addition, the Finalized Regulations should affirmatively confirm that interbank deposits are to be included with other deposits to determine whether the deposit-taking requirement is satisfied.[22]

A second problem with respect to meeting the lending requirement is closely linked to one of the permitted banking activities. Under both the Banking Notice and the Banking Regulations, the Service treats the underwriting of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers as genuine banking activities.[23] If the foreign corporation cannot successfully market the entire issue, it may then be left holding such securities. It is also possible that a broker-dealer subsidiary of a foreign corporation may act as the underwriter and transfer any unsold securities to the top-tier

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[20] *See id.*

[21] *See* 60 Fed. Reg. at 20,923.

[22] *See* 63 Fed. Reg. 39, 40 (Jan. 2, 1998) (preamble to a proposed amendment to the Banking Regulations).

[23] *See* Notice 89-81, 1989-2 C.B. 399, and Prop. Treas. Regs. § 1.1296-4(f)(2)(viii).

corporation because it might be better capitalized. We believe that the Finalized Regulations should treat such securities as being held as part of the lending business. If a narrower rule is desired, there could be a time period during which such assets are treated as part of a lending business (*e.g.*, one year) in order to provide for a reasonable time to sell such assets.

C. The Concept of Restricted Reserves

Although the restricted reserve provisions of the Banking Regulations may have been intended to be helpful in dealing with the requirement of certain jurisdictions, it creates an inference that assets held in "reserve" can be treated as passive. This would apply to the ownership of high quality assets, such as government securities, and short term assets, such as commercial paper. Under the Banking Regulations, a deposit of assets in a reserve is a banking activity if the deposit is maintained in a segregated account in order to satisfy a capital or reserve requirement under the laws of a jurisdiction in which the corporation actively conducts a banking business that is a trade or business.[24] A deposit of assets into a reserve qualifies as a banking activity if and only to the extent that the assets are not available for use in connection with the corporation's banking business because of significant regulatory restrictions on the investment of such assets.[25]

We believe that this concept of restricted reserves is too narrow for the current environment in which banks operate. Over the past 30 months, there have been numerous examples of banks with insufficient reserves. In addition, we are not sure that the concept of a restricted reserve takes into account the manner in which banks operate. Banks must raise a certain amount of equity capital and the required capital depends on the nature of the assets that

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[24] *See* Prop. Treas. Regs. § 1.1296-4(g).

[25] *See id.*

the banks hold. Greater or lesser amounts of capital are required depending on the assets (United States Treasuries, which require less in contrast to unsecured loans to corporations, which require more). Reserves, moreover, are often not held in a restricted account. In addition, some countries, such as Bermuda, do not have a central bank institution similar to the United States Federal Reserve. Banking entities in such countries will have to keep available much larger amounts of liquid assets than other banks because they cannot borrow from an entity such as the Federal Reserve. Thus, allowance should be given for liquid assets that are held to meet regulatory standards or the reasonable needs of the business. The concept of restricted reserves of a foreign bank should not be limited to the minimum required reserve but the limit should be based on a standard of reasonableness in light of the foreign corporations' business needs, customer expectations and the then current economic environment.

Although we believe that the capital and reserve requirement under the laws of a jurisdiction in which the corporation actively conducts a banking business is a proper standard, we would suggest that the Service and the Treasury consider adding a facts and circumstances test to determine what the appropriate amount of reserves should be for a foreign banking entity. We also believe that the concept of a restricted reserve should be eliminated. Rather, it should be recognized that any banking institution must maintain liquid assets (*e.g.*, government securities, commercial paper) in order to meet the liquidity needs of its banking activities. The amount of such assets that is reasonable must fluctuate based on the economic environment.

D. List of Banking Activities

The Banking Regulations further provide that only the gross income derived from the active conduct of any banking activity is banking income.[26] Both the Banking Notice and the Banking Regulations list certain activities that are viewed by the Service and the Treasury as banking activities.[27] The Finalized Regulations should provide guidance regarding the non-exhaustive character of the listed activities. Although these listed activities are viewed as traditional banking activities, neither of these lists permits any flexibility to treat new developing activities as genuine active banking activities. Because of the dynamic environment in which banking entities operate, they may engage in activities that are beyond the scope of the listed banking activities. The Service and the Treasury should provide that in addition to the listed activities other activities conducted by banks in general may constitute banking activities for purposes of the Finalized Regulations. We also believe that the Service and the Treasury should consider explicitly adding some activities that are nowadays commonly performed by multi-service banking corporations, such as investment banking activities, as well as the activity of securities dealing.

E. The License Requirement

In order to be an active bank for PFIC purposes, the Banking Regulations require that a foreign corporation must be licensed or authorized to accept deposits from residents of the country in which it is chartered or incorporated and to conduct, in that country, one or more of the listed banking activities.[28] In practice, this license requirement raises two distinct issues.

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[26] The gross income derived from the conduct of non-banking activities and the income from assets held for the conduct of such other activities are nonpassive only to the extent that such income is of a kind which (i) would not be foreign person holding company income as defined in section 954(c), or (ii) would qualify for one of the exceptions under section 1297(b)(2).

[27] *See* Notice 89-81, 1989-2 C.B. 399, and Prop. Treas. Regs. § 1.1296-4(f)(2).

[28] *See* Prop. Treas. Regs. § 1.1296-4(c).

The first issue is that many banks conduct certain activities through special purpose subsidiaries that are not licensed or do not need specific authorization to perform such activities.[29] The second issue is that many finance companies that are not licensed as banks provide bank-like services. Consequently, the income derived by such finance companies is usually treated as passive income for PFIC purposes, although these activities are clearly active and similar to the activities engaged in by banks. For example, a finance company may regularly provide long and short term credit to individuals and businesses, operate from branches, and have many employees. Although finance companies do not raise funds from deposits, it is not clear why the source of their funding should have a bearing on the appropriateness of treating these entities as PFICs.[30] Presently, there is a manifest anomaly that a finance company can qualify under section 954(h) and not generate Subpart F income for its United States shareholders who own 10 percent or more of the vote whereas less than 10 percent shareholders are subject to the complexities of the PFIC regime. We understand that because of the legislative history the Service may be limited in its power to modify the PFIC provisions of the Code in this regard.[31] Although we understand that the legislative history can be viewed as expressing the views of Congress on the scope of section 1297(b)(2)(A), we also note that the statute provides a fair amount of latitude by its grant of regulatory authority: "or, to the extent provided in regulations,

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[29] Subsidiaries of banks may be subject to the jurisdiction of bank regulators even if such entities are not licensed to conduct business as banks.

[30] In our experience, finance companies raise money by issuing commercial paper and other types of debt securities.

[31] *See* H.R. Conf. Rep. No. 103-213, at 641 (1993) ("The conference agreement provides that certain income derived in the conduct of a banking or insurance business, or, in the case of U.S. shareholders of a controlled foreign corporation, a securities business, may be excluded form the definition of passive income for purposes of the PFIC rules and the excess passive assets rules. These rules, however, do not apply to income derived in the conduct of financing and credit services businesses."); *see also* 60 Fed. Reg. 20,922, 20,922-23 (Apr. 28, 1995) (preamble to the Banking Regulations) ("The IRS and Treasury believe that Congress intended to grant the banking exception only to corporations that conform to a traditional U.S. banking model.").

by any other corporation."[32] This can be read to grant authority to exclude from PFIC treatment any company engaged in the banking business even if it is not licensed as a bank or does not accept deposits. For example, the Service might conclude that an entity that actively engages in consumer and commercial finance with unrelated customers and that satisfies the lending requirement should not be treated as deriving passive income to the extent of its income derived from the banking activities listed in the Finalized Regulations.

Some members expressed concern that if the Banking Regulations are liberalized as described above, it may facilitate the avoidance of PFIC status by companies that have more similarities to investment companies than to banks and other operating entities. In particular, the elimination of the home country deposit requirement could arguably facilitate the establishment of an entity in a tax haven jurisdiction that essentially engaged in investment type activities. The question (apart from any restriction under the legislative history) is whether the Service would have the tools to prevent the perceived abuse noted above. We note that the licensing and customer relationships provisions of the Banking Regulations contain their own anti-abuse provisions.

A majority of our Executive Committee believes that, if section 954(h) is not considered generally applicable for purposes of section 1297(b), then nevertheless, for periods while section 954(h) remains in effect, the license requirement should be relaxed by treating bank-like activities or services performed by foreign corporations that are not licensed or

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[32] H.R. Rep. No. 103-111, at 689 (1993). The legislative history appeared in connection with the adoption of section 956A, which subjected to tax the "excess passive assets" of controlled foreign corporations. Passive assets for purposes of section 956A were defined by reference to passive assets for PFIC purposes. We do not know if a potential concern was the credit affiliates of manufactures as opposed to independent finance companies. It is not clear whether this legislative language continues to be relevant in light of the repeal of section 956A and the continued effectiveness of section 954(h). The enactment of section 954(h) could be viewed as evidence that the licensing requirement is not relevant to whether a business is active.

authorized to accept deposits as activities that give rise to active income under the Finalized Regulations, provided that the corporation satisfies location requirements analogous to those under section 954(h) discussed at part 4.F immediately below. A substantial minority would not relax the rules for such corporations even under such circumstances.

F. Section 954(h)

Section 1297(b)(1) defines "passive income" for purposes of the PFIC regime as "any income which is of a kind which would be foreign personal holding company income as defined in section 954(c)." Section 1297 makes certain modifications to the section 954(c) definitions but it is lacking in detail on how concepts used for purposes of CFCs should be used when making PFIC determinations.[33] Section 954(c) contains numerous exceptions to the treatment of basic passive income (interest, dividends, rents, etc.) as passive income. Section 954(h)(1), which can, based on the particular foreign corporation's facts, exclude finance income from treatment as Subpart F income, provides:

> For purposes of subsection (c)(1), foreign personal holding company income shall not include qualified banking or financing income of an eligible controlled foreign corporation.

It is not clear whether for purposes of section 1297(b), section 954(c) should be treated as incorporating all the exceptions to passive income that are not within section 954(c) itself. Some practitioners may be taking the view that the reference to section 954(c) in section 1297(b) should incorporate all exceptions to passive income and that "controlled foreign corporation" should be substituted with "foreign corporation." The flush language of section 1297(b) and the 1993 legislative history cited above may undercut such a position to a degree.

[33] For example, the "flush" language of section 1297(b) in defining "related person" states that "foreign corporation" should be substituted for "controlled foreign corporation" each place as appears in section 954(d)(3).

Nevertheless, it is not unreasonable to believe that the original architects of the PFIC regime wished to incorporate in section 1297 whatever income was treated as passive for purposes of Subpart F.

We would recommend that the Service and Treasury resolve this issue. While we believe that it is sound policy to exclude foreign corporations that qualify for treatment under sections 954(h) and 954(i) from treatment as PFICs and that the definition of "passive income" should be consistent for PFIC and Subpart F purposes, we think that it is important for the Service and Treasury to state their views regarding the full scope of the cross-reference to section 954(c) in section 1297.

In general, we believe that, to the extent (as described at part 4.E above) a perceived abuse may arise as a result of permitting companies that satisfy section 954(h) (but are not licensed as banks) from being treated as PFICs, the requirements for qualification under section 954(h) themselves are an adequate safeguard to prevent abuse. For example, to qualify under section 954(h) a foreign entity must derive 70 percent of its gross income from lending and financing activities and 30 percent must be derived from transactions with entities in the home country. Further, such entity must conduct substantial activity with respect to the lending and finance business.[34]

5. Working Capital as Passive Asset

Working capital[35] may be treated as a passive asset even when held for use in an active business. Notice 88-22 provides that because "[c]ash and other current assets readily

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[34] *See* section 954(h)(2)(A)(ii).

[35] Although for financial or commercial purposes "working capital" may be defined as the excess of current assets over current liabilities, for purposes of the following discussion we will use the term "working capital" as *(cont'd)*

convertible into cash, including assets which may be characterized as the working capital of an active business, produce passive income," such assets are classified as passive assets for purpose of the Asset Test (the "Cash Rule").[36] In other words, irrespective of its use, cash and all other liquid assets are treated as passive assets generating passive income.[37]

As pointed out in our 2001 Report, the Cash Rule 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 meet the requirements to be treated as 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 near-term use in the company's active trade or business.

We believe that working capital if held for use in an active trade or business should not be treated as a passive asset so long as the amount is reasonable. Positive net working capital is essential to ensure that a business is able to continue its operations by providing sufficient funds to satisfy both anticipated operational expenses and maturing short-term debt. Companies with a working capital deficiency (an excess of current liabilities over current assets)

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referring to current assets, such as cash, cash equivalents, a portion of prepaid accounts that will be used within a year, and short-term investments.

[36] Notice 88-22, 1988-1 C.B. 489. 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 Treasury regulations proposed with respect to income of foreign banks, securities dealers and brokers).

[37] 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.

might run into difficulty in paying back their creditors in the short term. In particular, operating companies will seek to maintain a certain mix of liquid assets including certain amounts of cash or cash equivalents, in order to ensure the proper functioning of their business. The current financial crisis highlights the need for active businesses to maintain a prudent level of liquid assets to deal with liquidity problems that can arise through the "normal" operation of the business cycle or unexpectedly. Active businesses also need to accumulate liquid assets for expansion (*e.g.*, building a new plant, beginning or developing a new business) or maintenance. As more fully explained in the 2001 Report, a new or existing business can raise cash to build a new plant, a process that can take several years. Businesses have to raise the cash when it is available, such as when the interest rate environment is favorable, rather than immediately before it is used.

Examples of working capital that is reasonably maintained by an operating company do not include only cash to cover current operating expenses. Cash or other liquid assets that are maintained to fund future organic or acquisitive growth are also a necessary component of today's businesses. For example, a foreign operating corporation may raise cash to make a strategic acquisition of a competitor and invest the cash in liquid assets pending the acquisition. Until the acquisition is completed, the liquid assets will likely generate interest income that, under current rules, would be classified as passive income. If, in the same taxable year, such corporation generates only insignificant active income, because it is affected by an economic downturn the passive income generated from the liquid assets could exceed 75 percent of the corporation's gross income. This would result in the treatment of an otherwise active company as a PFIC. Another example of working capital that is essential for an active business is overnight loans in the interbank market.

To treat working capital that is reasonably maintained by a company engaging in an active trade or business as a passive asset and thereby increase the risk of such company being treated as a PFIC is inconsistent with the purpose of the PFIC regime, which is to distinguish between active businesses and passive investment companies. The PFIC regime, by incorporating the FPHCI rules of section 954(c), provides for a number of carve-outs for certain items that would ordinarily be passive but which are derived in an active trade or business. For example, although rents and royalties are generally FPHCI, they are not treated as FPHCI if derived in an active business.[38] FPHCI also includes gains from commodities transactions, unless such gains are derived from certain active business transactions.[39] Further, with respect to section 954(c)(1)(B) that treats gain from certain property transactions as FPHCI, the legislative history clarifies: "This provision is . . . not intended to apply to gain on the sale of land, buildings, or equipment used by the seller *in an active trade or business* of the seller at the time of the sale."[40] Finally, the PFIC regime also acknowledges carve-outs for items of passive income, such as interest, that are derived in an active banking or insurance business.[41]

For the above reasons, as already proposed in our 2001 Report, we suggest that assets held for "reasonable needs" of an active trade or business and earnings thereon not be treated as passive assets or passive income, respectively.[42] We understand that recognizing that there is a problem does not mean that there is an easy, viable solution. We continue to believe, however, that, as outlined in our 2001 Report, using the standard of "reasonable needs" of the

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[38] *See* section 954(c)(2)(A).

[39] *See* section 954(c)(1)(C).

[40] *See* H.R. Rep. No. 99-841, at II-615 (1986) (emphasis added).

[41] *See* section 1297(b)(2)(A) and (B).

[42] *See 2001 Report*, *supra* note 3, at 2220.

business as developed in the accumulated earning tax context would be a good approach. The use of this reasonable needs standard has the benefit that it is a standard that is already developed; it is a test that is based on the particular business being evaluated; and it was designed to prevent companies from accumulating liquid assets rather than paying dividends, which is similar in some respects to the goals of the PFIC regime.[43] Further, we believe that our proposal could be implemented through Treasury regulations based on the broad grant of regulatory authority under section 1298(f).

We recognize that the reasonable needs of the business test as developed for the accumulated earnings tax may not be acceptable because it is too subjective. Nevertheless, it is important to change the current test. There are several alternatives that should be considered. One alternative would be to use the reasonable needs concept but to cap the amount of assets that could be treated as held for the reasonable needs of the business to some percentage of aggregate assets. While this would be helpful in many cases, it would probably not address the fact-pattern of companies that are start-ups or that have raised funds for a major capital program. Another alternative would be to have a percentage cap that generally applies and provide a further exception for companies engaged in an extensive capital expansion program, which would be illustrated by examples. Yet another, but less desirable, alternative would be that such an exception, like the startup company exception, be applicable only for a limited period of time. For this purpose, the period of time should be greater than one year.

6. Mark-to-Market Election

[43] For more details of our proposal please see *id.* at 2220-26.

The mark-to-market provisions of section 1296 can potentially simplify the consequences of investing in a PFIC. Unfortunately, there are several issues that currently detract from the utility of the mark-to-market regime.

A. Mark-to-Market Election in Tiered PFIC Structures

The mark-to-market rules can lead to double taxation when applied in conjunction with the QEF or excess inclusion regimes to tiered PFIC structures. Under section 1296, a United States person that owns marketable stock in a PFIC can prevent the application of the excess inclusion regime by making a mark-to-market election with respect to such stock (hereinafter, a PFIC with respect to which a mark-to-market election may be made is referred to as a "traded PFIC"). If a mark-to-market election is made, any difference between the FMV of the stock of the traded PFIC and its adjusted tax basis at the end of the year is accounted for by either an inclusion in income or a deduction from income. If the traded PFIC owns stock in another PFIC, a United States shareholder in such traded PFIC will indirectly take into account the value of the lower-tier PFIC. Under current law, however, it is not clear whether the lower-tier PFIC will also be subject either to the excess inclusion regime or to the QEF rules.[44] As a

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[44] *See* 67 Fed. Reg. 49,634, 49,637 (July 31, 2002) (preamble to proposed Treasury regulations finalized by T.D. 9123, 2004-1 C.B. 907). The preamble explains:

> An issue not addressed in these proposed regulations is the treatment of certain situations involving multiple tiers of PFICs. For example, assume a United States person owns marketable stock in a PFIC, that itself owns stock in a second PFIC, the ownership of which is attributable to the United States person under section 1298(a)(2). If the United States person makes a section 1296 election with respect to stock of the upper-tier PFIC, the annual mark to market inclusions of income under section 1296 will be based on the fair market value of the upper-tier PFIC stock, whose value should reflect the value of the lower-tier PFIC, as such stock is an asset of the upper-tier PFIC. However, under current law, the United States person continues to be subject to taxation with respect to its indirect ownership of the lower-tier PFIC under section 1291 on any excess distributions from the lower-tier PFIC or gain from an indirect disposition of the lower-tier PFIC stock (although the consequences from the tiered ownership may be ameliorated by adjustments to the basis of the upper-tier PFIC stock). *See* [Prop. Treas. Regs.] §§ 1.1291-2(f), and 1.1291-3(e). Similar issues arise if the United States person makes a QEF election with respect to the lower-tier PFIC.

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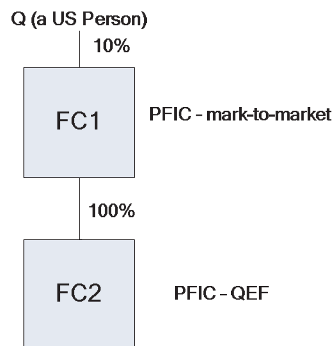
result, the United States shareholder would potentially become subject to an additional layer of tax. This uncertainty makes the mark-to-market election less attractive for many investors.

The following example illustrates the interplay between the mark-to-market election and the QEF regime in tiered PFIC structures: Q, a United States person, owns 10 percent of the common stock of foreign corporation FC1. Q's 10 percent interest has a FMV of $10 and a tax basis of $10. FC1's only asset is its 100 percent interest in foreign corporation FC2, with a FMV of $100 and a tax basis of $100. For the relevant time periods, FC1 and FC2 are classified as PFICs. FC1's common stock is "marketable" and Q made a valid mark-to-market election. With respect to FC2, Q made a valid QEF election (for a visual illustration of the ownership structure please see Chart 1, below). During year 1, the lower-tier FC2 has earnings and profits ("E&P") equal to $100. Consequently, FC2's FMV increases from $100 to $200. In year 2, Q sells its FC1 stock for $20. During year 1 and year 2, neither FC1 nor FC2 made any distributions.

Chart 1:



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Id.

In year 1, Q will mark-to-market its FC1 stock and, therefore, will have to take into account an appreciation in the amount of $10 (FMV of $20 minus a tax basis of $10).[45] Correspondingly, Q's tax basis in FC1 stock will be increased to $20.[46] In addition, under the QEF regime, Q will have to take into account its share of FC2's E&P, namely $10 (10 percent of $100).[47] Subject to the discussion below of the uncertainties regarding the tax basis adjustment in tiered PFIC structures, Q's tax basis in FC1 stock should be increased by $10. In year 2, Q will incur a loss of $10 by selling its FC1 stock ($20 purchase price minus $30 basis).

This result created by the interplay between mark-to-market and QEF rules is inappropriate. An economic profit in the form of increased value at the level of the second-tier PFIC is taken into account twice, once under the mark-to-market election for the first-tier PFIC stock and again under the current inclusion regime applicable to the second-tier PFIC. The double inclusion might be mitigated in a subsequent year, if the United States shareholder is able to utilize the loss generated by the disposition of the first-tier PFIC stock. Despite the possible use of such loss, the United States shareholder still faces the disadvantage of an accelerated income inclusion. Similar negative implications can also be encountered if the lower-tier PFIC is not a QEF and, thus, the United States shareholder is subject to the excess inclusion regime (again, notwithstanding that the United States shareholder has included in income value increases that are attributable to the lower-tier PFIC). While these inappropriate results were

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[45] *See* section 1296(a).

[46] *See* section 1296(b).

[47] *See* section 1293(a).

acknowledged by the Treasury in a Notice of Proposed Rulemaking for Treasury regulations under section 1296, the current Treasury regulations do not address this issue.[48]

This anomaly is partly attributed to the different approaches to income inclusion reflected in the mark-to-market and QEF regimes. In a mark-to-market system, the focus is on value whereas the QEF regime focuses on earnings. Increased earnings may produce an increase in value, particularly in an investment company. But that correlation will not always be present. The absence of correlation is more likely to be present in companies that are barely PFICs (*i.e.*, an entity that has an active business together with significant passive assets). It is reasonable to assume that when Congress adopted a mark-to-market approach it was not intending to create greater complexity.

In order to avoid a duplication and acceleration of income inclusions, we propose that if a United States shareholder has made a valid mark-to-market election with respect to the traded PFIC, such United States shareholder will be subject to neither the excess inclusion regime nor the QEF rules with respect to lower-tier PFICs owned by the traded PFIC. In other words, any lower-tier PFICs held under a traded PFIC will be excluded from the application of the PFIC regime. This proposal is economically sound because the mark-to-market concept should capture any appreciation in value that may arise from earnings at the first-tier PFIC or any lower-tier PFIC. Further, we believe that such proposal could be based on the regulatory authority under section 1298(f) or section 1293(g). Fixing this problem would also result in fewer tax basis issues of the type discussed below.

B. Definition of "Qualified Exchange or Other Market" for Mark-to-Market Election

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48 *See* 67 Fed. Reg. at 49,637.

The definition of exchange under the mark-to-market rules leads to uncertainties in determining whether PFIC stock is marketable. Under the Treasury regulations under section 1296, "marketable stock" includes stock that is regularly traded on a "qualified exchange or other market."[49] For this purpose, the term "qualified exchange or other market" means (i) a national securities exchange that is registered with the SEC or a national market system established pursuant to section 11A of the Securities Exchange Act of 1934, or (ii) a foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and which fulfills certain requirements guaranteeing an effective stock market and investor protection.[50] The Treasury regulations, however, do not provide a list of exchanges that will be treated as a "qualified exchange or other market."

The definition of "qualified exchange or other market" creates uncertainties. In order for an investor to determine whether it will be able to make a mark-to-market election with respect to stock in a foreign publicly traded corporation such investor will have to undertake an in-depth analysis of the regulatory framework governing the functioning of such foreign exchange. While such analysis will consume significant amounts of time and expertise, in many instances it will not be possible to make a final determination with certainty. Furthermore, such exercise seems superfluous with respect to established foreign exchanges that have already been acknowledged by the Service or the Treasury as being legitimate exchanges for other tax

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[49] Treas. Regs. § 1.1296-2(a)(1).

[50] *Id.* § 1.1296-2(c)(1). In particular, the foreign exchange must provide "trading volume, listing, financial disclosure, surveillance, and other requirements designed to prevent fraudulent and manipulative acts and practices, to remove impediments to and perfect the mechanism of a free and open, fair and orderly, market, and to protect investors; and the laws of the country in which the exchange is located and the rules of the exchange ensure that such requirements are actually enforced; and [the] rules of the exchange effectively promote active trading of listed stocks." *Id.* § 1.1296-2(c)(1)(ii).

purposes, for example to satisfy a limitation of benefits clause in a United States income tax treaty.

In order to avoid these uncertainties under current law, we propose that the Service or the Treasury provide further guidance with respect to which foreign exchanges will be treated as a "qualified exchange or other market" for purposes of the mark-to-market election. In particular, a list of recognized foreign stock exchanges would make the mark-to-market regime a more viable option for investors. A potential starting point for gathering such a list could be those foreign stock exchanges that are recognized under United States income tax treaties for purposes of applying the limitation of benefits provision.[51]

7. Application of the 25 Percent Look-Through Rule

The 25 percent look-through rule provides that, if a foreign corporation owns (directly or indirectly) at least 25 percent (by value) of the stock of another corporation, for purposes of determining whether such foreign corporation is a PFIC, such foreign corporation shall be treated as if it (i) held its proportionate share of the assets of such other corporation, and (ii) received directly its proportionate share of the income of such other corporation.[52] Congress' intent for enacting this rule was to avoid treating foreign corporations that own subsidiaries primarily engaged in active business operations as PFICs.[53]

A. Income and Assets in Separate Corporation of Foreign Integrated Group

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[51] Any test for determining whether the stock of a company is publicly traded should also be used for purposes of section 1297(e)(3).

[52] section 1297(c).

[53] *See* H.R. Conf. Rep. No. 99-841, at II-644 (1986); Staff of J. Comm. on Taxation, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, at 1026 (Comm. Print 1987).

With respect to the income and assets attributed from a 25 percent-owned subsidiary to its parent, section 1297(c) does not address at which level the Income and Asset Test should be applied. In other words, under the statutory language it is not clear whether the character of the attributed income and assets will be determined at the level of the subsidiary or at the level of the parent. We believe that, generally, the correct approach should be to test the character of income and assets at the level of the subsidiary (the "Separate Entity Approach"). Thus, assume that a holding company ("HC") whose status as a PFIC is being evaluated owns two subsidiaries, S1 and S2. S1 appears to be in the banking business and S2 appears to be a manufacturer. To determine HC's PFIC status, the income, assets and activities of S1 and S2 would be examined on a stand alone basis. If S1 constitutes a bank under the applicable Banking Regulations and its income is all active banking income under such regulations, its income and assets would "flow-up" to HC as active. A similar examination would be made of S2. Under this approach, income, assets and activities of S1 and S2 would not "flow-up" to HC for such income, assets and activities to be evaluated for PFIC status at the HC level. Any other approach would create problems because HC may not, for example, be licensed as a bank and if the S1 and S2 income were aggregated, the various banking tests of deposits and loans would not likely be met. For purposes of testing whether subsidiaries of an entity such as S1 are PFICs, the banking affiliates test of Proposed Treasury Regulations § 1.1296-4(i) should generally be applied to S1 and its subsidiaries.

The Service may already be following this interpretation because it has ruled that the character of gain from the sale of stock in a 25 percent-owned subsidiary will be determined

by reference to the percentage of active and passive assets in the subsidiary at the time of the sale.[54]

While we believe that the Separate Entity Approach should be the general rule, we acknowledge that this approach will lead to inappropriate results when applied to certain foreign integrated groups. For example, an active foreign business such as an active rental business might organize itself in a way to hold its real estate or other assets in a separate corporate subsidiary that does not itself have active operations (*e.g.*, it does not have the employees to manage and maintain the property). There may be valid non-tax business reasons for such a separation of assets, such as to shelter the assets from the claims of creditors of other entities of the group. Another subsidiary may employ the people who manage the properties and maintain them. Yet another subsidiary may have the employees who develop new properties and oversee their construction. Under the Separate Entity Approach, the real estate held and rents derived from such real estate may be characterized as passive, despite the real estate's use in an active trade or business by the foreign integrated group.[55]

An alternative approach would be to provide that the Separate Entity Approach applies for purposes of section 1297(b)(2)(A) or (C) (banking and insurance), and that for other purposes, the activities of 25 percent-owned companies tier up to the top company but that functionally unrelated activities cannot be used to make a passive asset nonpassive. For example, if in the real estate example above, the employees of the management company do not provide any management services for the building owned by another 25 percent-owned entity but instead,

[54] PLR 200813036 (Mar. 28, 2008).

[55] Such results can be partially avoided if the Service follows our proposal regarding the "own employee" rules discussed below.

the building is subject to a triple-net lease with a third party, then the income and assets of the building subsidiary may be passive.

Based on the above, we believe that the Service or the Treasury should provide guidance that is aimed to avoid inappropriate classifications resulting from the separation of business assets from the group's operations. Such guidance could include a test that provides that income generated and assets held by a 25 percent-owned subsidiary should not be treated as passive, if such income and assets would be treated as active but for the fact that such income is generated and such assets are held by the subsidiary and not by its parent. This test could be illustrated and limited by examples. We believe that such guidance could be issued under the broad regulatory authority granted under section 1298(f).

B. Intercompany Items and Sale of Stock in a 25 Percent-Owned Subsidiary

In addition to the issue described above, the following questions arise with respect to the application of the 25 percent look-through rule. First, there is no guidance on how to treat intercompany transactions (i) between a foreign corporation and its 25 percent-owned subsidiaries, or (ii) among such subsidiaries. The legislative history indicates that intercompany items, such as dividends and interest, received from a subsidiary are to be eliminated from the foreign parent corporation's income in applying the Income Test.[56] There is no guidance

[56] *See* Staff of J. Comm. on Taxation, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, at 1026 (Comm. Print 1987). The Joint Committee on Taxation explained:

> In determining whether a corporate shareholder is a PFIC, the Act attributes a proportionate part of a subsidiary's assets and income to the corporate shareholder. Under this look-through rule, amounts such as *interest and dividends* received from foreign or domestic subsidiaries are to be eliminated from the recipient's income in applying the Act's income test and the shareholder's stock investment is to be eliminated from its assets in applying the Act's asset test. For example, a foreign holding company that receives dividends or interest from a subsidiary is not treated as receiving passive income unless the subsidiary derives passive income. A corporation is a "subsidiary" of an upper-tier corporation for these purposes if at least 25 percent of the value of the corporation's stock is owned by the upper-tier corporation.

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regarding the treatment of other transactions, such as loans, licenses or leases, between a foreign parent and its subsidiary.

Intercompany items, such as dividends or interest received from a subsidiary, that are not ignored for the purpose of determining whether the foreign parent corporation is a PFIC may result in a duplication of items of passive income attributed to such foreign parent corporation. For example, a foreign corporation P wholly owns another foreign corporation S. S has E&P in the amount of $20, of which $10 is treated as active income and $10 is treated as passive income, and distributes the full amount of E&P to P. Under the 25 percent look-through rule, for purposes of determining whether P is a PFIC, the income of S is attributed to P. In addition, if the dividend from S to P is not ignored for purposes of determining whether P is a PFIC, the look-through rule under section 1297(b)(2)(C) (the "50 percent look-through rule") would provide that one half of the entire dividend has to be treated as passive income of P, because only one half of the dividend is properly allocable to nonpassive income of S.[57] As a result, P would be treated as receiving passive income in the amount of $20, even though such amount includes the passive income generated by S and attributed to P under the 25 percent look-through rule.[58]

(cont'd from previous page)
Id. (emphasis added).

[57] The 50 percent look-through rule provides that passive income does not include any income which is interest, a dividend, or a rent or royalty, which is received or accrued from a related person (within the meaning of section 954(d)(3)) to the extent such amount is properly allocable (under regulations prescribed by the Secretary) to income of such related person which is not passive income. *See* section 1297(b)(2)(C).

[58] Although the legislative history seems to indicate that the 25 percent look-through rule trumps the 50 percent look-through rule, the language of the statute does not explicitly provide for such priority. *See* S. Rep. No. 100-445, at 285 (1988). The legislative history explained:

> This change, in conjunction with the look-through rule for certain 25-percent-owned corporations and the look-through rules added by the bill (described below), makes it explicit that earnings of certain related foreign corporations organized in the same country as its shareholder that, if distributed to the shareholder would be excluded from foreign personal holding company income

(cont'd)

Second, it is not clear how the income from a sale of an interest in a 25 percent-owned subsidiary should be treated. Under section 954, gain from the disposition of stock is generally treated as FPHCI. In the PFIC context, this could mean that the sale of shares in a subsidiary would generate passive income.[59]

We believe that the Treasury should provide in Treasury regulations for details regarding the application of the 25 percent look-through rule. In particular, we propose the following guidance:

(1) For purposes of the Income Test and the Asset Test, transactions (i) between a parent and its 25 percent-owned subsidiaries and (ii) among such subsidiaries should be disregarded to the extent of the parent's direct or indirect ownership in the subsidiaries.

(2) When a corporation sells or disposes of an interest in a 25 percent-owned subsidiary, any gain that is recognized should be characterized as if the corporation had sold a proportionate share of the subsidiary's assets.[60]

8. Tiered PFIC Structures

A. Tax Basis Adjustments

The mechanic of the current inclusions and corresponding tax basis adjustments regime under section 1293 is unclear when applied to tiered PFIC structures.[61] A United States

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> under the same-country exception of subpart F (sec. 954(c)(3)), are subject to *either the section 1296(c) look-through treatment or the look-through treatment for amounts paid by related parties that are not 25 percent owned* (described below).

Id. (emphasis added).

[59] *But cf.* PLR 200015028 (Apr. 14, 2000) (for PFIC purposes, the Service held the sale of shares of a subsidiary as a direct sale of the subsidiary's assets), PLR 200604020 (Jan. 27, 2006) (same) and PLR 200813036 (Mar. 28, 2008) (same).

[60] This point was previously proposed in our 2001 Report. *See 2001 Report*, *supra* note 3, at 2238.

person who owns (or under attribution rules is treated as owning) stock in a QEF must include in gross income its pro rata share of such fund's ordinary E&P and net capital gain.[62] In order to avoid double taxation, any amount distributed by a PFIC that is attributable to E&P previously included in income under the above rule shall be treated as a distribution that is not a dividend, except that such distribution shall immediately reduce the distributing PFIC's E&P.[63] Correspondingly, under section 1293(d), the tax basis of the taxpayer's PFIC stock is increased by any QEF income recognized by the taxpayer and decreased by any amount distributed from previously taxed E&P. The flush language of section 1293(d) further provides that "[a] similar rule shall apply also in the case of any property if by reason of holding such property the taxpayer is treated under section 1298(a) as owning stock in a [QEF]."

The application of such tax basis adjustment rules to multiple tiers of foreign entities is uncertain and might possibly lead to double inclusion of QEF income. The uncertainty of this rule is illustrated in the following example. P, a United States person, owns stock of corporation FC1, that is a partner in a foreign partnership FP1. FP1, in turn, owns all of the stock of foreign corporation FC2. For the relevant tax period, both FC1 and FC2 are classified as PFICs and P has made a valid QEF election, with respect to FC1 and FC2 (for a visual illustration of the ownership structure please see Chart 2, below). For each tax year, P will have to include in income the ordinary E&P and net capital gain of FC1 and FC2. Further, based on

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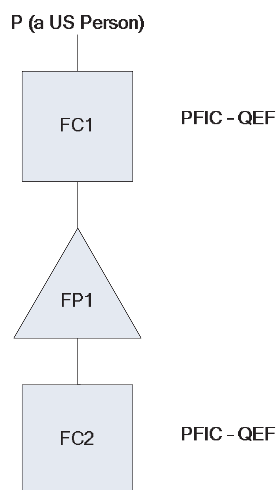
61 In addition to the issues discussed in the text, there is also little guidance on how the purging deemed sale election under Treasury Regulations § 1.1291-10 is applied to tiered PFIC structures. For example, if such purging election is made with respect to multiple PFICs in tiered structures, which of those PFICs is deemed sold first (the top-tier entity or a lower-tier entity)? It is also not totally clear whether duplicate gain is possible or not.

62 *See* section 1293(a).

63 *See* section 1293(c).

section 1293(d), P will correspondingly increase its tax basis in FC1 stock. By its terms, section 1293(d), however, does not seem to provide for tax basis adjustments for interests held by other entities in the above described chain.[64] The lack of a provision for tax basis adjustments for lower-tier entities means that there may be no increase of (i) FC1's tax basis in its interest in FP1 and (ii) FP1's tax basis in FC2 stock, for QEF inclusions attributable to FC2. This inappropriate result creates a potential for future multiple inclusions in P's income of FC2's E&P and capital gain, by virtue of the unadjusted tax basis in the interests in FP1 and FC2.

Chart 2:



Whereas it might be possible to justify an interpretation of section 1293(d) that allows a tax basis adjustment for interests held by lower-tier entities, such an interpretation is not clearly covered by the statute's express language. In Private Letter Ruling 200838003, the

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[64] Section 1293(d) provides that "the taxpayer" shall increase its basis "by any amount which is included in the income of the taxpayer" and that a similar rule shall also apply "in the case of any property if by reason of holding such property the taxpayer is treated" (through the application of attribution rules) as owning stock of the QEF. Arguably, this seems not to allow the application of a basis adjustment to persons other than the United States taxpayer.

Service dealt with a situation similar to the one described above.[65] The Service applied section 1293(d) to provide for a tax basis increase at lower-tiers and ruled, accordingly, that (i) FP1 increases its tax basis in FC2 by the full amount of the QEF inclusions attributable to FC2 taken into account by the electing shareholders, (ii) FC1 also increases its tax basis in FP1 by the same amount, and (iii) the tax basis in FC1 stock of electing shareholders of FC1 is increased by its QEF inclusion allocable to FC2. The Service's interpretation of section 1293(d) seems to be in line with its statutory objective of section 1293(g)(2) to prevent double inclusions. Apart from the discussed ruling, which lacks precedential value, the Service has not yet provided any regulatory guidance on this issue.

In other regimes under the PFIC regime, Treasury regulations have addressed the issue of tax basis adjustments in the case of indirect ownership of PFIC stock. For example, in the context of deemed dividend and purging elections, Treasury regulations provide that tax basis adjustments have to be made (i) to the indirect PFIC shareholder's interest in the intermediate entity, and (ii) to the intermediate entity's tax basis in the PFIC stock.[66] These Treasury regulations are, however, silent with respect to the mechanic of tax basis adjustments for ownership chains with more than one intermediary. Also, the mark-to-market regime provides for a tax basis adjustment at the United States shareholder and intermediate entity levels for

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[65] *See* PLR 200838003 (Sept. 19, 2008).

[66] *See* Treas. Regs. § 1.1291-9(f) ("If the shareholder makes the deemed dividend election with respect to a PFIC of which it is an indirect shareholder, the shareholder's adjusted basis of the stock or other property owned directly by the shareholder, through which ownership of the PFIC is attributed to the shareholder, is increased by the amount of the deemed dividend. *In addition, solely for purposes of determining the subsequent treatment under the Code and regulations of a shareholder of the stock of the PFIC, the adjusted basis of the direct owner of the stock of the PFIC is increased by the amount of the deemed dividend.*" (emphasis added)); *see also id.* §§ 1.1291-10(f), 1.1297-3(c)(6) and 1.1298-3(c)(6).

PFIC stock indirectly held through certain foreign pass-through entities;[67] but also here the exact mechanic of the tax basis adjustments for additional intermediary entities seems to be unclear.[68]

In order to avoid inappropriate double inclusions of income, we propose that the Service or the Treasury introduce rules clarifying that tax basis adjustments for corresponding QEF inclusions should also be made at the intermediate levels of multi-tiered PFIC structures. Section 1293(g)(2) seems to be an appropriate statutory authorization for the implementation for such rules. Further, it would be helpful to clarify that the existing tax basis adjustment rules in the context of deemed dividend, purging, and mark-to-market elections also apply to tiers including more than one intermediary.

B. Gain Recognition

In the case of tiered PFICs, the rules for indirect dispositions of PFIC stock are not clear. Moreover, the results provided in the proposed Treasury regulations are inappropriate.[69]

To illustrate, consider foreign corporation FC1 with its only asset being all the stock of FC2. FC1 has a basis of $0 in the stock of FC2, and the value of that stock is $1,000. Assume FC2, and therefore FC1, are PFICs. Q, a United States person, buys 10 percent of FC1 for $100, and later resells the stock for $100. Q does not make any QEF election, and neither FC1 nor FC2 makes any dividend distributions (for a visual illustration of the ownership structure please see Chart 3, below).

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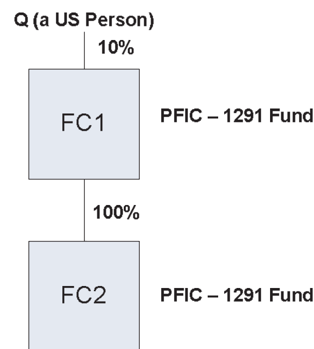
[67] *See* section 1296(b)(2) and Treas. Regs. § 1.1296-1(d)(2)(i).

[68] Treasury Regulations § 1.1296-1(d)(2)(i) provides that in addition to basis adjustments to the PFIC stock held by the intermediary, "[c]orresponding adjustments shall be made to the adjusted basis of the United States person's interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock."

[69] *See* Prop. Treas. Regs. § 1.1291-3(e).

Chart 3:



If FC2 were a branch of FC1 rather than a subsidiary, Q's sale of FC1 would not result in any tax liability to Q under section 1291. The reason is that under section 1291(a)(2), Q's excess distribution is equal to Q's "gain recognized" on the sale of FC1. Since Q has no gain, there is no excess distribution.

However, consider the case where FC2 is a subsidiary of FC1. Under section 1298(a)(2), Q is considered to constructively own the stock of FC2. Section 1298(b)(5) states that under Treasury regulations, Q's disposition of the stock in FC1 is therefore treated as a disposition by Q of the stock of FC2. Proposed Treasury Regulations § 1.1291-3(e)(4)(i) states that Q is treated as recognizing gain on the FC2 stock in an amount equal to "the gain the actual owner [FC1] would have realized on an actual disposition of such stock." Under Proposed Treasury Regulations § 1.1291-3(e)(4)(iii), Q's basis in FC1 is increased by the amount of the gain so recognized, and the buyer of Q's stock is treated on a resale of that stock as if FC1 had a "stepped up" tax basis in the stock of FC2.

Assume that Q is the first U.S. shareholder of the stock that Q purchased. As a result, the "step up" in tax basis does not arise. Consequently, Q has a gain of $100 on the indirect disposition of the FC2 stock, based on Q's 10 percent share of FC1's underlying gain of $1,000 on that stock. This gain is treated as ordinary income to Q and is subject to the interest

charge of section 1291. Q also has a capital loss of $100 on the direct disposition of the FC1 stock. Even if Q had sold the FC1 stock immediately after buying it, Q would have $100 of ordinary income and $100 of capital loss.

This result is completely non-economic, is inconsistent with the result when FC2 is a branch rather than a subsidiary of FC1, and is not compelled by the language of section 1298(b)(5). There is no logical reason why Q's gain on the indirect disposition of FC2 should be calculated by starting with FC1's basis in the stock of FC2. The problem arises because the built-in appreciation in the stock of FC2 that exists on Q's date of acquisition of FC1 is already being "purchased" by Q and is already reflected in Q's tax basis in FC1. When Q sells the stock of FC1, Q is in substance using that part of its tax basis in FC1 to dispose of that part of the value represented by FC2. Q should obtain credit for that tax basis, and not be limited to FC1's tax basis in FC2.

Putting it another way, the proposed Treasury regulations would tax to Q, as ordinary income, FC1's preexisting appreciation in FC2 that existed on Q's purchase date of FC1. The purpose of the PFIC regime is to prevent Q from deferring tax on income that arises during Q's holding period of FC1 and FC2, and not to subject unrealized appreciation that existed in either FC1 or FC2 on Q's purchase date to tax. Just as section 1291 does not tax Q on the unrealized appreciation in FC1's assets on Q's purchase date, there is no logical reason for it to tax Q on the unrealized appreciation in the stock or assets of FC2 on that date.

This problem could be resolved in either of two ways. First, the Treasury regulations could provide for a notional basis of the FC2 stock in the hands of FC1 that is equal to the "mark-to-market value" of the FC2 stock in the hands of FC1 on Q's purchase date. On any subsequent indirect disposition by Q of the FC2 stock, Q's gain would be based on such

notional tax basis. The proposed Treasury regulations adopt a limited form of this relief.[70] The relief only appears to apply, however, if the stock in question was previously transferred in an indirect disposition. Thus, it would not apply to a shareholder that bought newly issued shares in the top-tier PFIC, or to a shareholder that bought shares from a foreign shareholder of the top-tier PFIC (since the indirect disposition rules in section 1298(b)(5) only apply to U.S. shareholders).

An alternative method of dealing with this problem would be for Q's gain on the indirect disposition of the FC2 stock to be calculated on the basis of FC1's basis in FC2, but with a "cap" on all such indirect gain arising from all FC1 subsidiaries equal to Q's actual gain on the FC1 stock. While less precise, this method reflects the principle that Q should not have a greater tax liability because FC1 happens to have subsidiaries than if FC1 operated through branches. There is nothing in the policy of the PFIC regime that should cause a worse result in the latter case.

Finally, the same issues arise if Q does not dispose of the FC1 stock, but rather FC1 disposes of the stock of FC2. In that case, logically, Q's gain on the indirect disposition of FC2 should again be limited to the appreciation in the FC2 stock after Q's purchase date. If the alternative method were used, Q's gain would be based on its share of FC1's gain, but limited to Q's overall appreciation in the FC1 stock at the time. The latter result would be less economically correct, because the overall appreciation of Q's FC1 stock at the time of FC1's disposition of FC2 might be more or less than Q's share of the post-acquisition appreciation in the FC2 stock.

The approach of marking the stock held by FC1 to market works best in a variety of circumstances, particularly in more complex cases involving multiple holdings by FC1, but

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[70] *See id.* § 1.1291-3(e)(4)(iv).

requires Q to have access to significant amounts of information regarding FC1 and its business. The alternative approach of capping the gain may be more difficult to apply in some more complex cases, and will also produce a less accurate result. Nevertheless, we believe that it is important to give taxpayers these options of avoiding what is obviously an unintended result.

9. "Own Employees" Rules in the PFIC Context

The application of the FPHCI regulation's "own employees" rules in a PFIC context is unclear and might lead to undesirable results. In accordance with Treasury regulations under section 954, income in the form of rents and royalties are generally passive income, unless such income is generated through certain activities performed by the CFC's own employees.[71] In particular, a CFC's rents or royalties will be considered derived in the active conduct of a trade or business, if certain management, operational or marketing functions are conducted through the CFC's own employees (not employees of a related person).[72]

The application of these "own employees" rules to PFICs is unclear, particularly in relation to the 50 percent look-through rule and the 25 percent look-through rule and the policy behind them, which is to treat a group of related operating entities (whether connected by an operating parent or a holding company) as an active venture.[73] The appropriate manner of addressing this issue depends in part on the resolution of the issues regarding the look-through

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[71] Under the current Treasury regulations, the "own employees" rules would also apply to commodities transactions. *See* Treas. Regs. § 1.954-2(f)(2)(iii)(D). These Treasury regulations, however, were promulgated before the current version of section 954(c)(1)(C) was enacted by the American Jobs Creation Act, P.L. 108-35, 118 Stat. 1418, in 2004. It is, therefore, unclear whether these Treasury regulations remain applicable to commodities transactions that are covered by post-2004 section 954(c)(1)(C).

[72] With respect to rents, see Treasury Regulations § 1.954-2(c)(1)(ii) and (iv); with respect to royalties, see Treasury Regulations § 1.954-2(d)(1)(ii). Further, in determining if a CFC's "active leasing expenses" or "active licensing expenses" constitute at least 25 percent of its "adjusted leasing profit" or "adjusted licensing profit," compensation for services of employees of related persons may not be taken into account. *See* Treas. Regs. § 1.954-2(c)(2) and (d)(2).

[73] *See 2001 Report*, *supra* note 3, at 2236.

rule discussed above. If, for purposes of that rule, determinations of PFIC status are made on the basis of the Separate Entity Approach, it is more difficult to take into account the activities of the employees of related entities. If the Separate Entity Approach is not adopted, then an appropriate interpretation of the "own employees" rules to PFICs is that activities of employees of a 25 percent or more owned subsidiary of a foreign corporation will be attributed to the upper-tier entity since the 25 percent look-through can be fairly interpreted as treating all the assets and income of the lower-tier entity as, proportionally, the assets and income of the upper-tier entity.

In particular, in our 2001 Report, we pointed out that the "own employees" rules may create adverse consequences for a wide range of commonplace, economically sound arrangements for employee-sharing within foreign corporate groups.[74] As discussed above, 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. 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.[75] As a result, the strict application of the "own employees" rules to the PFIC analysis would frustrate the intention of the PFIC regime, which is to distinguish active operations from passive investment activities.

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[74] *Id*.

[75] Further, we identified that the same issue arises if a foreign corporation conducts activities through a partnership. *Id.* at 2237.

In order to clarify the impact of the "own employees" rules in the PFIC context, we continue to believe that the proposals suggested in the 2001 Report, as modified herein, should be adopted.[76] In determining if any foreign corporation is a PFIC, the above described "own employees" tests should be applied by attributing to the foreign corporation the relevant employee activities (and employee compensation expenses) of any person whose income is attributed to the foreign corporation under the 25 percent look-through rule provided that such employees are actually performing functions for the related corporation. We believe that under section 1298(f), the Treasury is authorized to implement our proposal through Treasury regulations.

As stated above in the discussion of the 25 percent look-through rule, even if the Separate Entity Approach were adopted, provision should be made for groups of companies that operate on an integrated basis. Thus, even if the conclusion is that employees of one 25 percent-owned company would not be attributed to another 25 percent-owned company, not permitting attribution when the parties have a greater than 50 percent relationship is hard to justify. Thus, we would recommend that employees of companies that are related to each other with at least 50 percent common ownership can be attributed to each other. As already highlighted in our 2001 Report, a failure to do so can lead to a distortion of the PFIC analysis.[77]

We also suggest that it be made clear that employees of a partnership in which a potential PFIC holds a significant interest will be attributed to such potential PFIC for purposes of classifying its income from rents and royalties transactions. We believe, however, that this

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[76] *See id.* at 2238.

[77] *See id.* at 2236.

issue could be solved by incorporating a general partnership look-through concept in the PFIC regime context. For details for such proposal, we refer to the 2001 Report.[78]

10. Reorganizations Involving PFICs

Section 1291(f) provides that, to the extent provided in Treasury regulations, in the case of any disposition of stock in a PFIC, the amount realized shall be treated as gain from the sale or exchange of such stock and shall be recognized notwithstanding any other provision under the Code that would provide for nonrecognition. Proposed Treasury Regulations § 1.1291-6 (the "Reorganization Regulation") provides for the details and mechanic of the override of certain nonrecognition provisions along with exceptions to gain recognition for specified transactions. In order to provide clarity for the taxpayer and given that PFICs may and do engage in reorganizations, we propose that the Reorganization Regulation be finalized with the following modifications and clarifications.

We believe that the Reorganization Regulation should include an exception to gain recognition for the liquidation of a section 1291 fund into another section 1291 fund holding at least 80 percent of the liquidating corporation's stock. In the absence of such an exception, gain recognized on the liquidation, which would otherwise be tax-free under sections 332 and 337, will be treated as an excess distribution to United States persons holding shares of the upper-tier section 1291 fund.[79] This is an inappropriate override of the nonrecognition provisions because the value of the lower-tier section 1291 fund continues to be reflected in that of the upper-tier section 1291 fund after the liquidation and, as a result, remains subject to future application of the excess inclusion regime.

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[78] For a summary of recommendations with respect to partnerships please see *id.* at 2246.

[79] *See* Prop. Treas. Regs. § 1.1291-3(e).

The Reorganization Regulation should also include an exception to gain recognition for transfers of stock of section 1291 funds to partnerships under section 721 in cases where section 704(c) applies. In Proposed Treasury Regulations § 1.1291-6(f), Example 7, a 100 percent shareholder of a section 1291 fund transfers its interests in the section 1291 fund to a domestic partnership in an exchange generally entitled to nonrecognition treatment under section 721. After the transfer, the shareholder is treated as owning only one-half of the shares of the section 1291 fund pursuant to Proposed Treasury Regulations § 1.1291-1(b)(8)(iii)(A) notwithstanding that gain recognized with respect to all shares of the section 1291 fund would be allocated to the shareholder under section 704(c). As a result, the shareholder is subject to tax on the disposition of half of the shares of the section 1291 fund. This result is inappropriate in part because section 704(c) ensures that the shareholder remains subject to pre-contribution gain on all shares of the section 1291 fund contributed to the partnership. Nevertheless, the seven year term of sections 704(c)(1)(B) and 737(b) are likely to have motivated this result. Consideration should be given to permitting such contributions without the recognition of gain at the time of the contribution if the shareholder elects to enter into a gain recognition agreement that would effectively extend the effect of sections 704(c)(1)(B) and 737(b) indefinitely.

We believe, moreover, that the Reorganization Regulation should clarify that nonrecognition transfers do not include securities lending transactions under section 1058.

The Service or the Treasury should also provide guidance on the applicability and effect of section 1291(e). Section 1291(e) provides that, except to the extent inconsistent with Treasury regulations prescribed under section 1291(f), certain rules that were applicable to foreign investment companies ("FIC") under former section 1246(c), (d) and (f) shall be applied

to PFICs.[80] Former section 1246(c) treated, to the extent provided under Treasury regulations (which have never been issued), non-FIC stock, the basis of which is determined by reference to the basis of FIC stock, as FIC stock. Applying that principle, non-PFIC stock with a substituted basis received for PFIC stock in a nonrecognition transaction might be treated as PFIC stock ("Substituted Basis Rule").[81] The Service and the Treasury have neither proposed nor issued regulations that address section 1291(e).[82] Absent such regulations, it might be questionable whether the Substituted Basis Rule in section 1291(e) is "self executing." It is also unclear whether the Substituted Basis Rule should be applied to nonrecognition transfers under the proposed Reorganization Regulation.[83] Thus, we suggest the Service or the Treasury should issue regulations that provide guidance on the applicability and effect of section 1291(e).[84]

11. QEF Election

A QEF election under section 1293 requires a United States shareholder in a PFIC to include in its income on a current basis its pro rata share of the PFIC's ordinary income and net capital gain for such year. A holder's tax basis is increased by the amount included in income. Thus, at the price of potentially recognizing phantom income, a United States shareholder avoids the interest charge of the excess inclusion regime and is entitled to capital gain upon a sale and a

[80] The Service has ruled that section 1291(e) is applicable only to PFICs subject to the excess inclusion regime under section 1291. *See* PLR 9625059 (June 21, 1996) and PLR 199939038 (Oct. 1, 1999). This is also indicated by the legislative history. *See* Staff of J. Comm. on Taxation, 99th Cong., *General Explanation of the Tax Reform Act of 1986*, at 1028 (Comm. Print 1987).

[81] *See id.* ("These rules . . . require stock with a substituted basis to inherit the attributes of PFIC stock . . . .").

[82] *See* Prop. Treas. Regs. § 1.1291-7.

[83] As stated above, section 1291(e) applies only to the extent inconsistent with Treasury regulations prescribed under section 1291(f). As long as the Reorganization Regulation is not finalized, it seems that section 1291(e) might apply even if the result is inconsistent with the proposed Reorganization Regulation.

[84] *See* N.Y. City Bar, *Report Offering Proposed Guidance Regarding the Passive Foreign Investment Company Rules* 74-75 (2009).

flow-through of capital gains. In our experience, many investors in entities that are PFICs would gladly accept the potential phantom income of the QEF election in order not to be subject to the draconian excess inclusion regime. Nevertheless, to make such an election the PFIC must comply with the requirements set forth by the Secretary of the Treasury. The requirements that presently apply, while understandable, are in practice difficult to satisfy. Essentially, the PFIC must provide one of the following: (i) the shareholder's pro rata share of the earnings of the PFIC as determined for United States federal income tax purposes; (ii) sufficient information to enable the United States shareholder to calculate such pro rata share; or (iii) a statement that the PFIC has permitted the United States shareholder to examine the books and records, etc., for the United States shareholder to calculate its pro rata share of the earnings in accordance with United States federal income tax accounting principles.[85] Although there is provision made for "alternative documentation" it is only to apply in rare and unusual circumstances and only pursuant to a private letter ruling and closing agreement.

In practice, these requirements make it very difficult for United States shareholders to make a QEF election. In many offerings of foreign issuers, the offering documents state that the issuer does not believe that it is a PFIC, but if it were, it would not provide the necessary information allowing a United States shareholder to make a QEF election. Even if the issuers state that they believe that they are, or are likely to become, a PFIC, they still advise investors that they will not provide the necessary information. For many non-United States issuers it is simply too difficult and expensive to convert their earnings to what they would be if United States federal income tax accounting principles applied. The conversion is not only quite difficult on an annual basis, but becomes even more difficult and burdensome if the foreign

[85] *See* Treas. Regs. § 1.1295-1(g)(1)(ii).

corporation engages in acquisitions, or other corporate restructurings. While a foreign corporation with a large number of United States shareholders may spend the money to hire the accountants to make the necessary computations, a minority United States shareholder cannot compel a foreign corporation to make the effort to provide the necessary information. While one might question why a United States person would invest in such a corporation, the fact is that many do. The goal of obtaining a diversified portfolio surely explains many of the investments but others result from inheritance, corporate combinations, or companies that become PFICs because their asset composition changes.

Thus, these requirements are resulting in many shareholders who cannot make a QEF election and who are potentially subject to the excess inclusion regime.

We also wonder whether the existing regime is one that the Service can properly administer. How reliable would a foreign corporation's translation of its income into income under United States federal income tax principles be? Perhaps in cases involving large holdings the Service can audit the results. But as a practical matter, it would appear that investors with smaller holdings cannot be audited in a way that makes it worth while for the Service or that would be fair to such investors in terms of the efforts required to validate the information.

A related problem is that the determination of whether a company is a PFIC is based in part on the Income Test, which depends on United States tax definitions of gross income, and in part on the Asset Test, which is either based on FMV or adjusted tax basis. In the case of a private company with non-traded assets, FMV may be hard to determine. The difficulties of making United States tax determinations apply if the Asset Test is to be based on adjusted tax basis. It may therefore be difficult to know whether a company is a PFIC. In many cases, the uncertainty regarding whether or not a company is a PFIC could be addressed by

making a QEF election, but such an option would not be available if the PFIC does not agree to provide the necessary information.

The problems outlined above suggest that a solution must be found to make the determination of whether a company is a PFIC simpler and more reliable and to make it easier for a United States shareholder to make a QEF election.

A. Preferred QEF Election

The "preferred" QEF election of Proposed Treasury Regulations §§ 1.1293-2 and 1.1295-2 ("Proposed Preferred Regulations ") is a reasonable approach for preferred stock. Providing a holder with the right to elect to include the stated dividend in income currently, together with any discount, provides certainty and simplicity. We recognize that if a dividend is in fact not paid the ordinary income inclusion is offset by a capital loss but that result appears to be mandated by the statutory tax basis adjustments. We would recommend that the basic approach of Treasury Regulations § 1.1293-2 be adopted. Nevertheless, prior to finalizing the Proposed Preferred Regulations we believe that some modifications in the requirements for the QEF election should be considered to make this election more widely available. We have previously made suggestions regarding the Proposed Preferred Regulations and continue to believe that the recommendations set forth in our previous report are sound.[86] Below we highlight some of our previous suggestions.

The requirements for the QEF election are set forth in Proposed Treasury Regulations § 1.1295-2. Among the requirements are (i) that the United States shareholder does not own, directly, indirectly, or constructively, 5 percent or more of the vote or value of any class

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[86] *See* N.Y. State Bar Ass'n, *Report on PFIC Election for Preferred Stock* (1994), *reprinted in* 94 Tax Notes Int'l 59-14 (1994).

of stock of the foreign corporation, and (ii) that the foreign corporation has provided a written statement certifying either that it is, or that it reasonably believes that it is, a PFIC, and that it is not a CFC within the meaning of section 957(a) for such taxable year of the corporation.[87] Further, a "preferred" QEF election can only be made with respect to a "qualified preferred share." For this purpose, a share of a foreign corporation is a qualified preferred share only if:

a) The share was originally issued for cash or in exchange for qualified preferred shares of the foreign corporation in a transaction to which section 354(a)(1) applied;

b) If the share were to constitute a debt obligation, the share would be in registered form within the meaning of Treasury Regulations § 5f.103-1(c);

c) All amounts payable with respect to the share are denominated in U.S. dollars and are not determined by reference to the value of a currency other than the U.S. dollar;

d) The share is limited and preferred as to dividends and does not participate in corporate growth to any significant extent within the meaning of section 1504(a)(4)(B);

e) The share has a fixed redemption or liquidation price;

f) The share provides for cumulative or non-cumulative dividend rights that are limited to an annual (or shorter period) amount computed by multiplying either the redemption or liquidation price of the share by a specified index described in Treasury Regulations § 1.446-3(c)(2)(i), (iii), or (iv) (specified index), or by a specified index periodically re-established pursuant to an auction reset mechanism, set in advance of the period with respect to which the specified index applies;

g) If the share may be redeemed under circumstances described in Treasury Regulations § 1.305-5(b) such that redemption premium (as described in Treasury Regulations § 1.305-5(b)) could be treated under section 305(c) as a constructive distribution (fixed term preferred stock), the share was not issued with redemption premium exceeding the *de minimis* amount described in section 305(c)(1) and Treasury Regulations § 1.305-5(b)(1);

h) If the share may not be redeemed under circumstances described in Treasury Regulations § 1.305-5(b) such that redemption premium would not be treated under section 305 as a constructive distribution (perpetual preferred stock), the share does not provide shareholders with the right to receive an amount upon liquidation or redemption that exceeds the issue price of the share (as determined under the principles of section 1273(b)) by an amount in excess of 5 percent of such liquidation or redemption amount;

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[87] *See* Prop. Treas. Regs. § 1.1295-2(c).

i) If redeemable, the share is redeemable only in whole and not in part and is not subject to mandatory redemption within five years of the issue date of the share. Further, the share is not subject to a holder put or issuer call that, based on all the facts and circumstances as of the issue date of the share, is more likely than not to be exercised at a time within five years of the issue date;

j) If convertible, the share is not convertible into a share other than a share meeting all the conditions set forth in Proposed Treasury Regulations § 1.1295-2(b)(1)(i) through (b)(1)(ix); and

k) The issuer of the share has indicated in an offering document relating to the original issuance of the share or in a written statement available to United States holders that the issuer has no current intention or belief that it will not pay dividends on the share on a current basis and that the share meets the conditions set forth in Proposed Treasury Regulations § 1.1295-2(b)(1)(i) through (b)(1)(xi).[88]

Some of these requirements are very reasonable in light of the objective and the income inclusion methodology. For example, it makes sense to require that the preferred not be a participating preferred and that the foreign entity not be a CFC. We are not sure whether some of the other requirements are as necessary. For example, why do the Proposed Preferred Regulations restrict the election to shares denominated in United States dollars? It may be that preferred denominated in hyperinflationary currencies can create concerns but a preferred denominated in a major currency should not give rise to any issues other than translation issues. Section 988 provides adequate guidance in that regard.

The proposed election requirements are also focused on the qualifying preferred not being issued at a discount in excess of the *de minimis* discount of section 305(c)(1) and Treasury Regulations § 1.305-5(b)(1). In the case of secondary market purchases, the discount is also limited to a specially defined *de minimis* rule.[89] We believe that the Proposed Preferred

88 *See id.* § 1.1295-2(b)(1).

89 *See id.* § 1.1295-2(b)(2).

Regulations, when finalized, should permit preferred stock with discount, whether acquired at original issue or in a secondary, and provide that such discount be included in income currently in accordance with the Treasury regulations governing the inclusion of original issue discount. The Proposed Preferred Regulations also require the issuer of the preferred to make a statement that it intends to pay dividends on the preferred on a current basis. Presumably this requirement is related to the requirement that there only be limited discount. For the reasons noted above, it should be eliminated. We also want to emphasize that any election should require as little as possible from the potential PFIC. Thus, we reiterate our recommendations that the issuer of the preferred not be required to make any declarations regarding its United States tax status.

We understand that the motivation for the limitations was to craft a narrow rule that would be principally available to retail investors.[90] Given that holders who make the election are required to include in income currently the stated dividend (together under our proposal with any discount) and that the election would not apply to preferred stock that is participating or which participates in corporate growth to a significant extent, it is not clear why the election should be overly restrictive.

B. Common Stock and Participating Preferred Stock

We believe that for common stock and participating preferred stock and for purposes of determining whether a company is a PFIC consideration should be given to permitting United States shareholders to rely on financial statements. Our proposal would be that if an issuer maintains audited financial statements under either United States GAAP or IFRS (the "Financial Statements") then such statements can be used for purposes of the Income Test and Asset Test. Of course, United States federal income tax principles would continue to be

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[90] *See* 61 Fed. Reg. 67,752, 67,753-54 (Dec. 24, 1996) (preamble to proposed Treasury regulations).

used in determining what income and assets are passive but the starting point can be the Financial Statements. As a practical matter, most investors will use the Financial Statements of the foreign corporation as the basis for determining whether this foreign corporation is a PFIC. Investors do not typically have access to any other information. In our experience representing both investors and foreign issuers, while one can ask questions to supplement the information shown on the financials, issuers are unlikely to have any historical data for determining asset basis that conforms to United States federal income tax principles.

Our first recommendation is that the Financial Statements of a foreign corporation can be used as the basis for making the determination of whether such corporation is a PFIC. What this would mean, for example, is that if the Service were to adopt a more liberal test for working capital, then the Financial Statements categorization of an amount as "working capital" could be used. Also, the amounts reflected on the Financial Statements as the values for plant and equipment could be used. In addition, the income reflected on the Financial Statements would be the income that is to be analyzed as active or passive. For example, interest income that is shown on the Financial Statements would need to be evaluated under United States federal income tax principles to determine whether it is active (*e.g.*, derived from a banking business or the earnings on working capital) but the actual determination of the amount of the interest income (*e.g.*, whether it was determined consistently with section 1271 *et seq.*) would not have to be analyzed. If the issuer uses mark-to-market accounting, the resulting income would be used without the need to determine whether the issuer would have qualified for such treatment under section 475 if it were a United States taxpayer.

Our next recommendation would be that the pro rata share of the income of the PFIC that would be included in a holder's income under the QEF election would be based on the

Financial Statements. A majority of our Executive Committee believes that such an election should be limited to shareholders who own less than a certain percentage of the PFIC's stock (for example, the five percent limitation in the Proposed Preferred Regulations). The theory for this limitation would be that shareholders with more significant ownership may be able to cause the PFIC to provide the information required under the current QEF regime.

Under this approach, an eligible United States shareholder would compute its income inclusion based on the earnings per share as derived from such Financial Statements. We recognize that permitting United States taxpayers to base income inclusions on accounting principles is a major departure from the general principles of United States federal income taxation. For that reason, we have spent considerable time weighing the merits of this recommendation. The advantage of the Financial Statements approach is that it is easier to apply for both the holder and the issuer. The Service can also require issuers to make certain information available regarding how the income was determined and the principles that were applied. For example, we would recommend that an issuer make available information regarding which entities were consolidated, which entities were not and any information that it might have regarding unconsolidated entities. In the case of the consolidated entities a separate QEF election would not have to be made but instead such entity would be covered by the QEF election of the "parent" entity since its financial results are included in the Financial Statements. We would also recommend that information be provided if income is computed on a mark-to-market basis (if not otherwise disclosed in the Financial Statements). In that case, the issuer would be treated as if it had made a mark-to-market election and capital gain treatment would not be available for the gains with respect to the assets that are marked-to-market. The issuer could also be asked to furnish other information that may be helpful in obtaining more reliable

earnings calculation but such information would be based on the issuer's financial records which should make such requirements easier to comply with. We would also recommend that an election once made can only be revoked with the consent of the Commissioner or if the holder elects to make a mark-to-market election under section 1296.

The first disadvantage of the Financial Statements approach is that it is a significant departure from United States federal income tax principles. The second is whether such an election would permit a United States shareholder in a PFIC to game the system. We believe that the departure from traditional principles is justified in this case.[91] The QEF inclusion regime itself departs from traditional principles by imposing an accrual regime with respect to income from stock. The proposed regime for preferred stock of Proposed Treasury Regulations § 1.1293-2 also departs from traditional principles. Both represent reasonable methods to implement a complicated regime. With respect to potential gaming of the system, we believe that requiring the election to use the Financial Statements to be revocable only as set forth above would provide a safeguard. Requiring the use of the accounting method used by the issuer is also potentially a safeguard. If mark-to-market were used in determining the issuer's income, it may produce losses in a year such as 2008, but could accelerate gain in other years. Similarly, the financial reporting principles of consolidation could result in over- and under-inclusions. There would also be no flow-through of capital gain in that case.

[91] Treasury regulations have permitted the use of Financial Statements in other areas. For example, Treasury Regulations § 1.475(a)-4 permits a taxpayer that is subject to section 475 to use the values of positions reported on certain Financial Statements as the FMV of such positions for purposes of section 475. The Treasury regulations that define what constitutes a United States real property holding company for purposes of section 897 generally provide that a corporation's real estate assets shall be presumed to be less than 50 percent of the aggregate assets of the corporation if the book value of the corporation's real property assets is 25 percent or less of the aggregate assets of the corporation. For these purposes "book value" is based on the financial accounting records of the company if the book value is determined in accordance with United States GAAP. *See* Treas. Regs. § 1.897-2(b)(2)(ii). We acknowledge that this is a 25 percent haircut, but we believe that it is a lot easier for a United States entity to obtain an appraisal if this haircut is disadvantageous than it would be for a non-controlling United States person to obtain information from a foreign issuer.

C. Option Holders

Under current law, a holder of shares acquired upon exercise of options has to compute the excess inclusion tax for the period that he or she held the option, notwithstanding that no QEF election is permitted for a United States holder of an option to acquire stock of a PFIC. As a result, a holder of stock acquired upon exercise of an option ("Optioned Stock") may have to pay tax in excess of its economic gain.[92] Such a result is not warranted. There are a number of potential solutions to ameliorate this problem, which are discussed below.

Under the proposed Treasury regulations relating to the excess inclusion regime, a United States person that holds an option to acquire PFIC stock will be treated as owning PFIC stock.[93] The proposed Treasury regulations further provide that the exercise of the option is not treated as a disposition that triggers the excess inclusion tax.[94]

The Treasury regulations relating to the QEF election provide that a United States holder of an option to acquire stock of a PFIC may not make a QEF election.[95] This principle was motivated by the difficulties that would be encountered in determining how to compute the QEF inclusions for option holders.[96] Responding to a request to formulate suggestions for administratively feasible mechanisms, the 2001 Report proposed that an option holder be permitted to make a QEF election.[97]

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[92] Tax in excess of economic gain can result because of the interest.

[93] *See* Prop. Treas. Regs. § 1.1291-1(d).

[94] *Id.*

[95] *See* Treas. Regs. § 1.1295-1(d)(5).

[96] *See* T.D. 8750, 1998-1 C.B. 562 (preamble to temporary Treasury regulations).

[97] *See 2001 Report*, *supra* note 3, at 2239-41.

As more fully explained and illustrated in the 2001 Report, an option holder would apply the existing QEF regime as if the option holder had exercised the option. Generally, to compute its pro rata share of the PFIC's ordinary income and capital gain, the option holder would assume that it 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 its options. Any other outstanding options held by other persons would not be treated as outstanding shares (and actual stockholders would determine their QEF inclusions without regard to option holders, whether electing or not). In order to allow a more precise computation of the QEF inclusion, the option holder could reduce his or her annual QEF inclusion so determined by the distributions actually made during that year on the stock for which the option is exercisable (to the extent made out of the year's current E&P). This adjustment should not apply if the option holder received an anti-dilution adjustment (including an exercise price adjustment) to compensate for the distribution.

As suggested in the 2001 Report, the QEF election on options would carry over to shares received upon an exercise of such options and to any subsequently acquired options to acquire shares of the same foreign corporation, as well as to shares of the same foreign corporation for which no ordinary QEF election was made by the shareholder/option holder. We do not favor a carryover of a QEF election on shares to options to acquire shares of the same corporation.

We continue to believe that the QEF election proposal for option holders as developed in the 2001 Report should be adopted.

Alternatively, a United States person holding options to acquire shares of a PFIC could be subject to a light version of the excess inclusion regime. Upon the receipt of an excess

distribution from the PFIC after the option has been exercised, the United States person would still have to include the excess distribution as ordinary income ratably to each day in its combined holding period of the options and the shares. The amount of such income allocated to any taxable year prior to the taxable year of the excess distribution would still be subject to tax as ordinary income on the highest rate in effect for such taxable year. Unlike the current excess inclusion rules, no interest would increase the amount of tax due by the United States person on his or her excess distribution. A related approach that could either be an alternative or an added option for the taxpayer would be to permit a taxpayer to make a purging election upon exercise of the option. The gain that would be generated would be ordinary but there would be no interest charge. In order to qualify for either of these alternatives, the options would have to meet certain criteria. Essentially the option could not be in the money at the time that it was acquired by the taxpayer. Standards similar to those used for purposes of consolidation in section 1504 and the S-corporation rules could be adopted.[98] Waiving the interest charge is justified by the difficulties inherent in making a QEF election with respect to an option. The interest charge is a penalty for not complying with the United States federal income tax principles. In the case of options that meet the suggested standards, it is both fair and administratively efficient to waive the interest charge. When options are used for good economic reasons, there is no reason for the tax law to disfavor options.

Another possible alternative to eliminate the inconsistency relating to options under the PFIC regime, would be to allow option holders to make a mark-to-market election. One alternative is that this mark-to-market election would only be possible for United States

[98] *See* Treas. Regs. §§ 1.1504-4(b) and 1.1361-1(b)(4). The option rules of section 382 may be less useful because of the procedures involved in determining ownership changes.

persons that own marketable options on stock of a PFIC. The mark-to-market rules applicable to stock would then generally also apply to the options. Once a United States person elected to mark-to-market its options, such election should also apply to any subsequently acquired option to acquire shares of the same foreign corporation, as well as to shares acquired upon exercise of the options or in the market. If the options are not traded but the Optioned Stock is, the Service and the Treasury should consider whether an election could be allowed under which a holder of an option would base the mark-to-market income inclusions on the difference between the value of the Optioned Stock and the exercise price of the option. Although at any point in time there may be a separate option value, such an election places the option holder in approximately the same position it would be in if it had exercised the option.

The Service and the Treasury should also consider adding to the Treasury regulations a definition of options for purposes of the PFIC regime. In section 1298(a)(4), Congress authorized the Service and the Treasury to address what types of options to acquire stock should be treated as PFIC stock for purposes of the PFIC regime. So far, the Service and the Treasury have not used this authority. As we already addressed in our 2001 Report, we believe that compensatory options should not be treated as PFIC stock.[99] The Service and the Treasury have excluded compensatory options from the concept of options as used in certain other areas of the United States federal income tax law.[100]

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[99] *See 2001 Report*, *supra* note 3, at 2241-42.

[100] Under the Treasury regulations promulgated under section 382, certain option holders are treated as constructively holding the underlying stock, but holders of compensatory options are excluded. *See* section 382(l)(3)(A)(iv) and Treas. Regs. § 1.382-4(d)(2) and (d)(7)(iii). Similarly, in the S corporation rules, in-the-money call options are classified as a second class of stock, but here again, an exception is made for compensatory stock options. *See* Treas. Regs. § 1.1361-1(l)(4)(iii)(A) and (l)(4)(iii)(B)(2). Finally, under Treasury Regulations § 1.1504-4(d)(2)(v) compensatory options are not treated as options.

Even if the Service and the Treasury are concerned that (i) compensatory options present the same opportunities for tax deferral as non-compensatory options or (ii) compensatory options in a PFIC are more likely to be a passive investment than compensatory options in an active corporation, we believe that such arguments are moot. First, Congress has decided to apply specific tax rules dictating the timing and character of gains for employees receiving compensatory options and deductions for their employers. Second, we do not believe that the treatment of a holder of compensatory options should be different based on whether the employee performed his or her services for a PFIC or an active corporation.