Opting Out of PFIC Tax-and-Interest Treatment: Making QEF Elections on Form 8621 Part II

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What is a PFIC?

A foreign corporation where, in any taxable year:

- 75% or more of the gross income of such corporation is "passive income," or
- 50% of more of the gross assets of such corporation are "passive assets," meaning assets that produce, or are held for the production of, passive income.
  - For gross basis for asset test, see Notice 88-22, 1988-1 C.B. 489 ("**Notice 88-22**").
- As discussed below in detail, always consider the various "look-though" rules in making this determination.

PFIC / CFC Overlap – IRC 1297(d)

- If a foreign corporation is both a PFIC and CFC, 10% U.S. shareholders are taxed under CFC rules, not the PFIC rules.
- The PFIC rules can still apply to U.S. persons that hold less than 10% of the foreign corporation.

Income Test

What is "Passive Income"

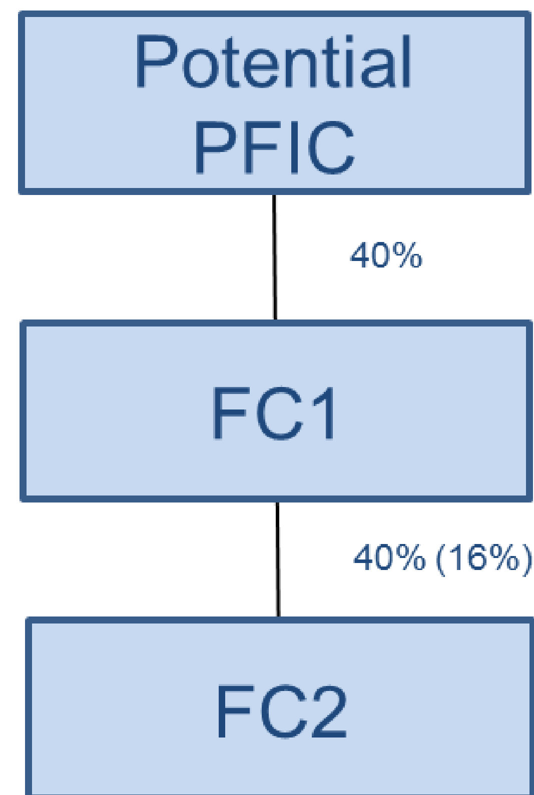
- Defined by reference to FPHCI. IRC 954(c).
- Generally includes:
    - (A) dividends, interest, royalties, rents, and annuities, other than certain active rents and royalties derived from unrelated persons; and
    - (B) gain from the sale of property the give rise to income described in (A).
- Active banking exception.
- Lack of clarity with regard to "active financing" exception in 954(h) (which references 954(c)(1)).

Asset Test

- Based upon the average gross assets (value or basis) at the end of each quarter of the corporation's taxable year.
- Assets valued based either on its FMV (required for public companies) or its adjusted basis (by election for non-public companies, except CFCs).
- Assets are passive if they have generated, or are reasonably expected to generate in the reasonably foreseeable future, passive income.
- Depreciable property used in an active business typically active.
- Intangible assets classified either (i) based upon the nature of the income they produce (e.g., a patent or license) or (ii) in the case of goodwill the nature of the income producing activity it is associated with.
- Cash, even working capital, is always passive.
- Subject to the related-party look through rules discussed below, stock and debt are typically passive assets as they produce passive income.
- No guidance for short years.

25% Subsidiary Look-Through Rule

- If a foreign corporation owns (directly or indirectly) 25% (by value) or more of a subsidiary corporation it is treated as owning/receiving its proportionate share of such subsidiary's income/assets. IRC 1297(c).
- The stock of a look-through subsidiary is ignored for the asset test.
- There is a lack of clarity applying the rule in a chain of ownership (top-down or bottom-up), though the language of the Code seems to suggest top-down as does Notice 88-22.
- Application to partnership interests unclear.



Related Party Look-Through Rules

- Interest, dividends, rents, or royalties received or accrued from a "related person" are not passive income if allocable to active income of such related person. IRC 1297(b)(2)(C).
- Relatedness tested by "control test" of IRC 954(d)(3), for example:
    - Two corps are related if same the same person or persons, directly or indirectly, own stock with (a) more than 50% of the total voting power of all classes of stock entitled to vote <u>or</u> (b) more than 50% of the total value of stock of such corporation.
    - Constructive ownership rules apply
- The asset test treatment of the stock or debt that gives rise to "related-party" interest or dividends follows the treatment of such income.

Annual Determination of PFIC Status

- PFIC status must be determined each year.
- A foreign corporation may be a PFIC one year despite not previously being a PFIC.
- Once treated as PFIC in one taxable year, interests (whether held directly or indirectly) of the corporation will be treated as interests in a PFIC indefinitely, absent a "purging election." IRC 1298(b)(1).
    - i.e., once a PFIC, always a PFIC.

Who Owns Interests in a PFIC?

- Attribution rules apply to treat U.S. persons that do not directly own stock of a PFIC as owning stock of such PFIC. E.g., a person that:
  - owns interests in a foreign partnership is considered to own proportionately any stock owned by the partnership.
  - directly or indirectly owns 50% or more in value of the stock of a non-PFIC foreign corp is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the corp.
  - directly or indirectly owns any stock of a PFIC is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the PFIC.
- The attribution rules are applied successively in a chain of ownership.
- A U.S. person treated as indirectly owning a PFIC under the attribution rules is generally treated as a shareholder of the PFIC for all purposes of the PFIC rules.

Issues Raised by Indirect Ownership

- Indirect ownership of a PFIC is relevant with respect to which parties can make certain elections (i.e., "QEF" as discussed below).
- Multiple PFICs can be owned indirectly.
    - Tiered QEFs

Tax Consequences of PFIC Status

- Subject the ability of stockholders' of PFICs to make certain elections triggering the current realization of income (QEF & MTM), U.S. persons treated as owning stock of PFIC are not subject to tax until:
  - Their interest in the PFIC is (directly or indirectly) disposed of, or
  - They receive (directly or indirectly) a distribution from the PFIC.

PFIC Distributions—"Excess Distributions"

- If a distribution from a PFIC is characterized as an "excess distribution" it will be subject to current tax. IRC 1291.
- Generally taxable at ordinary income rates.
- Need not be supported by current or accumulated E&P.
- Portion of a distribution that is the "excess distribution" is excess of total distributions for the current year over 125% of the average distributions for the last three years.
    - The other portion is taxed under ordinary foreign corp. rules.
    - Applies to liquidating distributions as well.
- PFICs do not pay qualified dividends (even on non-excess distributions)

Taxation of Excess Distributions—IRC 1291

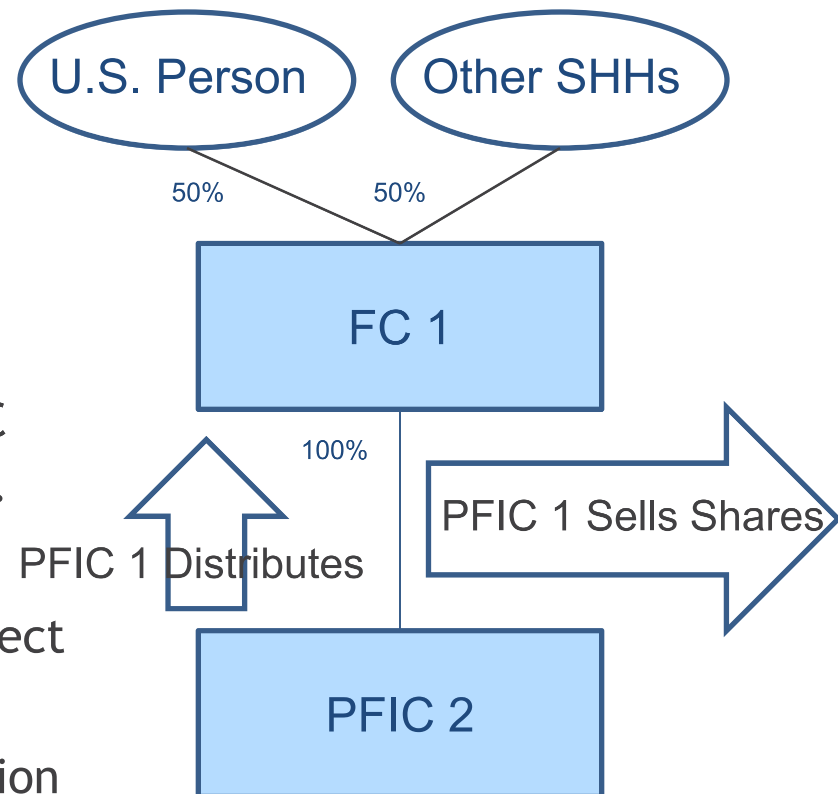
- The "excess distribution" is allocated ratably to each day of the U.S. person's (entire) holding period of the PFIC stock.
  - Portion allocated to (1) current year and (2) pre-PFIC years = taxable as current year ordinary income (rates currently 43.4% for individuals, 35% for corps).
  - Portion allocated to prior years during which the entity was a PFIC are taxed at the highest rate applicable to that year is subject to an "interest charge."

Taxation of Dispositions of PFIC Stock

- Capital gain treatment is not available.
- Instead, the gain from the disposition is treated as an excess distribution and is subject to the rules discussed previously.

Indirect Distributions & Dispositions

- A U.S. person that is treated as indirectly holding shares of a PFIC through the attribution rules previously discussed is treated as was the party:
  - directly selling shares of a PFIC when sold by an intermediate holder.
  - directly receiving distribs. from a PFIC when made to an intermediate holder.
- Disposition of interests in an intermediate entity (i.e., FC 1) is also treated as an indirect disposition o f a PFIC (PFIC 2).
- Taxed like a directly disposition or distribution (pro rata share of gain), but with basis adjustment.



Reporting – Form 8621

- HIRE Act (2010) added new PFIC annual reporting rules.
- Requires annual filing of Form 8621, which supplies information about the PFIC investment, including:
    - Share information (class, acq. date, number, etc.),
    - Value of the investment, and
    - Type of PFIC (i.e., are QEF or MTM elections made).
- Also includes information about annual QEF & MTM inclusions as well as elections to defer current QEF inclusions and "excess distribution" inclusions from the disposition of PFIC stock and distributions from PFICs.

The QEF Election – a Summary

The qualified electing fund ("QEF") election turns a PFIC into a modified flow-through entity for the shareholder.

<u>Advantages</u>*:

- Avoids interest charge and excess distribution rules
- Allows recognition of capital gain on sale of PFIC stock
- Flows through capital gain recognized by the PFIC

<u>Disadvantages</u>:

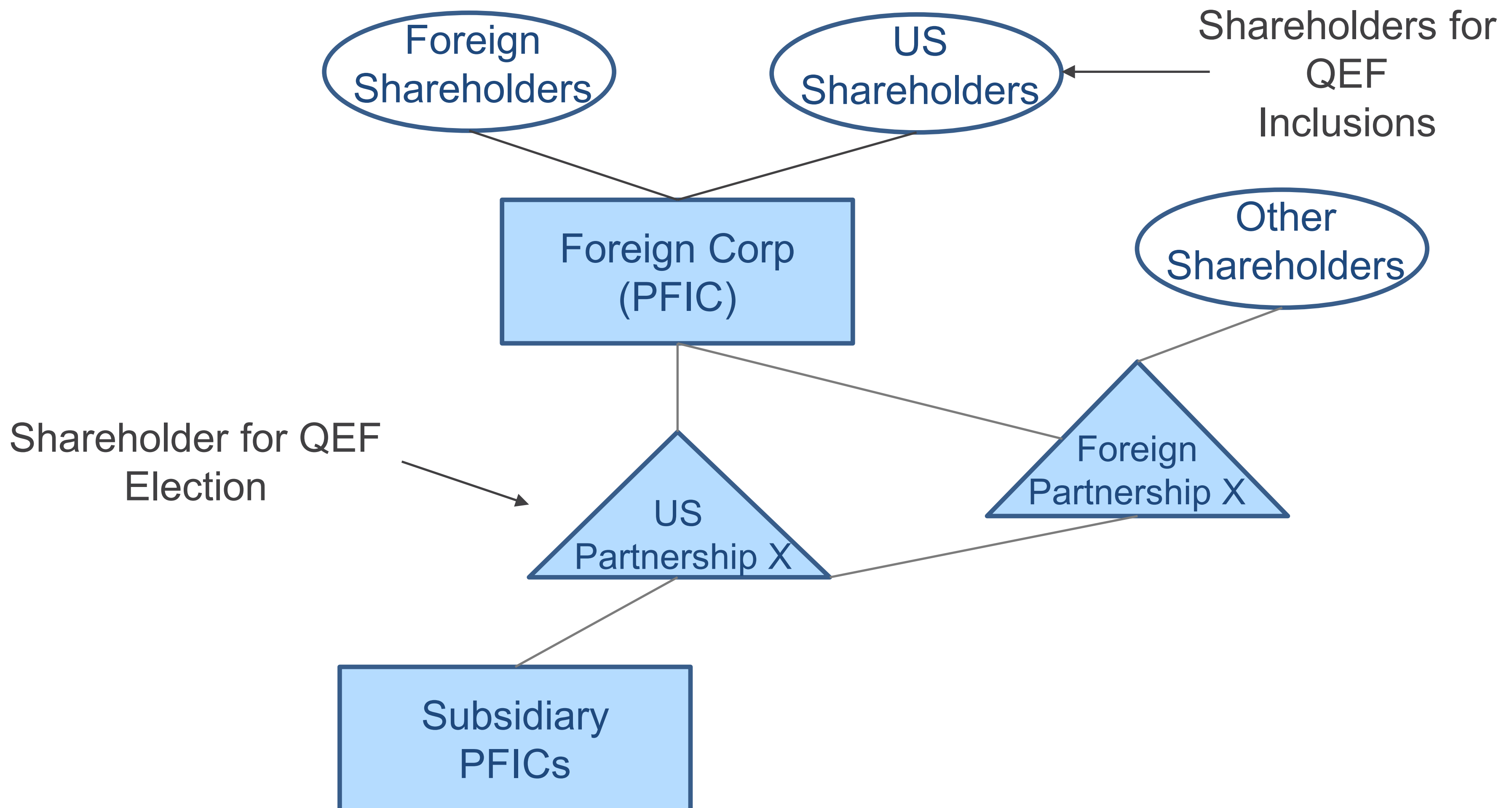
- Current taxation on income, whether or not distributed
- Corporation and shareholder must comply with information reporting for flow-through (i.e., QEF information statement)

**These advantages assume QEF election is made timely with respect to first date of ownership of the PFIC stock.*

Electing Shareholders

- QEF Election is made by any US Person that is a PFIC shareholder. This includes:
    - US taxpayers that own PFIC stock directly
    - US taxpayers that own PFIC stock indirectly through foreign entities, such as foreign partnerships, foreign trusts /estates, or foreign corporations
- US flow-through entities, such as US partnerships and non-grantor trusts, are themselves considered to be PFIC shareholders for purposes of making the QEF election

Domestic Partnership as a PFIC Shareholder-PLR 200838003



Requirements for QEF election

- The election is made by the shareholder by attaching Form 8621 to a timely filed US tax return for the taxable year for which the election is made.
- QEF Election requires the PFIC to provide the shareholder with sufficient information on an annual basis to calculate the impact of the election ("annual PFIC information statement").
- PFIC alternatively may permit the shareholder to review its books and records as necessary to determine and verify its share of PFIC earnings and net capital gain for each year.

Effect of QEF Election

- When election is made, shareholder is required to include its pro rata share of QEF's ordinary earnings and net long-term capital gain for the year.
    - Net loss does not flow through or reduce an inclusion in a later year.
    - Capital gains remain eligible for rate preferences
    - Actual distributions of previously taxed amounts are tax-free.
    - Stock basis is adjusted to reflect previously taxed amounts
- Unless QEF shareholder is a US C corporation with >=10% of voting stock, taxes imposed on the PFIC at the corporate level are not creditable by the shareholder.

Section 1294 Tax Deferral Rules

- A QEF shareholder may elect to defer paying tax on the QEF undistributed earnings tax liability until actual distributions are received.
- Deferred tax is subject to normal underpayment interest and IRS may require a bond.
- Transfers of PFIC stock, loans from the PFIC or pledges of PFIC stock, etc., accelerate the deferred tax liability.

Numerical Example of QEF Inclusions

	Shareholder's Pro Rata Share Long-term Capital Gain / (Loss)	Ordinary Income	Total QEF Inclusions
Year 1	$50	$25	$75
Year 2	($75)	$30	$0
Year 3	$25	$30	$55
			$130

Shareholder will have included $75 of long-term capital gain and $55 of ordinary income from the QEF over the three-year period.

Interaction with Section 1291

- “Pedigreed QEF.” A US shareholder that has made a valid QEF election for the shareholder’s entire holding period for the stock will not be subject to Section 1291 fund rules. IRC 1291(d).
- Non-Pedigreed QEFs. By contrast, if QEF election is made for a year after the shareholder’s first date of ownership of the PFIC stock, both Section 1291 and QEF rules apply at the same time.
  - Gain from sale of stock is ordinary
  - Interest charge and excess distribution rules apply
  - QEF inclusions for all years, not just years in which corporation is a PFIC under the asset test or income test (Cf. Reg. 1.1295-1(c)(2)(v), Example 1).

Purging Elections

- Shareholder wishing to make a QEF election after the first year of PFIC holding period may elect to eliminate the PFIC taint through a purging election:
    - Deemed sale elections
    - Deemed dividend elections for a PFIC that is also a CFC
- Shareholder includes the gain on deemed sale, or the deemed dividend out of post-1986 E&P, as an excess distribution for year of election.
- In the future, the PFIC is considered to be a pedigreed QEF.

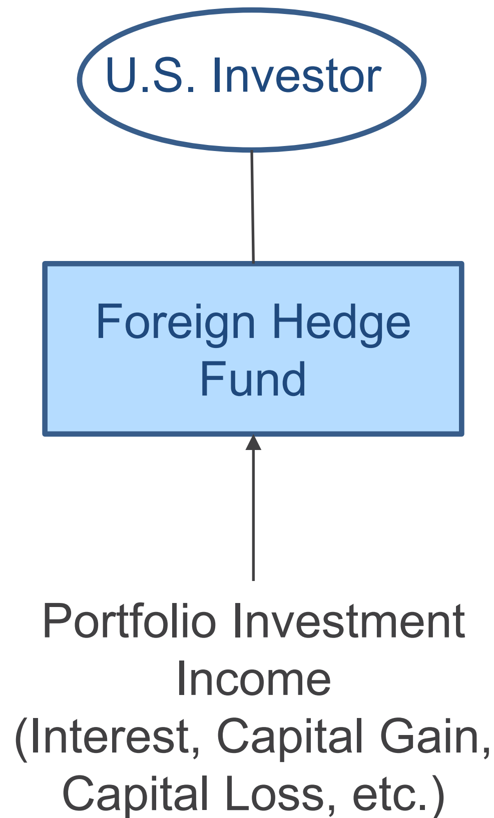
Late Filing Relief – Protective Statement

- If a shareholder acquires stock in a corporation and has a reasonable belief that it is not a PFIC, the shareholder file a "protective" QEF election.
- Protective election also requires shareholder to include with its tax return:
    - Statement as to why the shareholder reosanably believes corporation is not a PFIC
    - Consent to extend statute of limitations for PFIC related taxes for all taxable years for which the QEF election could apply

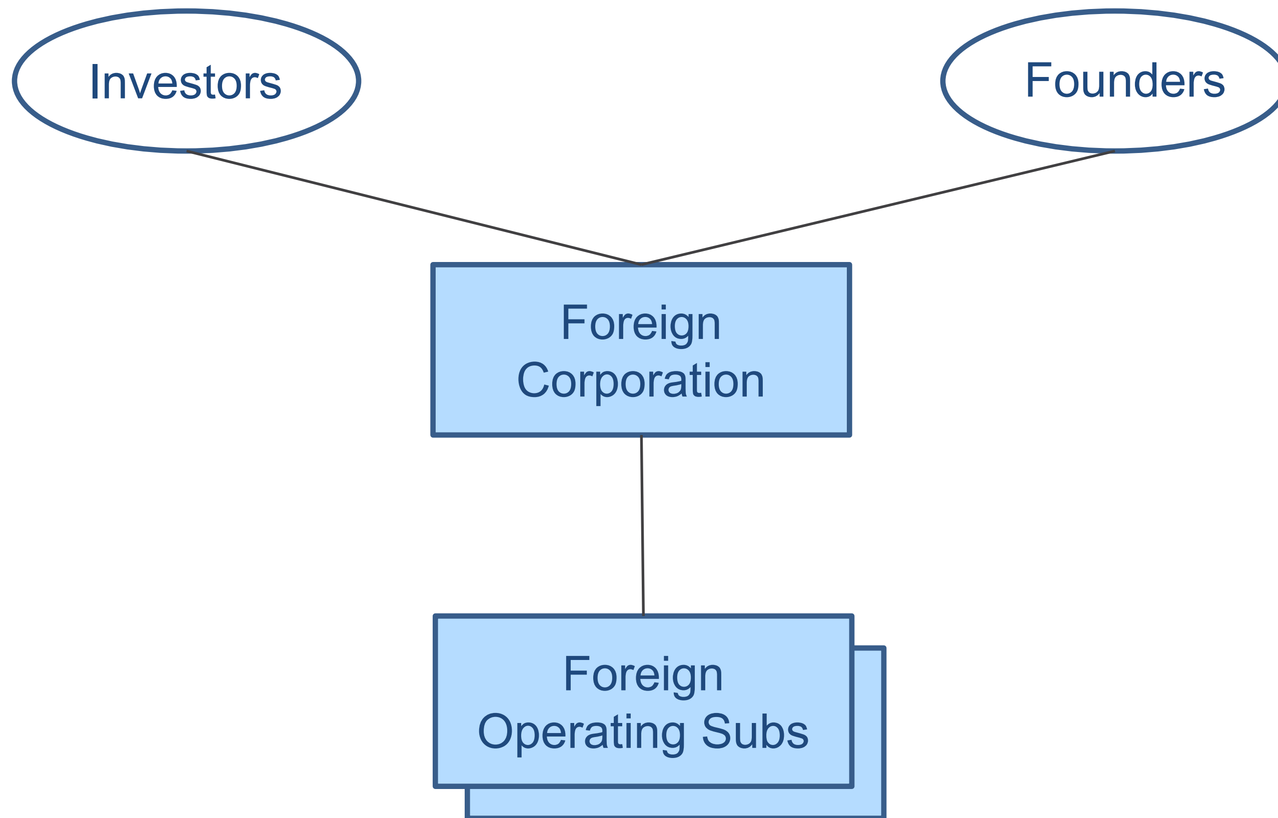
Late Filing Relief – IRS Consent

- Taxpayer can also apply to obtain relief to make a retroactive QEF election from the IRS by private letter ruling.
- Taxpayer must demonstrate reasonable cause through reasonable reliance on the advice of a qualified tax professional
- No prejudice to the government from granting the election (i.e., no reduction in tax liability for the years affected by the election)
- Consent is sought before the IRS raises the PFIC issue on audit of the shareholder.

Example of a QEF Election: Offshore Investment Fund



Example of a QEF Election: Foreign-Based Entrepreneurial Venture



Mark to Market Election – IRC 1296

- Who can elect MTM treatment?
  - A U.S. person that owns (cf. QEF election):
    - directly, or
    - through a foreign partnership, trust or estate,
  - shares in a PFIC that are "marketable."
  - A controlled foreign corporation (a "**CFC**"). Treated as a U.S. person for this purpose.
- The election must be made by checking a box in Part II of Form 8621 for the first year the entity is a PFIC (avoids "unpedigreed").
- It applies to the taxable year in which it is made, and all future years, unless the stock is not marketable or is required to be MTM by another Code provision, or IRS consents to a revocation.

MTM Election – "Marketable Stock"

- Generally, this is any stock "regularly traded" on a "qualified exchange" (a "**QE**") or other market.
- Stock is Regularly Traded
  - if its is traded, other than in *de minimis* quantities, on at least 15 days during each quarter.
  - Special rules for the year of IPO and anti-abuse rules.
- QE or Other Market includes
  - A national securities exchange that is registered with the SEC or established Under §11A of the Sec. Exch. Act of 1934.
    - https://www.sec.gov/divisions/marketreg/mrexchanges.shtml
  - Foreign exchange supervised by governmental authorities and utilizing certain anti-fraud policies and other policies, rules and laws facilitating open trading.

MTM Election – Taxation (1 of 2)

- Generally, a holder is required to mark their shares to market annually.
- This means an annual:
  - inclusion of ordinary income to the extent the FMV of the stock at the end of the year exceeds the adjusted basis in the stock (per applicable basis adjustments, the prior year's FMV), or
  - an ordinary deduction to the extent the adjusted basis of the stock exceeds the FMV at the end of the, but only to the extent that amount is less than "unreversed inclusions."
- **Unreversed Inclusion** = the amount by which, if any, the shareholder's included MTM gains for prior years exceed the shareholder's MTM losses realized for prior years.

MTM Election – Taxation (2 of 2)

- Basis Adjustments:
  - When a stockholder realizes either an annual MTM gain or loss, they adjust their basis in the shares through which they hold the PFIC by the amount of such gain or loss (increase for gain, decrease for loss), such that the ending basis is always equal to the FMV of the shares.
- In the case of **indirect ownership** (through a foreign partnership, estate or trust), basis adjustments will be made to:
  - (1) the shares held by the intermediate entity (but only with regard to future tax treatment of the electing holders—similar to an IRC 734(b) or 743(b) adjustment), and
  - (2) the shares held directly by the electing holder (for all purposes).

MTM Election – Disposition of MTM Stock

- Any gain realized is ordinary.
- As is any loss. However, losses are only allowed to the extent of prior unreversed inclusions.
- Indirect Dispositions
    - If a U.S. persons owns stock in a PFIC through an intermediate tax-transparent entity and either:
        - the tax-transparent intermediary disposes of the stock, or
        - the U.S. person disposes of the interest in the tax-transparent entity through which it holds the PFIC,
    - this is treated as a disposition of the PFIC stock. IRC 1296(g)(2).

MTM Election – Unpedigreed 1296 Funds

- This concept applies when:
  - An eligible U.S. person makes an MTM with respect to shares in a PFIC, **BUT**
    - the election was not made with respect to the foreign corp. in the first year it was a PFIC,
    - and a QEF election was not made for the foreign company in the first year it was a PFIC.
- In short, this applies when a MTM election is made with respect to a PFIC for that has previously been subject to the excess distribution regime of IRC 1291.

MTM Election – Unpedigreed 1296 Funds

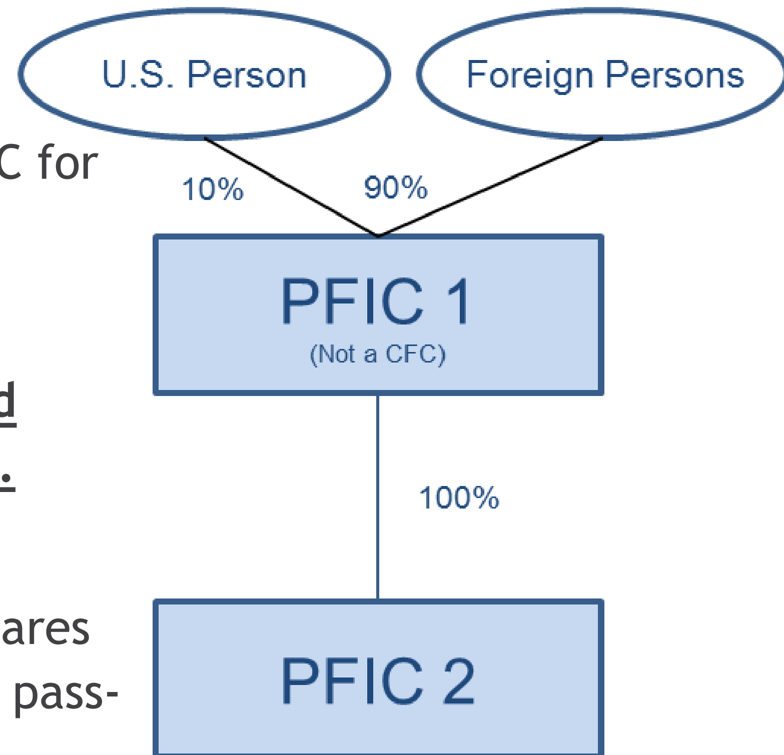
- What is the effect of making a MTM on an unpedigreed fund?
- The MTM election is still permitted.
- In the first year the election is effective, distributions from and dispositions of the PFIC are subject to the excess distribution regime (IRC 1291).
- At EOY, for the year of the election, any gain inherent in the stock that would otherwise be an ordinary MTM inclusion is treated as an excess distribution, subject to tax in that year under the applicable rules (with a corresponding upwards basis adjustment in the amount of the gain).
- After that point, MTM rules apply as usually.
- This is a similar effect to the purging elections previously discussed.

MTM Election – Interaction with QEF

- If a person that had previously made a QEF election with respect to a PFIC makes a MTM (note inconsistencies in eligibility), the QEF election automatically terminates (as of the end of the year before the year of the MTM election).

QEF v. MTM – Differentiating Results

- Eligibility to Make the Election
- QEF
  - Can be made with respect to any PFIC for which shares are deemed owned.
  - Can be made for both PFIC 1 & 2.
  - **The entity must supply the required information to allow QEF inclusions.**
- MTM
  - Can only be made with respect to shares owned directly (or through a foreign pass-though entity) if marketable
  - Can be made only for PFIC 1 (if marketable).
  - Corp need not provide any information.



QEF v. MTM – Differentiating Results

- Timing of inclusion
- QEF
    - Annual inclusion of pro rata share of ordinary earnings and net capital gain of QEF.
    - An election is available to defer the inclusions (subject to interest charge. IRC 1294.
- MTM
    - Annual inclusion that cannot be deferred.

QEF v. MTM – Differentiating Results

- Pass-through of Losses
- QEF
    - Losses never flow through.
- MTM
    - Current losses can be realized, but only to the extent of previously included gains that have not otherwise been offset by prior losses. In short, no loss, in absolute terms with regard to the initial investment can be passed through.

QEF v. MTM – Differentiating Results

- Character of Income
- QEF
  - A portion of current inclusions, as applicable, are taxed at capital gain rates (23.8% for long-term capital gains for individuals, while corps are taxed at 35% on all income).
  - Gain or loss on the disposition of interests is a taxed at capital gain rates. Capital losses generally can offset only capital gains.
- MTM
  - Any losses that can be realized are ordinary.
  - Any gain on a disposition is ordinary income (currently taxed a 43.4% for individuals).

PFIC Reporting Requirements

- Generally an annual filing of IRS Form 8621 is required for **each PFIC owned**.
- Who must report:
    - Generally the first U.S. person in a chain of ownership treated as a holder of PFIC stock under 1298.
    - For example, a domestic partnership is treated as a shareholder for information reporting purposes and can file on behalf of its members (unless those partner are receiving: excess distributions (by gain or sale), or are required to report the status of a 1294 (QEF deferral election)).
        - The domestic partnership can report for members receiving QEF or MTM inclusions. In the case of QEF, the pship must have made the election for its partners.

PFIC Reporting Requirements

Exceptions

- *De Minimis* Holdings Exception to reporting:
    - *De minimis* aggregate PFIC Holdings of a 1291 (ex. distrib.) fund
        - If the value of all PFIC stock owned by a person, directly and indirectly, is less than $25,000, **OR**
        - The person owns an indirect interest worth less than $5,000.
    - So long as, in each case, no excess distribution is received in that year and no QEF election was made, no filing is required.
- Not required if the PFIC stock is marked to market under a section other than 1296. Notice 2014-51.

Information Required

- Stock information, applicable tax regime, relevant inclusions, etc.