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International Tax ADVISORY ■

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The PFIC Regulations Get a Facelift

On December 28, 2016, the Treasury issued final regulations (T.D. 9806) that primarily address passive foreign investment company (PFIC) ownership and reporting rules and largely adopt 2013 proposed (REG-140974-11) and temporary (T.D. 9650) PFIC regulations and implement two notices (Notice 2014-28 and Notice 2014-51).

Background

A foreign corporation is a PFIC if either 75% or more of its gross income for a taxable year is passive or 50% or more of its assets held during a taxable year produce, or are held for the production of, passive income. Three general tax regimes apply to U.S. shareholders of a PFIC. For certain PFICs, a shareholder can elect to annually mark its shares to market and include any appreciation in the value of the stock (as well as any gain on the actual disposition of the stock) as ordinary income. A shareholder can instead elect to treat the PFIC as a qualified electing fund and include its share of the PFIC's earnings and profits in income as it is earned by the corporation. If no election is made, the shareholder will be subject to tax at maximum applicable rates, plus an interest charge, upon "excess distributions" by the PFIC (or dispositions of PFIC stock treated as excess distributions).

The PFIC rules are designed to eliminate the economic benefit of deferral to U.S. shareholders in foreign corporations and work in tandem with the controlled foreign corporation (CFC) rules. The PFIC rules can be more expansive, but a U.S. shareholder is exempt from the PFIC rules if the corporation is also a CFC and the shareholder is subject to tax with respect to the corporation under Subpart F.

Ownership

PFIC status depends on the amount of a foreign corporation's passive assets or income, not on a specific level of stock ownership like a CFC. However, the amount of stock ownership is relevant when applying special attribution rules, including rules for constructive ownership of PFICs through other domestic or foreign entities.

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The final regulations establish a new "non-duplication rule" to avoid double counting ownership. A person that directly or indirectly owns 50% or more of the value of the stock of a non-PFIC foreign corporation is deemed to own a proportionate amount of the value of any PFIC stock owned directly or indirectly by the non-PFIC foreign corporation; and solely for purposes of determining ownership through a non-PFIC foreign corporation, a person that directly or indirectly owns 50% or more of the value of the stock of a *domestic* C corporation is deemed to own a proportionate amount of the value of any PFIC stock owned directly or indirectly by the domestic corporation. The non-duplication rule then provides that the ownership attributed through the domestic corporation for this purpose does not apply to treat a U.S. person as owning stock of a PFIC that is directly or indirectly owned by another U.S. person without regard to the attribution through the domestic corporation.

Example. Suppose A, a U.S. person, directly owns all of the stock of DC, a U.S. corporation. A also directly owns 49% of the stock of FC, a foreign corporation that is not a PFIC, and DC directly owns the remaining 51% of the stock of FC. FC owns 100 shares of P, which is a PFIC and not a CFC. DC is treated as owning 51 shares in P indirectly through FC. Because A owns 100% of the stock in DC, it is treated as owning 100 shares in P indirectly (49 shares indirectly through FC and 51 shares indirectly through DC) under the general rule. The non-duplication rule, however, limits A's indirect ownership of P to the 49 shares held through FC because DC is already treated as owning the other 51 shares indirectly under the general rule.

S corporations are excluded from these attribution rules and are treated similarly to other pass-through entities, including partnerships, estates and trusts: any PFIC stock owned directly or indirectly by a pass-through entity is treated as owned proportionately by its owners, except for purposes of information reporting.

The final regulations also supersede Notice 2014-28 and exempt U.S. persons as PFIC shareholders if they own PFIC shares through tax-exempt organizations or accounts (e.g., IRAs). The preamble embraces the explanation in the notice that the application of the PFIC rules to such shareholders would be inconsistent with the tax policies underlying the PFIC rules and the treatment of tax-exempt organizations and accounts (because these owners are otherwise exempt from or benefit from deferred taxation under the Code).

Reporting

U.S. shareholders of PFICs are generally required to annually file IRS Form 8621 to report their PFIC interests. The new regulations finalize and add several exceptions.

The regulations incorporate and supersede the reporting exception granted under Notice 2014-51 for PFIC stock that is marked to market under a provision of the Code other than the Section 1296 mark-to-market election for PFICs (e.g., the mark-to-market rules for traders in securities or commodities under Section 475(f)), unless subject to an applicable mark-to-market coordination rule.

The regulations offer other reporting exceptions for certain dual-resident taxpayers, bona fide residents of U.S. territories that are so-called mirror code jurisdictions (Guam, the Northern Mariana Islands and the U.S. Virgin Islands) and PFIC stock held through certain foreign pension funds, including funds covered by U.S. income tax treaties, regardless of their entity classification under the Code.

A new exception under the final regulations applies to a domestic partnership if none of its direct or indirect partners is required to file IRS Form 8621 because the partners are not subject to the PFIC rules. For example, if all of the partners of a domestic partnership are foreign persons or tax-exempt U.S. entities and thus excluded as PFIC shareholders, the partnership will not be required to file IRS Form 8621 for its shares in a PFIC. The regulations note, however, that a domestic partnership would still need to file IRS Form 8621 even if some or all of its shareholders are exempt from filing IRS Form 8621 but would be subject to tax on excess distributions (or on dispositions treated as excess distributions) on the stock of a PFIC.

The regulations also include valuation and holding period thresholds for Section 1291 funds (PFICs that are not qualified electing funds and for which a Section 1296 mark-to-market election is not in effect). A U.S. shareholder is exempt from reporting in a taxable year if it is not treated as receiving an excess distribution (or as recognizing gain on a disposition treated as an excess distribution) and, as of the last day of its taxable year, either the value of the PFIC's stock held by such shareholder is $25,000 or less ($50,000 for joint returns) or, if the stock of the Section 1291 fund is owned indirectly, the value of the stock owned is $5,000 or less. Certain shareholders are also exempt if they have not owned the shares for more than 30 days in the taxable year.

The regulations also adopt filing procedures, including requiring each U.S. person to file a separate IRS Form 8621 for each PFIC, except that taxpayers filing a joint return can file a single IRS Form 8621 for each PFIC jointly or individually owned. Consolidated filings for multiple PFICs are not permitted.

Certain U.S. shareholders are also required to file IRS Form 5471 for their ownership in certain foreign corporations, including PFICs. If information required to be provided by a shareholder on IRS Form 5471 for a PFIC is furnished by another person having an equal or greater stock interest in the PFIC, the final regulations permit that shareholder to satisfy its reporting requirement by filing a statement on an IRS Form 5471 indicating that the requirement has been satisfied and identifying the other person's return that includes the information.

Effective Dates

The IRS Form 5471 reporting rules apply to tax returns filed on or after December 31, 2013, and all other rules provided under the final regulations apply to shareholders' taxable years ending on or after December 31, 2013.

For more information, please contact Edward Tanenbaum at 212.210.9425 or Danny Reach at 704.444.1272.

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