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International Tax ADVISORY ■

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IRS to Eliminate PFIC Reporting for Certain Mark-to-Market Investments

In Notice 2014-51, released September 10, 2014, the Internal Revenue Service announced plans to amend regulations under Section 1298(f) of the Internal Revenue Code, relating to information reporting by U.S. holders of passive foreign investment companies (PFICs). The guidance, which may be relied on for tax years ending after December 31, 2013, provides an exception to the information reporting obligation for U.S. persons that hold PFIC stock that is marked to market under provisions of Chapter 1 of the Code, other than Section 1296. This change is especially welcome for dealers employing mark-to-market accounting for PFIC stock under Section 475.

Background

A foreign corporation is a PFIC if either 75 percent or more of its gross income is passive income or 50 percent or more of the average value of its assets produce passive income. The Code seeks to deny the benefits of tax deferral to U.S. holders of PFICs through three alternate sets of rules: the default excess distribution regime or the elective qualified electing fund (QEF) and mark-to-market (MTM) rules.

The excess distribution regime of Section 1291 deters the accumulation of passive earnings in a PFIC by imposing an interest charge on "excess distributions" from the PFIC, which may include actual distributions as well as gain on the disposition of PFIC stock. Under Section 1293, a U.S. holder can elect to treat its PFIC interest as an investment in a QEF. Similar to the inclusion rules applicable to U.S. shareholders of controlled foreign corporations, a U.S. holder in a QEF is deemed to receive an annual distribution of its pro rata share of the PFIC's earnings and profits. A PFIC treated as a QEF must agree to provide sufficient information for the U.S. holder to determine its income inclusions. Finally, under Section 1296, a U.S. person may elect to apply the MTM rules (but only for "marketable" PFIC stock), which treat the investor as having sold its PFIC stock at the end of each year. Under the MTM rules, gains, including gains on disposition, are taxed as ordinary income (not subject to lower capital gains rates), and losses are deductible as ordinary losses but only to the extent of prior unreversed inclusions.

Provisions under Section 1291(d) coordinate the application of the default excess distribution rules with the QEF and MTM regimes and other Code sections. Specifically, Section 1291 will not apply if a Section 1296 MTM election is in effect for a tax year or if PFIC stock is marked to market under any other provision of Chapter 1 of the Code (e.g., Section 475).

In addition to the special tax rules, Section 1298(f) imposes a reporting requirement on U.S. holders of PFICs. Temporary regulations clarify that U.S. persons that directly or, in some instances, indirectly own PFIC stock must file Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, for each PFIC owned by a U.S. investor (directly, indirectly or by attribution). The regulations provide only two main exceptions to the reporting obligation: tax exempt entities and U.S. investors with "low-value" PFIC stock below specified thresholds.

Notice 2014-51

The recent notice states that the Treasury and IRS have determined that U.S. persons that hold PFIC stock that is marked to market under provisions of the Code other than Section 1296 should not be subject to the Section 1298(f) reporting requirement. For example, dealers who mark to market PFIC stock under Section 475 generally would not have to file Form 8621 for such stock. Moreover, a U.S. person not subject to information reporting on such marked-to-market PFIC stock would not have to take the value of such stock into account in determining whether a relevant low-value threshold is exceeded under Regulations Section 1.1298-1T(c)(2)(i)(A)(1).

There are limits on the reporting exception, however. First, the exception would not be available for any year in which the excess distribution rules apply pursuant to the coordination rules under Regulations Section 1.1291-1(c)(4)(ii). This limitation would not affect U.S. persons who properly mark to market stock under Section 475 in the first year and subsequent years they hold PFIC stock, which would not be subject to any provisions of the PFIC regime. Second, the reporting exception would not be available if PFIC stock is not in fact marked to market for any reason–as may be the case for certain PFIC stock held for investment or as a hedge under Section 475.

U.S. persons may rely on the provisions in the notice for taxable years ending after December 31, 2013, which will be the effective date of the future final regulations incorporating the notice's guidance.

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