

PASSIVE FOREIGN INVESTMENT COMPANIES¹

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I. INTRODUCTION

The passive foreign investment company ("PFIC") provisions were added by the Tax Reform Act of 1986 (the "1986 Act").² Outlined below in Section II are the basic operative rules of current law.³ Section III outlines the Bluebook⁴ clarifications and proposed technical corrections⁵ relating to the PFIC provisions. Section IV includes some ideas for avoiding PFIC status, living with PFIC status, and affirmatively using PFIC status in tax planning.

II. 1986 LEGISLATION

A. Background

1. *Legislative History.* The PFIC provisions in §§ 1291 through 1296 of the

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² Pub. L. 99-514, 100 Stat. 2085, 99th Cong., 2d Sess. (October 22, 1986).

³ For a thorough discussion of the PFIC provisions under current law, see K. Klein and N. Kaufman, *Passive Foreign Investment Companies*, 16 *Tax Management Int'l J.* 223 (1987).

⁴ Staff of the Joint Committee on Taxation, *General Description of the Tax Reform Act of 1986* (Comm. Print 1987) (hereinafter "Bluebook").

⁵ H.R. 2636 and S. 1350, 100th Cong., 1st Sess. (June 10, 1987) (hereinafter "Technical Corrections"). Technical Corrections is accompanied by a description prepared by the Staff of the Joint Committee on Taxation. Staff of the Joint Committee on Taxation, *Description of the Technical Corrections Act of 1987* (Comm. Print 1987) (hereinafter "Technical Corrections Description").

Code⁶ were intended to remove the economic benefit of tax deferral and the ability to convert ordinary income to capital gain which could be obtained under prior law by U.S. investors in foreign investment funds who were able to weave their way through the "pentapus;" that is, the accumulated earnings tax ("AET") (§§ 531-537); the personal holding company ("PHC") provisions (§§ 541-547); the controlled foreign corporation ("CFC") provisions (§§ 951-964 & 1248); the foreign personal holding company ("FPHC") provisions (§§ 551-558); and the foreign investment company ("FIC") provisions (§§ 1246-1247).

2. *ALI Proposals.* Many of the concepts which emerged in the 1986 Act as the PFIC provisions originated with proposals of the American Law Institute for current taxation of foreign investment company income to U.S. person shareholders, subject to a shareholder's election to defer tax with an interest charge. However, only corporations which were engaged, or held themselves out as being engaged, in trading stock, securities, or commodities would have been covered.

B. *Definition of Passive Foreign Investment Company*

1. *Definition.* A foreign corporation is a PFIC if, for any taxable year, either

a. 75% or more of its gross income consists of "passive income" (the "Income Test"), or

b. At least 50% of the average value of its assets produce, or are held to produce, passive income (the "Asset Test"). § 1296(a).

PFIC status is determined without regard to how much stock is owned (separately or in the aggregate) by U.S. persons. Regulations can treat separate classes of

⁶ Unless otherwise specified, all section references are to the Internal Revenue Code of 1986 ("Code") or the regulations thereunder.

stock or other interests in a foreign corporation as interests in separate corporations. § 1297(b)(4).

2. *Definition of Passive Income*

a. *In General.* Subject to certain exceptions, "passive income" generally includes most dividends; interest and its equivalents; passive royalties and rents; annuities; net gains from assets which produce such income and from non-income producing property; net gains from certain commodity transactions; and certain foreign currency gains. §§ 1296(b), 904(d)(2)(A), & 954(c).

b. *Exceptions.* Passive income does not include 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, to the extent provided in regulations, by any other corporation, or any income derived in the active conduct of an insurance business by a corporation which would be subject to tax under subchapter L if it were a domestic corporation. §§ 1296(b)(2).

c. *Breadth of Definition.* The typical foreign-incorporated fund investing in stocks, securities, or commodities would be a PFIC; however, many active businesses with substantial accumulated cash also could be classified as PFICs, even where the corporation is subject to high rates of foreign tax.

3. *The Look-Through Rule.* A foreign corporation is treated as holding directly its proportionate share of the assets of, and receiving directly its proportionate share of the income of, any corporation in which it owns at least 25% (by value) of the stock ("§ 1296(c) Look-Through Rule"). § 1296(c).

4. *Exceptions for Active Businesses*

a. A foreign corporation will not be treated as a PFIC for the first taxable year during which it has gross income if (i) no predecessor corporation (an undefined term) was a PFIC, (ii) the corporation can establish that it will not be a PFIC for either of the two succeeding taxable years, and (iii) the corporation is not in fact a PFIC for either of such two succeeding taxable years. § 1297(b)(2).

b. A foreign corporation will not be treated as a PFIC for any taxable year if (i) the corporation (and a predecessor) was not a PFIC in any prior taxable year, (ii) the corporation establishes that (a) substantially all of its passive income for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses, and (b) the corporation will not be a PFIC for either of the first two years following the taxable year, and (iii) the corporation is not in fact a PFIC during either of such two succeeding taxable years. § 1297(b)(3).

C. *Ownership of PFIC Stock*

1. *Attribution Rules.* In determining stock ownership, a U.S. person is considered to own his proportionate share of the stock of a PFIC owned by any foreign corporation of which the U.S. person owns 50% or more (by value) of the stock or owned by any partnership, trust, or estate of which the U.S. person is a partner or beneficiary. § 1297(a)(2)(A) & (3). If the U.S. person owns any stock of a PFIC, the person is considered to own his proportionate share of any PFIC stock owned by the upper-tier PFIC. § 1297(a)(2)(B). These rules apply successively, although, except to the extent to be provided in regulations, they do not apply to treat stock owned by a U.S. person as owned by any other person, U.S. or foreign. § 1297(a)(1) & (4). Regulations probably should permit reattribution in appropriate cases.

2. Anti-Avoidance Rules

a. *Continuing PFIC Taint.* Stock in a corporation is treated as stock in a PFIC if, at any time during the taxpayer's holding period for such stock, such corporation (or any predecessor) was a PFIC which was not a qualified electing fund (described below). § 1297(b)(1).

b. *Purging PFIC Taint.* If a PFIC ceases to meet the Income Test and Asset Test for PFIC status, the shareholder may make a mark-to-market election to recognize gain as if such stock were sold at fair market value on the last day of the last taxable year for which such corporation is a PFIC. §§ 1297(b)(1) & 1291(d)(2). The shareholder gets a step-up in basis and a new holding period. § 1291(d)(2)(B).

c. *Carryover Basis Transactions.* In the case of nonqualified funds, to the extent provided in regulations, stock in a foreign corporation, the basis of which is determined by reference to stock of a PFIC, will be treated as PFIC stock held by the shareholder throughout his holding period. §§ 1291(e) & 1246(c). The same principle would apply to other transfers (e.g., tax-free reorganizations).

d. *Trusts and Domestic Corporations.* In the case of nonqualified funds, to the extent provided in regulations, trust certificates of a grantor trust and stock of a domestic corporation will be treated as stock of a PFIC to the extent that such trust or corporation has an investment in PFIC stock. §§ 1291(e) & 1246(d).

D. *Treatment of U.S. Person Shareholders of PFICs*

1. *Policy Considerations.* The PFIC provisions make a major break with traditional U.S. tax policy by seeking to impose current tax, or a rough equivalent thereof, on the U.S. shareholders of a foreign corporation

without regard to whether U.S. persons control the company. There are basically two ways of doing so. First, by reference to the ALI proposals, deferral may be retained, but an interest charge attributable to the value of deferral may be imposed on the tax incurred on distributions and dispositions. Second, by reference to the CFC and FPIC provisions, the foreign corporation's earnings may be included in the shareholder's income currently. The Code chose to continue deferral, subject to an interest charge, with an election out of such regime in favor of current inclusion.

2. *In General.* Separate rules are established for two types of PFICs:

a. *Nonqualified Funds*, the U.S. person shareholders of which pay tax on amounts realized with respect to PFIC stock and an interest charge based on the value of deferral; and

b. *Qualified Electing Funds* ("QEFs"), the U.S. shareholders of which are required currently to include in gross income their pro rata share of the PFIC's earnings, with an election to defer the payment of tax, subject to an interest charge, on undistributed earnings.

3. *Nonqualified Funds.* If a U.S. person shareholder of a PFIC which is not a QEF receives an "excess distribution" from, or disposes of stock of, a PFIC, the amount of such excess distribution or gain recognized on such disposition is ratably allocated to each day of the shareholder's holding period of the stock. § 1291(a)(1)(A) & (2). The portion of an excess distribution or gain allocated to the period beginning with the first post-1986 taxable year for which the foreign corporation is a PFIC through the year preceding the year of the distribution or disposition ("PFIC years") is excluded from gross income, and the U.S. person's tax for the year is increased by the "deferred tax amount." § 1291(a)(1)(B) & (C). The portion allocated to pre-PFIC years and the year of the distribution or disposition is included in income as ordinary

income (and may be offset by other deductions). § 1291(a)(1)(B). Though the PFIC provisions generally apply to taxable years of foreign corporations beginning after December 31, 1986, the throw-back rules can taint distributions and gain attributable to pre-1987 earnings and result in an interest charge thereon.

a. The deferred tax amount is the sum of (1) the "aggregate increases in taxes" (i.e. the sum of the amounts determined by multiplying the amount of the excess distribution or gain allocated to any PFIC year by the highest rate of tax in effect for such taxable year (without regard to other income or expenses the investor may have) and (2) the "aggregate amount of interest" on such increases in taxes (i.e., the sum of the amounts determined for each such increase in tax for the period beginning on the due date for the return for such taxable year and ending on the due date of the taxable year with or within which the distribution or disposition occurs. § 1291(c).

b. An excess distribution is any distribution in respect of PFIC stock to the extent such distribution does not exceed its ratable portion of the "total excess distribution" for such taxable year. § 1291(b)(1). A "total excess distribution" is the aggregate amount of distributions received during the taxable year in excess of 125% of the average distributions received by the shareholder with respect to the stock during the three preceding taxable years. § 1291(b)(2)(A). The total excess distribution for the taxable year in which the shareholder's holding period begins is zero. § 1291(b)(2)(B). Application of the interest charge to excess distributions, as well as dispositions, prevents a foreign corporation from defusing the interest charge on dispositions by making distributions, while acknowledging that regular distributions of current earnings should not be subject

to an interest charge. § 1291(b)(2)(B). However, the determination of whether there has been an excess distribution apparently is made without regard to earnings and profits. A return of capital can constitute an excess distribution.

c. *Dispositions.* Regulations can be promulgated requiring gain to be recognized on otherwise nonrecognition transfers of stock in nonqualified funds. § 1291(f). Under regulations, if a U.S. person is treated as indirectly or constructively holding stock in a PFIC under the previously discussed attribution rules, any disposition which results in the U.S. person being no longer treated as owning PFIC stock is treated as a disposition of PFIC stock. § 1297(b)(5). A disposition includes the use of PFIC stock as security for a loan ("pledge rule"). § 1297(b)(6). The basis of PFIC stock acquired from a decedent determined under § 1014 (generally fair market value) is generally reduced by the excess of the basis determined under § 1014 over the adjusted basis of the stock immediately before the decedent's death. §§ 1291(e) & 1246(e).

d. *Foreign Tax Credit.* The indirect foreign tax credit does not apply to any dividend paid by a nonqualified fund. § 1291(a)(5).

4. *Qualified Electing Funds.* A U.S. person who owns, directly or indirectly, stock in a QEF is required currently to include in gross income the shareholder's pro rata share of the QEF's current earnings and profits as long-term capital gain, to the extent of the shareholder's pro rata share of the QEF's net capital gain (but not in excess of current earnings and profits), with the balance (referred to as "ordinary earnings") treated as ordinary income. § 1293(a) & (e). Generally, other characteristics of the PFIC's income, e.g., source, do not pass through to the shareholder. But see § 904(g). Under the

QEF rules, a year-end loss does not pass through to affect the shareholder's income.

a. *Distributions.* If it is established that any amount distributed by a PFIC was paid out of earnings and profits which were previously included in income under the QEF provisions, the amount distributed is not treated as a dividend. § 1293(c). Cf. § 959(d).

b. *Basis.* The basis of PFIC stock held by a U.S. person is increased by any amount which is included in the shareholder's income under the QEF provisions and is decreased by any amount distributed which is not includible in income by reason of having been previously taxed under the QEF rules. § 1293(d). Similar rules apply to adjust the basis of property on account of which a U.S. person is treated under the attribution rules as indirectly owning shares of a QEF. *Id.* These rules are similar to the rules in subpart F and result from the "leap-frog" approach to QEF inclusions.

c. *Dispositions.* If a PFIC makes a QEF election in its first PFIC year and maintains such election throughout the shareholder's holding period, any gain recognized by the shareholder on the disposition of the stock will not be subject to the interest charge rules. §§ 1291(d)(1)(B) & 1297(b)(1). If the QEF election were made in a year subsequent to the first PFIC year in the shareholder's holding period, gain recognized on a disposition of stock would be subject to the interest charge rules, unless the shareholder made a mark-to-market election for the year a QEF election was made to purge the PFIC taint. §§ 1291(d)(2) & 1297(b)(1).

d. *Foreign Tax Credit.* For purposes of the indirect foreign tax credit provisions of § 960, any amount included in gross income under the QEF rules will be treated as if it were

an inclusion under § 951(a) (relating to current inclusions in income of U.S. shareholders of CFCs), and any amount excluded from gross income on account of being previously taxed under the QEF rules will be treated in the same manner as amounts excluded from gross income under § 959. § 1293(f). QEF inclusions are included in the foreign tax credit limitation basket for passive income, and may be resourced under § 904(g). § 904(d)(2)(A)(ii) & (g).

e. *Making the QEF Election.* The QEF election is made for any taxable year at any time before the 15th day of the third month of the following taxable year. § 1295(b)(2). In order to make the election, a PFIC is required to comply with information requirements to be prescribed in regulations. § 1295(a). The QEF election is made only at the corporate level; shareholder consent is not required. Once made, the election applies to all subsequent taxable years for which the company is a PFIC unless revoked with consent of the Secretary. § 1295(b)(1). Transferees of QEF stock are subject to the current inclusion rules.

f. *Election to Defer Tax.* A U.S. person owning shares in a QEF may elect to extend the time for payment of tax on undistributed earnings of a QEF ("§ 1294 election"). § 1294(a)(1). The election may not be made for a taxable year if any amount is includible in gross income of the shareholder with respect to the QEF stock under the FPHC or CFC provisions for such year. § 1294(a)(2). Tax deferred under the election is subject to an interest charge. The extension granted under the § 1294 election terminates on the due date of the return for the taxable year in which an actual distribution is made of previously taxed earnings with respect to which the election was made. § 1294(c)(1)(A). When QEF stock is disposed of or a PFIC ceases to be a QEF, all extensions of time to

pay tax attributable to the stock disposed of (or in the case of a cessation, attributable to any stock of the corporation ceasing to be a QEF) which have not expired before the date of such disposition (or cessation) expire on the due date for filing the income tax return for the taxable year in which the disposition or cessation occurs. § 1294(c)(2).

E. *Interaction with Other Provisions*

1. *Controlled Foreign Corporations and Foreign Personal Holding Companies*

a. *Termination of Deferral for Operating Income.* Although directed to U.S. persons investing in foreign mutual funds, the PFIC provisions can apply to operating CFCs which accumulate earnings. The result in such instances is a termination of deferral of U.S. tax on the operating income of such corporations, either by imposition of the interest charge on certain distributions and on dispositions or by current inclusion of all of the earnings and profits of the PFIC under the QEF election.

b. *CFC/QEF Coordination.* Under § 951(f), if an amount is included in gross income of a U.S. shareholder under both §§ 1293 and 951(a)(1)(A)(i), then CFC (not QEF) rules apply. § 951(f). However, there is no coordination rule for other CFC inclusions (e.g., investments in United States property).

c. *CFC and FPHC/Nonqualified Funds Overlap.* There are currently no rules coordinating the rules for nonqualified funds and CFCs. Absent a technical correction, this apparent oversight could lead to particularly harsh results for U.S. shareholders of CFCs which do not elect to be QEFs. For example, the interest charge would apply to distributions of earnings previously taxed under the CFC provisions. The interest charge also would apply to all of the gain on a disposition of the stock of the

CFC. Similar problems exist for a U.S. person owning stock in a corporation which is both a FPHC and a PFIC.

2. AET and PHC. Neither the AET nor the PHC provisions apply to a PFIC. §§ 532(b) & 542(c).

III. AN UPDATE (BLUEBOOK, TECHNICAL CORRECTIONS, ETC.)

A. Definition of Passive Foreign Investment Company

1. Definition of Passive Income

a. *Bona fide banks.* The Bluebook states that regulations may provide circumstances in which income derived by a bank licensed to do business as a bank in the United States is not automatically excluded from passive income. Bluebook at 1025.

b. *Insurance Companies.* The Bluebook states that the income of a *bona fide* insurance company is treated as non-passive income only to the extent the income would be subject to tax under subchapter L if derived by a domestic insurance company. Bluebook at 1025. A statutory clarification would be added by Technical Corrections to achieve this result. Technical Corrections § 112(n) (16). Thus, an insurance company may derive passive income where its financial reserves are in excess of the reasonable needs of its insurance business. Technical Corrections Description at 209. The Bluebook also states that a captive insurance company may be a PFIC if there is no risk-shifting to the foreign entity such that the company is not an insurance company. Bluebook at 1025-26.

c. *Underwriters.* The Bluebook state states that *bona fide* underwriters of securities should be excluded from classification as PFICs both under the Asset Test (because the majority of their assets, particularly securities held for

sale to the public, are assets that do not give rise to passive income by virtue of the dealer exception in § 954(c)) and under the Income Test (because a substantial amount of their income is commission income, which is not passive income). Bluebook at 1025.

d. § 904(d)(3) & (5) Look-Through Rules. The Technical Corrections Description, in discussing present law, states that the definition of passive income, by incorporating the definition of such term for foreign tax credit limitation purposes, also incorporates the look-through rules contained in § 904(d)(3) & (5). Technical Corrections Description at 209. Thus, for example, interest received from a related person, e.g., a subsidiary (see § 954(d)(3)),⁷ none of the income of which is passive income, generally would not be passive income to the recipient.

e. Payments from Related Persons. Technical Corrections would amend § 1296(b)(1) to provide that dividends, interest, rents, and royalties received from related persons, which would not be passive income for foreign tax credit limitation purposes by virtue of the exception in § 954(c)(3), will constitute passive income for purposes of the PFIC provisions (unless treated as non-passive income under the § 904(d) look-through rules). Technical Corrections §112(n)(5); Technical Corrections Description at 212.

2. § 1296(c) Look-Through Rule

a. Application to Lower-Tier Corporations. The Bluebook clarifies that the look-through for 25%-owned corporations applies to direct or indirect 25%

⁷ Technical Corrections would also amend the definition of related person in § 954(d)(3) to require more than 50% direct, indirect, or constructive stock ownership (rather than 50% or more). Technical Corrections § 112(h)(14)(A).

ownership held by an upper-tier foreign corporation. Bluebook at 1026. This would be made explicit in Technical Corrections. Technical Corrections § 112(n)(2); Technical Corrections Description at 213.

b. *Attribution of Assets.* The Bluebook and the Technical Corrections Description clarify that interest and dividends received from 25%-owned corporations are eliminated from the shareholder's income in applying the Income Test, and the stock or debt investment is eliminated in applying the Asset Test. Bluebook at 1026; Technical Corrections Description at 210.

c. *Scope of Application.* Under Revenue Ruling 87-90, 1987-37 I.R.B. ___, the § 1296(c) look-through rule can apply to cause a manufacturing company which owns a PFIC subsidiary to be a PFIC.

d. *25%-owned U.S. Corporations.* Under the § 1296(c) look-through rule, if a foreign corporation owns at least 25% of the stock of a domestic corporation, stock held by the domestic corporation generally would be treated as a passive asset of the foreign corporation (barring application of the § 1296(c) look-through rule to the corporation the stock of which is held by the domestic corporation). Technical Corrections would add a new rule under which stock of a regular domestic C corporation which is not a regulated investment company or real estate investment trust owned by a 25%-owned domestic corporation would not be treated as an asset which produces passive income or is held for the production of passive income, and income derived from such stock would not be treated as passive income, provided the foreign corporation is subject to the AET. Technical Corrections § 112(n)(24); Technical Corrections Description at 213. If, under a treaty, the foreign corporation is not subject to the AET, the foreign corporation must agree to

waive such benefit. *Id.* The new rule is designed to mitigate the potentially disparate treatment between U.S. individuals who hold U.S. stock through a U.S. holding company and those who hold U.S. stock through a foreign holding company. Technical Corrections Description at 213. In the former instance, the U.S. individual is not subject to an interest charge on distributions or dispositions of the U.S. holding company's stock.

3. *Corporations Changing Businesses.* One requirement of the exception to PFIC status for corporations changing businesses, as enacted, is that the foreign corporation (and any predecessor) was not a PFIC for any taxable year. § 1297(b)(3)(A). A Technical Correction would clarify this requirement by providing that neither the foreign corporation nor any predecessor can have been a PFIC for any taxable year. Technical Corrections § 112(n)(22).

B. *Ownership of PFIC Stock*

1. *Attribution Rules*

a. *U.S. Partnerships.* The Bluebook provides that it may be necessary in the case of a U.S. partnership for regulations to treat stock considered to be owned by the partnership as actually owned by the partnership so as to attribute the stock to the partnership's partners. Bluebook at 1031-32.

b. *Grantor Trusts.* The Bluebook clarifies that, in the case of a grantor trust, the owner of the trust under the rules of subchapter J is treated as the owner of PFIC stock held by the grantor trust, rather than the beneficiaries. Bluebook at 1032. This may provide insight to the proper construction of §§ 318(a)(2)(B) and 554(a)(1).

c. *Options.* Technical Corrections would amend the attribution rules to provide that, to the extent provided in

regulations, any person with an option to acquire stock will be treated as the owner of such stock. Technical Corrections § 112(n)(10)(A); Technical Corrections Description at 215. For this purpose, an option to acquire an option, and each one of a series of options, may be considered as an option to acquire stock. *Id.*

2. *Anti-Avoidance Rules.* Technical Corrections would amend § 1291(e) to provide that the § 1246 rules incorporated therein by reference apply only to the extent not inconsistent with the regulations promulgated under § 1291(f) (authority to require gain to be recognized on otherwise nonrecognition transactions) and that the rules of § 1246(c) (requiring foreign corporate stock with a substituted basis to inherit the attributes of PFIC stock) and § 1246(d) (treating trust certificates in a grantor trust and domestic corporate stock as stock of a PFIC) apply "except to the extent provided in regulations," rather than "to the extent provided in regulations." Technical Corrections § 112(n)(6)(B).

C. *Treatment of U.S. Person Shareholders of PFICs*

1. *Nonqualified Funds*

a. *Previously Taxed Income.* Technical Corrections would provide that an excess distribution does not include any amount that is treated as previously taxed income under the CFC, FPHC, and QEF provisions. Technical Corrections § 112(n)(3); Technical Corrections Description at 213.

b. *Holding Period.* Technical Corrections would clarify that a taxpayer's holding period ends on the date of receipt of an excess distribution only for purposes of that distribution; the holding period for the stock does not end. Technical Corrections § 112(n)(14); Technical Corrections Description at 214.

c. *Prior Year Excess Distributions.* Technical Corrections would modify the calculation of an excess distribution to exclude from the 3-year average distribution that part of an excess distribution that is considered attributable to deferred earnings (i.e., that part of the excess distribution that is not allocable to pre-PFIC years or to the current year). Technical Corrections § 112(n)(13); Technical Corrections Description at 213-14. The effect of this modification is potentially to increase the amount of a total excess distribution constituting an excess distribution.

d. *Distributions Paid to Another Entity.* Under current law, where a U.S. person is treated as owning PFIC stock indirectly under the attribution rules, a disposition of the PFIC stock by the entity owning the PFIC stock directly is treated as a disposition by the U.S. person of the PFIC stock. § 1297(b)(5). However, a distribution in respect of indirectly held PFIC stock to the entity holding the stock directly is not expressly treated as a distribution to the U.S. person. Technical Corrections would provide that, under regulations, where a U.S. person is treated as owning stock indirectly under the attribution rules, a distribution made in respect of the PFIC stock will be treated as a distribution to the U.S. person with respect to stock in the PFIC. Technical Corrections § 112(n)(17). The Bluebook indicates that this result could be achieved under the regulatory authority already provided in the PFIC provisions. Bluebook at 1032.

e. *Dispositions.* Under § 1291(f), regulations may require gain to be recognized on otherwise nonrecognition transactions. The Bluebook provides an example where regulations may treat a gift of PFIC stock in a nonqualified fund to a non-taxpaying entity, such as a charity or foreign person, as a disposition on which gain is recognized.

Bluebook at 1028. Technical Corrections includes a provision designed to clarify that the regulatory authority to override nonrecognition provisions extends to all transfers of stock in nonqualified funds. Technical Corrections § 112(n)(6)(A); Technical Corrections Description at 214. Technical Corrections also would clarify that the denial of the step up in basis of PFIC stock held by a decedent does not apply to stock held by a nonresident alien decedent. Technical Corrections § 112(n)(9).

f. *Pledge Rule.* Technical Corrections would amend the pledge rule of § 1297(b)(6) to provide regulatory authority not to apply the rule. Technical Corrections § 112(n)(20).

g. *Foreign Tax Credit.* Technical Corrections would repeal § 1291(a)(5) which denies U.S. corporate shareholders in nonqualified funds the indirect foreign tax credit. Technical Corrections § 112(n)(7); Technical Corrections Description at 214. The Bluebook clarifies that, in claiming the foreign tax credit in the year of receipt of an excess distribution, the amount of any withholding tax may be applied against the total amount of the deferred tax and interest charge, as well as the amount of tax computed on the distribution that is attributable to the current year and any pre-PFIC year. Bluebook at 1027.

2. *Qualified Electing Funds*

a. *Current Inclusion*

- *Earnings and Profits.* The Bluebook indicates that, for purposes of calculating QEF inclusions, the characterization of income and the determination of earnings and profits are to be made pursuant to the general Code rules. Bluebook at 1029. Technical Corrections would allow earnings and profits to be computed for income inclusion pur-

poses by using the installment method of accounting (and completed contract method and LIFO inventory method, if applicable) if the PFIC uses such method to compute its income. Technical Corrections § 112(n)(18); Technical Corrections Description at 215. Under § 312(n)(4)-(6), the use of these methods for general earnings and profits purposes is qualified and, in the case of the installment method, prohibited. However, the Technical Correction would further provide that to the extent the use of such method in computing earnings and profits would increase earnings and profits by an amount which was previously distributed the exception to the application of § 312(n)(4)-(6) will not apply. *Id.* This latter restriction prevents a current inclusion in income of an amount previously distributed and treated as a dividend at that time. For example, if there were an installment sale, earnings and profits for all purposes except QEF inclusions would be increased by the total amount of the gain. A distribution made from such earnings and profits before the gain is recognized under the installment sale rules would constitute a taxable dividend. Without the restriction prohibiting use of the installment method to calculate earnings and profits for income inclusion purposes to the extent such use would result in an increase by an amount previously distributed, such amount also would be currently included under the QEF rules in the year recognized under the installment method. Technical Corrections would also clarify that distributions of amounts previously taxed under the QEF rules, although not treated as dividends, would reduce earnings and profits. Technical Corrections § 112(n)(23). The need

for this provision arises from the divorce between income and earnings and profits brought about by current inclusion rules. Cf. § 959(d).

- *Pro Rata Share.* Under § 1293(b), pro rata share is the amount that would have been distributed in respect of the shareholder's stock if, on each day during the QEF's taxable year, the QEF had distributed to the shareholder the shareholder's pro rata share of the QEF's ordinary earnings and net capital gain for such year. Technical Corrections would provide regulatory authority to allow pro rata shares to be determined over a period other than a year, e.g., a month. Technical Corrections § 112(n)(15); Technical Corrections Description at 214.

b. *Gain on Disposition.* The Bluebook indicates that distributions by a QEF may be subject to the interest charge rules unless the PFIC is a QEF for each of its PFIC years during the U.S. person's holding period. Bluebook at 1030. However, the statute, as enacted in the 1986 Act, provides that distributions from a QEF are not subject to the interest charge rules. § 1291(d)(1)(A). Technical Corrections would implement the Bluebook approach by first providing that distributions by a QEF may be subject to the interest charge unless the PFIC was a QEF for each of its PFIC years during the taxpayer's holding period. Technical Corrections § 112(n)(1). Distributions of amounts previously taxed under the QEF election would be excluded from excess distributions. Technical Corrections Description at 214; Technical Corrections § 112(n)(3).

c. *Foreign Tax Credit*

- § 960 Credit. The Bluebook states that the QEF rules, as enacted, provide a U.S. corporate

shareholder which owns 10% of a QEF with an indirect foreign tax credit under § 960. Bluebook at 1029.

- Foreign Tax Credit Limitation. Technical Corrections would provide that look-through rules apply in determining the appropriate foreign tax credit limitation basket for amounts included under the QEF rules in the income of a 10% CFC shareholder. Technical Corrections § 112(n)(11); Technical Corrections Description at 215.

d. *Making the QEF Election.* The Bluebook indicates that it is anticipated that regulations will require the reporting of information similar to that required of domestic investment companies such as the U.S. investor's pro rata share of the fund's ordinary income and capital gain income, based on U.S. tax principles. Bluebook at 1030. The Bluebook also indicates that information reporting will be limited to U.S. investors, with verification of investors' tax status as U.S. or foreign under regulations. *Id.* The Bluebook also states that the QEF election continues until the year the corporation ceases to be a PFIC or until revoked. *Id.* Query whether the QEF election would spring back into being if a corporation which ceases to be a PFIC later becomes a PFIC again. According to the Bluebook, revocation of a QEF election should be granted only in circumstances where compliance with the 1986 Act's provisions is assured, and a fund that intentionally fails to meet its compliance obligations will not thereby revoke its QEF election. *Id.* However, technically a PFIC which fails to meet its compliance obligations for a taxable year would not be a QEF for such year. § 1295(a). Thus, although the election may not be revoked, the rules for nonqualified funds would appear to become applicable.

e. *Election to Defer Tax.* The Bluebook indicates that the § 1294 election to defer the payment of tax terminates if the foreign corporation ceases to be a PFIC. Bluebook at 1029 & 1031. The Bluebook also states that the election terminates on any transfer of PFIC stock regardless of whether the transfer constitutes a realization or recognition event under general Code rules, including transfers at death and by gift. Bluebook at 1029. A Technical Correction to § 1294(c)(2) is designed to accomplish this result. Technical Corrections § 112(n)(4); Technical Corrections Description at 215. Technical Corrections also would add to § 1294 a cross-reference to § 6601 for provisions providing for interest for the period of the extension. Technical Corrections § 112(n)(8).

D. *Interaction with Other Provisions*

1. *CFCs and FPHCs*

a. *Nonqualified Funds.* As noted, Technical Corrections would amend the rules for nonqualified funds to provide that an excess distribution does not include amounts previously taxed under the CFC or FPHC provisions. However, the interest charge still would apply to the appreciation of the stock, as well as gain attributable to earnings and profits which are tax deferred under the CFC provisions. The Bluebook clarifies that the rules governing nonqualified funds apply to dispositions of stock of CFCs which are also nonqualified funds, rather than § 1248 of the Code. Bluebook at 1033.

b. *QEFs.* Technical Corrections would amend § 1248(d) to exclude from the amounts treated as ordinary income under that section amounts previously taxed under the QEF election. Technical Corrections § 112(n)(19); Technical Corrections Description at 215.

2. *FICs*. The Bluebook states that § 1246 does not apply to post-1986 earnings of a PFIC which is also a FIC. Bluebook at 1033. The Bluebook also provides that if a fund is subject to the interest charge rules on disposition, as well as the FIC rules, the interest charge rules apply to treat all earnings as ordinary income and earnings from PFIC years with an interest charge. *Id.* Technical Corrections would make clerical changes to § 1246. Technical Corrections § 112(n)(21).

IV. TAX PLANNING UNDER THE PFIC PROVISIONS

A. *Avoiding PFIC Status*

1. *Active Operating Companies Not Yet PFICs*. The key to avoiding the PFIC provisions is to fail both the Income and Asset Tests for PFIC status. The following suggestions for active operating companies and multinational groups might prove useful in avoiding PFIC status.

a. *Income Subject to CFC or FPHC Provisions*. Income subject to current tax under the CFC or FPHC provisions may be repatriated.

b. *Tax-Deferred Income*. Tax deferred income under the CFC provisions may be reinvested in non-passive assets producing non-passive income either directly or indirectly through 25%-owned foreign corporations or related persons with high levels of non-passive income and assets. Care must be exercised in investing such income in domestic corporations so as not to give rise to an increase in earnings invested in the United States property under § 956.

c. *Amounts Held for Active Business Needs*. Although not entirely clear, amounts held for active business needs might be able to be invested in obligations the interest from which is exempt from tax under § 103(a). *Cf.* Rev. Rul. 72-527, 1972-2 C.B. 456. Bearing in mind the loss of the time value of the money,

to the extent necessary, amounts held for active business needs, e.g., working capital, could also be held in non-interest bearing accounts.

B. *Living with PFICs*

1. *Temporary PFICs.* An active operating company which meets the Income Test or Asset Test only temporarily, might consider the QEF election. If the QEF election is in effect for each of the foreign corporation's PFIC years, the company will cease to be a QEF in the year it ceases to be a PFIC without the stock carrying the PFIC taint.

2. *Organizational Structure.* To prevent the § 1296(c) look-through rule from operating to treat an active operating company as a PFIC, consideration should be given to placing entities likely to be PFICs as first-tier foreign subsidiaries of U.S. corporations, rather than lower tier foreign subsidiaries.

C. *Affirmatively Using PFIC Status.* Foreign individuals resident in a foreign country that has an income tax treaty with the United States prohibiting imposition of the branch profits tax (§ 884) may utilize a PFIC to obtain favorable tax treatment of income derived from trading stocks or securities in the United States. Under § 864(b), a foreign corporation the principal business of which is trading in stocks or securities for its own account, which would otherwise be engaged in trade or business within the United States on account of such trading and which is not a dealer in stocks or securities, will not be so engaged, even though its principal office is in the United States, if it would be a PHC but for the fact that all of its stock is held by foreign persons during the last half of the taxable year. §§ 864(b)(2)(A)(ii), 542(c)(7) & 543(b)(1)(C). Thus, U.S. source dividends paid to such a foreign corporation generally are subject to a 30% (or lower treaty rate) tax. § 881(a). However, if such corporation also is a PFIC, it will be treated as engaged in trade or business within the United States if its principal business is trading in stocks or securities for its own account, if its principal office is in the United States, if it trades through a person other

than a resident broker, commission agent, custodian, or other independent agent, and if its trading activities otherwise rise to the level of a trade or business within the United States. Cf. Rev. Rul. 79-116, 1979-1 C.B. 213. In that event, dividends received in respect of domestic corporate stock would be eligible for the dividends received deduction under § 243 resulting in very little U.S. regular corporate tax. The corporation generally can later be liquidated without imposition of U.S. tax on the gain. However, where the branch profits tax applies, this structure may not be economical. Further, U.S. persons owning shares in such company would be subject to the PFIC provisions.