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PFICs Gone Wild!

Monica Gianni

University of Florida Levin College of Law, gianni@law.ufl.edu

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PFICs GONE WILD!

*Monica Gianni**

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* Monica Gianni is a Visiting Assistant Professor at the University of Florida Levin College of Law. She previously was an adjunct professor at the University of Washington LL.M. in taxation program where she taught international and corporate tax since 1997. She was formerly a partner at Davis Wright Tremaine LLP in Seattle, Washington. The author would like to thank Professors Lawrence Lokken and Kevin Yamamoto for their helpful suggestions and encouragement.

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I. INTRODUCTION

My father passed away last year. With the sadness surrounding me, I began the task of inventorying his estate and taking action to put order in the investments he left. Much to my chagrin, I found that one-third of his estate consisted of stock in a foreign corporation that owned gold and silver, and much of the rest of his estate was invested in Canadian mining companies. All of these investments were passive foreign investment companies (“PFICs”). Instead of getting the usual step-up in basis for the stock upon death, the PFIC law prohibited a step-up. Instead of a simple computation of capital gain on the sale of the investments, PFIC rules mandated that the gain was ordinary income. In addition, the PFIC statute required that the gain had to be allocated pro rata over his entire holding period, taxed at the maximum tax rate in effect for the year to which the gain was allocated. With an interest charge required to be applied as well under these rules, how could the tax on the sale of the investments even be computed?

Were these the types of abusive investments that Congress wanted to reach when it enacted the PFIC rules as part of the Tax Reform Act of 1986, which were directed against foreign investment companies? Should an individual who owns stock in some perhaps risky investments be so penalized? If my father had owned the precious metals directly, there would have been no U.S. tax until the metals were sold, and there would have been a step-up in basis in the metals upon death. But owning the precious metals through a foreign corporation was the tax kiss of death. And the mining companies? If the mining companies had been U.S. companies or had a shorter start-up period, they would not have qualified as PFICs, and, hence, there would not have been these

harsh tax consequences.

U.S. investors in foreign corporations should always be fully informed of the tax consequences of venturing into this realm. The investments will be subject to a whole host of special U.S. tax laws that would not apply if the investments were in U.S. corporations. Particular laws include the Subpart F¹ and investment in U.S. property rules² for controlled foreign corporations (“CFCs”),³ transfers of property to foreign corporations,⁴ sales of CFCs,⁵ and liquidations of U.S.-owned foreign subsidiary corporations.⁶ In addition to these U.S. tax laws, the laws of the foreign jurisdiction in which the corporation is formed or has a taxable presence may apply. Compounding the complexity of dealing with the laws of two or more countries, the overlay of applicable tax treaties also must be considered,⁷ as well as the complex IRS reporting requirements.⁸ Throw into this mix the harsh rules for PFIC owners, and you have a recipe for a tax disaster.

This Article begins in Part II with a discussion of what constitutes a PFIC and follows in Part III with the tax rules applicable to PFICs. Part

1. I.R.C. § 952 (1986). All references to “I.R.C.” or the Internal Revenue Code are to the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

2. I.R.C. § 956 (1986).

3. A controlled foreign corporation is any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or 50 percent of the total value of the stock of the corporation, is owned (directly, indirectly or constructively) by U.S. shareholders (as defined in I.R.C. § 951(b) (1986)).

4. I.R.C. §§ 367(a), (d) (1986).

5. I.R.C. § 1248 (1986).

6. I.R.C. § 367(b) (1986).

7. In addition to determining the rules under a tax treaty, whether a tax treaty even applies has become more complicated, as evidenced by limitation on benefit provisions in more recent treaties (or protocols thereto) between the United States and several European countries. *See, e.g.*, limitation on benefit provisions in the following tax treaties: Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-U.K., art. 23, Jul. 24, 2001, 30 U.S.T. 7223; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes, U.S.-Ger., art. 28, Jan. 1, 1990, 1708 U.N.T.S. 3; Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Bel., art. 21, Nov. 27, 2006, <http://www.irs.gov/pub/irs-trty/belgiumt06.pdf>; and Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Swe., art. 17, Jan. 1, 1996, <http://www.irs.gov/pub/irs-trty/sweden.pdf>.

8. *E.g.*, IRS Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations; IRS Form 8621, Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund; IRS Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities; IRS Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships; and IRS Form 8938, Statement of Specified Foreign Financial Assets.

IV begins with a general explanation of the goal of tax deferral, with discussion of several anti-deferral tax regimes enacted prior to the PFIC provisions, i.e., Personal Holding Companies (“PHCs”), Foreign Personal Holding Companies (“FPHCs”), Subpart F income of CFCs, Foreign Investment Companies (“FICs”), and Regulated Investment Companies (“RICs”). An understanding of these regimes is necessary to appreciate the genesis of the PFIC rules. Part V analyzes the policy behind Congress enacting the PFIC provisions as part of the Tax Reform Act of 1986,⁹ i.e., preventing U.S. investors in foreign investment companies from having more favorable tax treatment than U.S. investors in domestic investment companies. Congress wanted to correct the perceived abuses of U.S. taxpayers investing in foreign investment companies to obtain U.S. tax deferral on their investments and close the gap in previously enacted legislation.

After a crash course in the basic PFIC rules and other anti-deferral regimes, and an understanding of why the rules exist, Part VI examines unexpected consequences of the PFIC rules. PFIC treatment, although targeted to stop abuses with foreign investment companies, can reach start-up and operating companies. In addition, otherwise nontaxable transfers can be subject to tax, such as an exchange of PFIC stock in a tax-deferred reorganization, a gift of PFIC stock during life and upon death, and taxation to immigrants and expatriates who own PFIC stock. Transfers of PFIC stock can result in disastrous consequences to the unsuspecting (or even the suspecting) investor, a result that seems to go beyond what Congress intended when it enacted the PFIC legislation. Part VI additionally addresses specific solutions for these problems. The simple purpose of not allowing tax deferral on investments in foreign investment companies has resulted unfortunately in “PFICs Gone Wild!”

Part VII questions whether the legislative purpose of the PFIC legislation is even valid, asking why PFICs should be subject to such punitive tax consequences when other types of investments allow for deferral of U.S. tax without punishment. The Article concludes in Part VIII that the policy behind the PFIC legislation does not justify the far-reaching and burdensome treatment to PFIC shareholders. Even if the PFIC rules are limited to a defined set of foreign investment companies and issues with transfers of PFIC stock are solved, the overriding question remains whether the basic premise of the legislation should stand. The PFIC rules must either be eliminated entirely, or at least limited to the purpose for which they were enacted—to prevent more

9. Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

favorable tax treatment to an investor in a foreign investment company than an investor in a U.S. investment company.

II. DEFINITION OF PFIC

A foreign corporation is a PFIC if it meets either an income test or an assets test. The income test is met if 75 percent or more of the foreign corporation's gross income is passive income.¹⁰ For purposes of the PFIC provisions, "gross income" means all income under Internal Revenue Code Section 61, such as sales revenues less cost of goods sold.¹¹ "Passive income" generally includes dividends, interest, royalties, rents, and gains from commodities or securities transactions.¹² The asset test requires that the average percentage of assets held by the foreign corporation, which either produce passive income or are held for the production of passive income, is at least 50 percent or more (by value¹³).¹⁴ Unlike the rules for PHCs,¹⁵ CFCs,¹⁶ or FICs,¹⁷ the PFIC provisions apply to any U.S. person¹⁸ who owns stock in a PFIC, regardless of how small a percentage the U.S. person owns.¹⁹

Some relief from the long reach of the definition of PFICs is provided for foreign corporations that are determined to be PFICs under

10. I.R.C. § 1297(a)(1) (1986).

11. Treas. Reg. § 1.61-3(a).

12. I.R.C. §§ 954(c), 1297(b) (1986). Certain types of passive income are specifically excluded from the numerator of the income alternative of the PFIC test, including interest, dividend, rents and royalties received from a related person (within the meaning of I.R.C. § 954(d)(3) (1986)) to the extent this income is properly allocable to income of the related person that is not passive income. I.R.C. § 1297(b)(2)(C) (1986).

13. I.R.C. § 1297(e) (1986). Instead of using value as the measure for the corporation's assets, adjusted bases are used in the asset component of the PFIC test if either the corporation is a CFC or elects to use adjusted bases as the factor. I.R.C. § 1297(e)(2) (1986). Publicly traded corporations cannot use the alternative determination method of adjusted bases. I.R.C. § 1297(e)(1) (1986).

14. I.R.C. § 1297(a)(2) (1986).

15. An ownership prong must be met in determining if a corporation is a PHC, *i.e.*, at any time during the last half of the taxable year more than 50 percent in value of its outstanding stock is owned, directly or indirectly, by or for not more than five individuals. I.R.C. § 542(a)(2) (1986). See discussion of PHCs *infra* Part IV.A.

16. See *supra* note 3; see also discussion of CFCs *infra* Part IV.C.

17. To meet the definition of a FIC, a foreign corporation had to be owned 50 percent or more, directly or indirectly, by U.S. persons. I.R.C. § 1246(b) (repealed 2004). See discussion of FICs *infra* Part IV.D.

18. U.S. persons include a citizen or resident of the United States and U.S. corporations. I.R.C. § 7701(a)(30) (1986).

19. I.R.C. § 1298(a) (1986) contains attribution of ownership rules that can result in stock in a PFIC being owned by a U.S. person that does not own the stock directly, such as a subsidiary corporation of another PFIC.

one of the above tests. First, a look-through rule provides that if the foreign corporation directly or indirectly owns 25 percent (by value) of another corporation, a proportionate amount of the assets and income of the subsidiary are attributed to the foreign corporation in determining if the parent is a PFIC.²⁰ If this look-through rule had not been enacted for PFICs, holding companies would be deemed to own all passive assets (i.e., stock in its subsidiaries), and all of the holding company's income (i.e., dividends) would be passive income.²¹ This exception recognizes the reality that corporations often use holding companies in their structures and, therefore, prevents a holding company from automatically qualifying as a PFIC.

Second, a PFIC does not include within its definition a foreign corporation in a start-up phase of an active business.²² This exception is available only if: (1) no predecessor of the corporation was a PFIC, (2) it is satisfactorily established that the corporation will not be a PFIC for either of the two subsequent years following the start-up year, and (3) the corporation is not in fact a PFIC during those two subsequent years.²³ The start-up exception addresses the common situation where a new company does not generate active income in its initial taxable year.

Although the start-up exception is a welcome recognition of business realities, it often takes a company more than one year to generate active income. In addition, the initial year that is exempt from the PFIC rules is the first taxable year that a PFIC has gross income. A corporation could thus start its business on the last day of its taxable year and have only that day as the "start-up year" if the corporation has even a minimal amount of passive income. Use of a "shelf company,"²⁴ a common practice in many countries (e.g., Canada), is assisted somewhat by the start-up exception, but can still result in a foreign corporation qualifying as a PFIC where the shelf company has been financed with cash and the corporation has been kept "on the shelf" in a year prior to its use by an operating company. Despite the limitations of the PFIC start-up exception, it does prevent some foreign operating corporations

20. I.R.C. § 1297(c) (1986).

21. I.R.C. § 543(a) (1986). Contrast this with the PHC rules, which have no look-through rule and consider dividends from foreign subsidiaries to be passive income.

22. I.R.C. § 1298(b)(2) (1986).

23. *Id.*

24. A "shelf" company is a generic company formed in advance of the need for the corporation, often funded with cash and earning interest, prior to an investor having a need to utilize a corporation. Through the use of a shelf corporation, the investor can have corporate formalities taken care of prior to the commencement of the investor's planned activity, thus avoiding delays in the incorporation process.

that do not generate active income in their initial years from being classified as PFICs.

Third, a foreign corporation transitioning from one active business to another active business is provided with an exception.²⁵ The business-change exception allows a corporation to sell a business, thereby generating capital gain, passive income, and start a new business without the risk of being classified as a PFIC as a result of the passive income generated from the disposition of the business. The requirements for meeting this exception are: (1) neither the corporation nor a predecessor was a PFIC, (2) it is satisfactorily established that (a) substantially all of the passive income of the corporation of the year of change 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 the first two years following the business change, and (3) the corporation is not in fact a PFIC for those two subsequent years.²⁶

Finally, if a foreign corporation is a CFC, it is not a PFIC.²⁷ This overlap rule was a much-welcomed clarification, enacted into law in 1997, effective beginning in 1998.²⁸ Prior to the overlap rule, a company that qualified as a CFC could, for example, still be a PFIC if 50 percent or more of its assets held directly, or indirectly through lower-tier corporations, produced passive income or were held for the production of passive income.²⁹ The CFC rules should have adequately covered the anti-deferral issues of the foreign corporation without the necessity of imposing the PFIC rules on such corporations. Unfortunately, foreign corporations that were PFICs on the effective date of the overlap legislation remained PFICs unless they purged the PFIC taint. This taint can be purged by making an election that generally results in income recognition but better income tax consequences going forward.³⁰

Besides the broad definition of PFIC that will catch many foreign corporations unaware, there is an even more egregious rule that defines

25. I.R.C. § 1298(b)(3) (1986).

26. *Id.*

27. I.R.C. § 1297(d) (1986). The Tax Technical Corrections Act of 2007 (effective Dec. 29, 2007), Pub. L. No. 110-172, § 11(a)(24)(A), 121 Stat. 2473, deleted former I.R.C. § 1297(d) and redesignated I.R.C. § 1297(e) as I.R.C. § 1297(d).

28. Taxpayer Relief Act of 1997, Pub. L. No. 105-34, § 1121, 111 Stat. 787.

29. *See, e.g.*, Rev. Rul. 87-90, 1987-2 C.B. 216.

30. For a U.S. shareholder of a PFIC that no longer meets the tests for qualifying as a PFIC under I.R.C. § 1297(a) (1986) or is also a CFC that overrides PFIC characterization under I.R.C. § 1297(d) (1986), the shareholder can make a deemed-dividend or deemed-sale election out of PFIC treatment. I.R.C. §§ 1291(d)(2), 1298(b)(1) (1986); Treas. Reg. §§ 1.1297-3, 1.1298-3.

what a PFIC is: "Once a PFIC, always a PFIC."³¹ Stock owned by a U.S. person in a foreign corporation is treated as stock in a PFIC if, at any time during the U.S. person's holding period, the corporation was a PFIC.³² The PFIC taint attaches to a foreign corporation if it was a PFIC during any taxable year, unless a Qualified Electing Fund ("QEF") election has been made.³³ A U.S. person investing in a foreign corporation must therefore determine not only if the corporation currently meets the definition of a PFIC, but also whether it ever met the definition during that person's holding period of the stock, in order to know if the U.S. person will be subject to the PFIC tax rules. Thus, even if a corporation does not currently meet one of the PFIC tests, but it did at one time, for example, during the second taxable year as a start-up, it will remain a PFIC.

III. TAXATION OF A PFIC AND ITS U.S. SHAREHOLDERS

A PFIC is a foreign corporation and, as such, is subject to U.S. federal income tax on its earnings only if it receives U.S.-source³⁴ fixed and determinable annual or periodical income³⁵ or has income that is effectively connected with a U.S. trade or business.³⁶ Foreign corporations are not subject to U.S. income taxation on capital gain income, unless the gain is effectively connected with a U.S. trade or business.³⁷ Congress could not accomplish its purpose of foreign investment companies not having a U.S. tax advantage by imposing a tax on a PFIC, since the PFIC itself would not be subject to U.S. federal income tax if it made no U.S. investments and carried on no trade or

31. I.R.C. § 1298(b)(1) (1986).

32. *Id.*

33. See discussion of QEF *infra* Part III.B.

34. The rules for determining whether a type of income is U.S. or foreign source are contained in I.R.C. §§ 861-863, 865 (1986).

35. Fixed or determinable annual or periodical income includes interest, dividends, rents, salaries, wages, premiums, annuities, compensations, remunerations, emoluments and royalties. I.R.C. § 881 (1986); Treas. Reg. § 1.881-2(b).

36. I.R.C. § 882 (1986). Income is effectively connected with a U.S. trade or business as determined under I.R.C. § 864(c) (1986). The existence of U.S. trade or business is a facts and circumstances test. Treas. Reg. § 1.864-2(c). Generally, activity in the United States constitutes a trade or business if the activity is regular, substantial and continuous. See, e.g., *Linen Thread Co. v. Comm'r*, 14 T.C. 725 (1950). If a tax treaty applies, instead of the effectively connected income concept, foreign corporations are taxable in the United States on income attributable to a U.S. permanent establishment. See, e.g., *Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.-U.K.*, art. 5, Jul. 24, 2001, 30 U.S.T. 7223.

37. I.R.C. §§ 881-882 (1986).

business in the United States. Congress, therefore, imposed the onerous PFIC tax consequences on the PFIC's U.S. shareholders, who are subject to U.S. federal income taxation on their worldwide incomes. The PFIC rules have been characterized as “draconian”³⁸ and “the bane of international tax practitioners.”³⁹ They have further been described as “[not] working properly,” “complied with only in the easiest cases,” “fairly routinely overlooked by IRS agents,” and “mostly ignored, overlooked and misunderstood.”⁴⁰

A U.S. shareholder of a PFIC is taxable under one of three regimes: Section 1291 fund,⁴¹ QEF,⁴² or mark-to-market election.⁴³ If a U.S. shareholder of a PFIC does not make either a QEF election or a mark-to-market election, the Section 1291 fund regime will apply by default. To make a QEF election, the PFIC must agree to provide U.S. shareholders with certain information.⁴⁴ A mark-to-market election may be made for a PFIC only if the stock is “regularly traded” on a “qualified exchange or other market.”⁴⁵ A brief summary of PFIC taxation under the three different regimes follows.

A. Section 1291 Fund

Under the Section 1291 fund taxation rules, a U.S. shareholder must recognize gain on either the disposition of PFIC stock or income from an excess distribution, pro rata over the shareholder's holding period.⁴⁶ An excess distribution is a distribution with respect to stock to the extent the distribution received by the taxpayer during the taxable year exceeds 125 percent of the average amount of distributions during the three preceding years.⁴⁷ Any gain from either the disposition of PFIC stock or income from an excess distribution is taxed as ordinary income, even if the stock is a capital asset.⁴⁸ The amount of income allocated to the current year and to years in which the corporation was

38. See N.Y. ST. BAR ASS'N TAX SECT., REPORT ON PROPOSALS FOR GUIDANCE WITH RESPECT TO PASSIVE FOREIGN INVESTMENT COMPANIES 2 (2001).

39. See Thomas D. Fuller, *Passive Foreign Investment Company Rules Contain Many Pitfalls*, 81 TAX NOTES 879, 884 (1998).

40. See Kimberly S. Blanchard, *PFICs*, TAXES – THE TAX MAGAZINE (Mar. 1, 2012), at 47.

41. See discussion *infra* Part III.A.

42. See discussion *infra* Part III.B.

43. See discussion *infra* Part III.C.

44. I.R.C. § 1295(a)(2) (1986); Treas. Reg. § 1.1295-1(g).

45. I.R.C. §§ 1296(a), (c) (1986).

46. I.R.C. § 1291(a) (1986).

47. I.R.C. § 1291(b) (1986).

48. I.R.C. § 1291(a)(1)(B) (1986).

not a PFIC is taxed as ordinary income in the current year.⁴⁹ Amounts allocated to each of the other taxable years in the U.S. shareholder's holding period are subject to tax at the highest rate of tax in effect for the taxpayer for the year to which it is allocated, referred to as the "deferred tax amount."⁵⁰

The PFIC gain allocated to prior years is actually never included in income. Instead, the deferred tax amount is added to the total tax owed by the taxpayer in the year of disposition or excess distribution. In addition, an interest charge for the deemed deferral benefit of not having to pay tax on the PFIC income as it was earned is imposed on the tax attributable to each of the years to which the income is allocated.⁵¹ The amounts allocated to the current year and pre-PFIC years escape this treatment because no income deferral has occurred. If a distribution is not an excess distribution, it is taxed to the shareholder in the year received under general corporate distribution rules.⁵²

The purpose of this taxation regime is to treat the U.S. shareholder as if the income of the PFIC had been distributed when it was earned, based on the broad assumption that income of a corporation is earned ratably over the period of the shareholder's ownership. The U.S. shareholder of a PFIC, however, is in fact penalized for this assumption, as the shareholder does not receive the income ratably over the period of ownership yet has to pay interest on income beginning in a period prior to when cash from the investment was received. In addition, the U.S. shareholder's tax on a PFIC excess distribution is at the highest ordinary income tax rate in effect in the period to which the income was assigned under the PFIC rules, even if the U.S. shareholder's other income does not rise to the level of this highest tax bracket.

B. Qualified Electing Fund

If a QEF election is made, the U.S. shareholder is taxed on the shareholder's share of the PFIC ordinary income and net capital gains, essentially on a pass-through basis similar to how a partner in a partnership is taxed.⁵³ This method of taxation taxes a U.S. shareholder

49. I.R.C. § 1291(a)(1) (1986).

50. I.R.C. §§ 1291(a)(1)(C), (c) (1986).

51. I.R.C. §§ 1291(c)(1)(B), (c)(3) (1986).

52. I.R.C. § 1291(b) (1986). I.R.C. § 301 (1986) specifies the tax treatment of corporate distributions outside of the PFIC context. For PFIC distributions, earnings and profits are allocated to the excess and nonexcess distributions pro rata. Prop. Treas. Reg. § 1.1291-2(e)(3), 57 Fed. Reg. 11027 (Apr. 1, 1992).

53. I.R.C. § 1293(a)(1) (1986).

of a PFIC as the PFIC earns its income. The taxable year of inclusion of the PFIC's income is the taxable year of the shareholder in which the taxable year of the PFIC ends.⁵⁴ Congress recognized the hardship that could be imposed on a U.S. shareholder that has to pay tax on income not received and allows a shareholder to elect payment of the tax to be deferred, subject to an interest charge.⁵⁵ If the PFIC distributes its earnings that have already been taxed to a U.S. shareholder, there is no further income inclusion to the shareholder.⁵⁶ Any gain on the sale of the PFIC stock is capital gain.⁵⁷

As stated above, the QEF election can only be made if the PFIC agrees to provide information to the U.S. shareholder regarding the ordinary income and net capital gain of the company.⁵⁸ The PFIC must provide to a QEF shareholder a "PFIC Annual Information Statement," which states: (1) the PFIC's taxable year; (2) the shareholder's share of the corporation's ordinary earnings and net capital gain for the year, and the amount distributed to the shareholder during the year; and (3) that the shareholder may inspect and copy the PFIC's books to establish that the income has been computed in accordance with U.S. tax rules.⁵⁹ Many foreign companies are not willing to commit to providing this information,⁶⁰ thus eliminating the possibility for U.S. shareholders in many cases to be taxed under a less harsh U.S. tax regime than the Section 1291 fund default rules.⁶¹

C. Mark-to-Market Election

Another election possibility is the "mark-to-market election"⁶² for U.S. shareholders of "marketable stock"⁶³ to reduce the harsh tax

54. I.R.C. § 1293(a)(2) (1986).

55. I.R.C. § 1294 (1986).

56. I.R.C. § 1293(c) (1986).

57. STAFF OF JOINT COMM. ON TAX'N, 99TH CONG. GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1030, (Comm. Print 1987) [hereinafter 86 BLUEBOOK].

58. I.R.C. § 1295(a)(2) (1986); Treas. Reg. § 1.1295-1(g).

59. Treas. Reg. § 1.1295-1(g)(1).

60. See, e.g., *NXT Energy Solutions Inc., Annual Report 76* (Form 20-F) (May 16, 2012), available at <http://www.sec.gov/Archives/edgar/data/1009922/000113717112000223/nxt20F50112012.htm> ("U.S. Holders should be aware that, for each tax year, if any, that the company is a PFIC, the company can provide no assurances that it will satisfy the record keeping requirements of a PFIC, or that it will make available to U.S. Holders the information such U.S. Holders require to make a QEF Election under Section 1295 of the Code with respect of the company or any Subsidiary PFIC.").

61. See discussion of Section 1291 funds *supra* Part III.A.

62. I.R.C. § 1296 (1986).

63. To qualify as "marketable stock," the corporation must be regulated by a government

consequences of the Section 1291 fund rules. If a U.S. shareholder makes a mark-to-market election, the shareholder recognizes ordinary income or loss on the stock at the end of each year that the shareholder owns the PFIC stock, equal to the difference between the basis of the stock and its fair market value at that time.⁶⁴ A shareholder can take a loss deduction only to the extent of prior-year income inclusions not previously offset by losses (i.e., “unreversed inclusions”).⁶⁵ The basis of the stock is adjusted for the gain and loss recognition.⁶⁶ When the shareholder actually sells PFIC stock that is subject to a mark-to-market election, any gain is ordinary income,⁶⁷ and any loss on the disposition is an ordinary loss deductible only to the extent of unreversed inclusions.⁶⁸ This method is based on the assumption that the value of a publicly traded fund will change based on the company’s income for the year, an assumption that may or not be valid in any particular case. Although this regime mitigates some of the harsh consequences of the Section 1291 fund regime,⁶⁹ it is generally not as beneficial as the QEF rules⁷⁰ and is available only in the limited situation where the PFIC stock is marketable.

Besides the onerous tax consequences that result under the three PFIC taxation regimes described above, adding insult to injury is the fact that the PFIC rules are less than clear in many respects, often providing no definite answer to the PFIC shareholder in need of guidance.⁷¹ Complicating the interpretation of the PFIC rules are proposed regulations under I.R.C. § 1291 that were published in 1992.⁷² More

agency and listed on a national securities exchange that publishes the price of the fund’s shares at least weekly.

64. I.R.C. § 1296(a) (1986).

65. I.R.C. § 1296(a)(2) (1986).

66. I.R.C. § 1296(b) (1986).

67. I.R.C. § 1296(c)(1) (1986); Treas. Reg. § 1.1296-1(c)(2).

68. I.R.C. § 1296(c)(1) (1986); Treas. Reg. § 1.1296-1(c)(4)(i).

69. See discussion of Section 1291 funds *supra* Part III.A.

70. See discussion of QEFs *supra* Part III.B.

71. See, e.g., NYC BAR COMM. ON TAX’N OF BUS. ENTITIES, REPORT ON PASSIVE FOREIGN INVESTMENT COMPANY RULES (2009) (responding to the request for comments in which the NYC Bar sets forth recommendations for changes to Treasury Regulations “to make the PFIC rules work more effectively . . .”). For example, Proposed Treasury Regulation 1.1291-3(c)(2) treats indirect dispositions of stock in a lower-tier PFIC as if the U.S. shareholder of the upper-tier PFIC disposed of its proportionate share in the lower-tier PFIC, provided that the U.S. shareholder’s interest in the lower-tier PFIC is reduced as a result of such disposition or other transaction. Prop. Treas. Reg. § 1.1291-3(c)(2), 57 Fed. Reg. 11028 (Apr. 1, 1992). There would thus seem to be an indirect disposition if the lower-tier PFIC issues new shares to new investors, not just when the U.S. shareholder disposes of shares in the lower-tier PFIC or an intervening entity, which may not be the intended result.

72. Regulation Project INTL-656-87, 1992-1 C.B. 1124.

than twenty years have now gone by since 1992, and no one knows if the regulations will ever be finalized, and if they are finalized, in what form. The proposed regulations list an effective date of April 11, 1992,⁷³ and thus a taxpayer who does not follow these regulations, does so at his or her peril.

IV. ANTI-DEFERRAL REGIMES

A U.S. person who owns stock in a corporation is generally not subject to U.S. federal income tax on earnings of the corporation until the corporation makes a dividend distribution. Although a U.S. corporation is of course subject to U.S. income tax on its earnings, a foreign corporation escapes U.S. income taxation unless it earns U.S.-source fixed or determinable annual or periodical income, or income effectively connected with a U.S. trade or business.⁷⁴ If the foreign corporation operates in a low- or no-tax jurisdiction, U.S. taxes on the foreign corporation's earnings thus can be deferred until the foreign corporation makes a taxable distribution to its U.S. shareholders.⁷⁵

"Deferral" delays taxation on economic gain earned by a taxpayer. If a taxpayer's wealth increases in a year and the increase is not taxed currently, the taxpayer economically benefits. If the taxpayer had to pay tax on the increase, his or her wealth would decrease by the amount of the tax, and thus his or her investment would grow less. In a deferral structure, the taxpayer, instead of having to pay tax, could invest that amount and earn income on it before he or she had to pay the U.S. government. Tax on the increase in wealth in a deferral structure is delayed until a later date, reducing the effective tax rate because of the time value of money, to as low as zero if the deferral is for a sufficiently long period.

Tax deferral is not always seen as a bad outcome. For example, certain retirement plans are allowed to grow without tax on their earnings⁷⁶ as an incentive to save for retirement. Other tax provisions allow gain to be deferred on a realization event, because the taxpayer's

73. The PFIC proposed regulations were published in the Federal Register on April 1, 1992. I.R.C. § 7805(b) (1986) allows proposed regulations to be effective no earlier than the date on which the regulation is filed with the Federal Register.

74. See *supra* text accompanying notes 34-37.

75. Of course, if the foreign corporation is subject to income tax in a foreign country at rates higher than the U.S. tax rates, the benefits of overall tax deferral are negated, even if U.S. tax is deferred.

76. See, e.g., I.R.C. § 401(k) (1986).

investment continues in a different form.⁷⁷

In the international area, however, deferral is generally seen as an evil that must be stopped.⁷⁸ Consider this commentary in the opening paragraph of the Congressional Research Service report on *Tax Havens: International Tax Avoidance and Evasion*:⁷⁹

The federal government loses both individual and corporate income tax revenue from the shifting of profits and income into low-tax countries, often referred to as tax havens. The revenue losses from this tax avoidance and evasion are difficult to estimate, but some have suggested that the annual cost of offshore tax abuses may be around \$100 billion per year. International tax avoidance can arise from large multinational corporations who shift profits into low-tax foreign subsidiaries or wealthy individual investors who set up secret bank accounts in tax haven countries.⁸⁰

This paragraph shows the bias against foreign business activities of U.S. persons—mixing commentary on a multinational’s foreign business operations with “tax havens,” “tax avoidance and evasion,” “offshore tax abuses,” “international tax avoidance,” and “secret bank accounts.” A reader could easily conclude from this excerpt that a U.S. person who has income in foreign countries could only be doing one thing—avoiding the reach of U.S. tax laws through unlawful means. This makes for great political hay,⁸¹ but results in any type of foreign operations or investments of U.S. persons being viewed as suspect at best and fraudulent criminal activity at worst.

Setting aside this bias for now, an examination of deferral in the international context is necessary. Deferral can occur in the

77. See, e.g., tax-deferred reorganization provisions of I.R.C. §§ 355-356, 368 (1986), or corporate formation provisions in I.R.C. § 351 (1986) and partnership formation provisions in I.R.C. § 721 (1986).

78. In *International Taxation*, Charles I. Kingson succinctly summarizes the deferral conflict: “Attitudes toward deferral may just depend on self-interest. Those who benefit from deferral tend to like it; those who don’t benefit from it tend not to like it.” CHARLES I KINGSON, *INTERNATIONAL TAXATION* 451 (1st ed. 1998).

79. JANE G. GRAVELLE, CONG. RESEARCH SERV., R40623, *TAX HAVENS: INTERNATIONAL TAX AVOIDANCE AND EVASION* (2010).

80. See *id.* at Summary.

81. Mitt Romney was roundly criticized in the press for having Swiss bank accounts and Cayman Island investments during the 2012 presidential campaign. See, e.g., Josh Hicks, *Did Romney Avoid Taxes with Swiss Bank Accounts and Cayman Investments?*, WASH. POST, Aug. 29, 2012, http://www.washingtonpost.com/blogs/fact-checker/post/did-romney-avoid-taxes-with-swiss-bank-accounts-and-cayman-investments/2012/08/29/c4c6afc2-f18a-11e1-adc6-87dfa8eff430_blog.html. This blog posting states: “Opponents have criticized Romney for these financial arrangements, saying he must have something to hide—perhaps tax avoidance . . .”

international realm because foreign corporations are not subject to U.S. federal income taxation unless the income is effectively connected with a U.S. trade or business, or the corporation receives certain U.S.-source fixed or determinable annual or periodical income. Despite the very long arm of the U.S. tax laws, these laws cannot reach a company that is not formed in, does not do business in, or does not have investments in, the United States.⁸² A U.S. taxpayer could potentially be able to take advantage of these limitations and invest funds through a foreign corporation. Without anti-deferral rules, a U.S. taxpayer could benefit from deferring U.S. income taxation until the foreign corporation the U.S. taxpayer invested in pays a dividend.⁸³ In fact, the income could be deferred indefinitely if it is not repatriated to the United States. And, if the income is never repatriated during the life of the owner of the foreign corporation that generates the income, I.R.C. § 1014 would mandate a step-up in basis upon death to fair market value of the stock in the foreign corporation, which fair market value would reflect the income retained in the corporation, and thus allow those earnings to escape U.S. taxation.

Congress enacted a number of special tax regimes, beginning in 1934, which are summarily described below, to deal with tax opportunities generated by the deferral of U.S. income tax through the use of corporations. This series of anti-deferral regimes culminated in 1986 with the enactment of the PFIC legislation.

A. Personal Holding Company

The PHC rules⁸⁴ were enacted in 1934⁸⁵ to prevent individuals from deferring individual income tax on passive income by holding portfolio investments in corporations. This was considered by Congress to be “[p]erhaps the most prevalent form of tax avoidance practiced by individuals with large incomes”⁸⁶—“incorporated pocketbooks.”⁸⁷ A U.S. corporation is subject to the PHC rules if at least 60 percent of its adjusted gross income for a year is PHC income⁸⁸ and at any time during

82. See *supra* text accompanying notes 34-37.

83. I.R.C. § 956 (1986) would also prevent the U.S. taxpayer from receiving funds in the form of a loan from the foreign corporation if the U.S. taxpayer is a “U.S. shareholder” of a CFC.

84. I.R.C. §§ 541-547 (1986).

85. Revenue Act of 1934, Pub. L. No. 73-216, 48 Stat. 680.

86. H.R. REP. NO. 73-704, at 11 (1934).

87. *Id.*

88. I.R.C. § 542(a)(1) (1986). PHC income is passive income, such as royalties, rent, interest, and dividends. I.R.C. § 543(a) (1986).

the last half of the taxable year more than 50 percent in value of its stock is owned, directly or indirectly, by five or fewer individuals.⁸⁹ If both of these requirements are met, a corporate-level tax is imposed, equal to 20 percent of the undistributed PHC income.⁹⁰

At the time these provisions became law, the highest corporate income tax rates were 13.5 percent and the highest individual income tax rates were 63 percent—a difference of 49.5 percent. In addition, the *General Utilities* doctrine⁹¹ prevented taxation at the corporate level when appreciated assets were distributed to a shareholder in either a liquidating or non-liquidating distribution. In such an environment, individuals had the incentive to hold their portfolio investments in “incorporated pocketbooks” to delay the higher individual income tax rate of 63 percent when the profits were distributed by the corporation. With the change of individual and corporate rates to close to the same rate, i.e., currently 35 percent for corporations and 39.6 percent for individuals,⁹² and the repeal of the *General Utilities* doctrine,⁹³ the PHC legislation does not presently serve the purpose for which it was intended. Instead, the PHC remains as a complicated set of rules that regularly reach active businesses that utilize holding company structures.⁹⁴ The rules do not currently apply to foreign corporations.⁹⁵

89. I.R.C. § 542(a)(2) (1986).

90. I.R.C. § 541 (1986). This rate increased from 15 percent to 20 percent for taxable years beginning after Dec. 31, 2012, with the enactment of the American Taxpayer Relief Act of 2012, Pub. L. No. 112-240, 126 Stat. 1632.

91. The *General Utilities* doctrine is based on the U.S. Supreme Court’s decision in *Gen. Utilities & Operating Co. v. Helvering*, 296 U.S. 200, 206 (1935), and was codified in the Internal Revenue Code of 1954. I.R.C. §§ 311, 336 (1986), Pub. L. No. 83-591, 68A Stat. 3, 94-95, 106. See David Scott Sloan & John M. Loalbo, *The Ultimate Disposition of General Utilities: An Analysis of the General Utilities Doctrine From Inception to Repeal*, 6 B.U. J. TAX L. 177 (1988).

92. The top individual tax rate rose to 39.6 percent on Jan. 1, 2013, from 35 percent.

93. The Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (repealed Sections 336 and 337 of the Internal Revenue Code of 1954, Pub. L. No. 83-591, 68A Stat. 3).

94. Unlike the PFIC look-through rule for dividends received from subsidiaries, the PHC rules consider a dividend from a foreign subsidiary to be PHC income. I.R.C. § 543(a)(1) (1986).

95. I.R.C. § 542(c)(5) (1986). Prior to the American Jobs Creation Act of 2004, Pub. L. No. 108-357, 118 Stat. 1420 [hereinafter AJCA], only certain types of foreign corporations were excluded from the definition of a personal holding company: (1) PFICs, (2) foreign personal holding companies, and (3) foreign corporations that had no U.S.-source personal service income and all of the outstanding stock of which was owned by foreign persons during the last half of the tax year. Section 413(b)(1) of the American Jobs Creation Act of 2004 changed this rule such that all foreign corporations were excluded from the definition of PHCs. This change was effective for tax years beginning after December 31, 2004, and tax years of U.S. shareholders with or within which the tax years of such foreign corporations end.

B. Foreign Personal Holding Company

Three years after the PHC rules came into force, Congress enacted the first legislation to target deferral of U.S. income taxation by using foreign corporations—the FPHC rules—in 1937.⁹⁶ Like the PHC rules described immediately above, the FPHC regime attacked incorporated pocketbooks.⁹⁷ Because dividends received by FPHCs, or gains on sales of investments held by FPHCs, were subject to little or no tax in the FPHC’s country of incorporation, earnings of FPHCs would not be taxed in the United States until the foreign corporation paid dividends to a U.S. shareholder. If the FPHC rules applied, each U.S. shareholder of the FPHC on the last day of the corporation’s tax year had to include in income his or her pro rata share of the FPHC’s undistributed income for the year.⁹⁸

A foreign corporation is a FPHC if both: (1) at least 60 percent (50 percent after the first year that the corporation has been a FPHC) of its gross income is foreign personal holding company income (i.e., passive income, including dividends, interest, royalties, annuities, rents, and certain gains from transactions involving securities and commodities⁹⁹), and (2) more than 50 percent of the total voting power or value of all classes of stock is owned by five or fewer U.S. individuals.¹⁰⁰

The FPHC rules reached only U.S. individuals trying to defer tax on passive income. They did not reach publicly traded U.S. corporations that owned foreign subsidiaries or foreign subsidiaries with active income. Congress recognized that its job was not done in preventing tax avoidance issues, stating in a report of the Joint Committee on Tax Evasion that the committee “should continue its study of the problem and should consider other and additional measures which may be feasible for preventing the use of spurious foreign entities to thwart the intent and purposes of the revenue laws.”¹⁰¹

The FPHC rules were determined to be unnecessary after the enactment of the Subpart F regime discussed immediately below and the PFIC provisions. The FPHC rules were thus repealed by the American

96. I.R.C. §§ 551-558 (repealed 2004); Revenue Act of 1937, ch. 815, Pub. L. No. 75-377, 50 Stat. 813.

97. See *supra* text accompanying notes 84-87.

98. I.R.C. §§ 551(a)-(b) (repealed 2004).

99. I.R.C. § 553(a) (repealed 2004).

100. I.R.C. § 552 (repealed 2004).

101. CHAIRMAN OF J. COMM. ON TAX EVASION AND AVOIDANCE, REP. OF THE J. COMM. ON TAX EVASION AND THE AVOIDANCE OF THE CONG. OF THE U.S., H.R. DOC. NO. 75-337, at 22 (1937).

Jobs Creation Act¹⁰² effective for tax years beginning after December 31, 2004, in an effort to simplify anti-deferral rules.

C. Subpart F

The next major set of anti-deferral rules were enacted in 1962—the Subpart F¹⁰³ and FIC rules.¹⁰⁴ President Kennedy wanted to completely end deferral through the use of foreign corporations, such that all income from foreign subsidiaries would be taxed immediately to U.S. shareholders, even if the income was not distributed.¹⁰⁵ To “avoid artificial encouragement to investment in other advanced countries as compared with investment in the United States,” the Kennedy Administration proposed that “American corporations be fully taxed each year on their current share in the undistributed profits realized by subsidiary corporations organized in economically advanced countries.”¹⁰⁶ No deferral would be allowed that would give U.S. multinationals a competitive advantage over U.S. corporations operating wholly within the United States. Congress did not embrace the end-of-deferral proposal of the Kennedy Administration, fearing that this would make U.S. companies uncompetitive with companies of other countries. Instead, Congress and the President compromised and enacted the Subpart F rules.¹⁰⁷

Under the Subpart F provisions, a U.S. shareholder of a CFC is taxed currently on his or her pro rata share of certain types of income of the CFC, even if the U.S. shareholder does not receive a dividend distribution.¹⁰⁸ On a subsequent distribution of previously taxed income, there is no further U.S. federal income taxation.¹⁰⁹ In order for Subpart F to apply, the foreign corporation must be a CFC.¹¹⁰ A foreign corporation is a CFC if “U.S. Shareholders” collectively own more than 50 percent of the total combined voting power of the foreign corporation’s stock or more than 50 percent of the stock’s total value.¹¹¹ A U.S. Shareholder is defined as any U.S. person who owns at least 10

102. AJCA, *supra* note 95, at § 413.

103. Revenue Act of 1962, Pub. L. No. 87-834, 76 Stat. 961.

104. See discussion of FIC rules *infra* Part IV.D.

105. *President's Tax Message: Hearings Conducted by Committee on Ways and Means House of Representatives*, 87th Cong. 1 (1961).

106. *Id.*

107. I.R.C. §§ 951-960 (1986).

108. I.R.C. § 951(a) (1986).

109. I.R.C. § 959 (1986).

110. I.R.C. § 951(a)(1)(A)(i) (1986).

111. I.R.C. § 957(a) (1986).

percent or more of the voting power of all classes of stock entitled to vote.¹¹² U.S. persons who own less than 10 percent of the stock of a foreign corporation are not counted in determining whether U.S. Shareholders own more than 50 percent of the vote or value of the corporation. Direct ownership, as well as indirect and constructive ownership, is considered in determining if a foreign corporation is a CFC.¹¹³

Subpart F income is composed of specific categories of income that can in general be manipulated easily, either because it is passive income or it is income that is separated from the income-producing activity. The most important type of Subpart F income is foreign base company income.¹¹⁴ Foreign base company income includes the following types of income: (1) foreign personal holding company income, (2) foreign base company sales income, and (3) foreign base company services income.¹¹⁵

Foreign personal holding company income consists of passive income, such as interest, dividends, rents, royalties, and net gains from the sale of passive assets.¹¹⁶ Foreign base company sales income includes income from personal property purchased from, or sold to, a related party if the property is manufactured and sold for use outside the CFC's country of incorporation.¹¹⁷ If the CFC manufactures the property sold, or the property is manufactured in the CFC's country of incorporation, the income is not foreign base company sales income.¹¹⁸ Foreign base company services income consists of income derived from the performance of specified services for, or on behalf of, a related person outside the country where the CFC is organized.¹¹⁹ Services subject to this rule include technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial, or like services.¹²⁰

In addition to taxing certain income of a CFC directly to the CFC's U.S. shareholders, Congress enacted I.R.C. § 956, which taxes the

112. I.R.C. § 951(b) (1986).

113. I.R.C. §§ 957(a), 958 (1986).

114. I.R.C. § 954(a) (1986). There are special rules that apply to Subpart F income that can cause income to be excluded or included as Subpart F income, such as the *de minimis* rule, full-inclusion rule, and high-tax exception. I.R.C. § 954(b) (1986).

115. I.R.C. § 954(a) (1986). Foreign base company income also includes foreign base company oil-related income. I.R.C. §§ 954(a)(5), (g) (1986).

116. I.R.C. § 954(c) (1986).

117. I.R.C. § 954(d) (1986).

118. I.R.C. § 954(d)(1) (1986).

119. I.R.C. § 954(e) (1986).

120. I.R.C. § 954(e)(1) (1986).

CFC's U.S. shareholders if earnings of the CFC are used in the United States, even if the corporation has not made a dividend distribution. For example, a loan by the CFC to the CFC's U.S. corporate parent or a purchase of property located in the U.S. by the CFC, would be subject to U.S. income taxation on an amount determined by reference to the amount of the loan or U.S. property, respectively.¹²¹

D. Foreign Investment Company

In tandem with the enactment of the Subpart F rules described above, Congress enacted the FIC rules in 1962.¹²² Congress was motivated by the belief that foreign investment companies were being used to avoid taxation and had determined that "the seriousness of [the] problem [had] increased substantially."¹²³ Since a foreign investment company had no requirement that it distribute its income as was in place for its U.S. counterpart, the Regulated Investment Company,¹²⁴ U.S. tax on the foreign investment company's income could be avoided by the company not making U.S. investments and delaying distribution of its profits. A U.S. shareholder of such a company that did not make shareholder distributions could turn the earnings of the foreign investment company into capital gain by selling the stock.

The FIC provisions addressed this deferral and gain conversion by requiring that gain from the disposition of stock in a foreign investment company be treated as ordinary income instead of capital gain, up to the selling shareholder's share of post-1962 accumulated earnings and profits of the FIC.¹²⁵ To be subject to these rules, a FIC had to have ownership by U.S. persons of 50 percent or more of its stock, directly or indirectly, by vote or value. If this U.S. ownership requirement was met, the rules applied to any U.S. person who was a shareholder in the FIC no matter how small the shareholding.¹²⁶ In addition to the ownership requirement, the foreign corporation had to be either: (1) registered under the Investment Company Act of 1940 as a management company or as a unit investment trust or (2) engaged primarily in the business of investing or trading in securities or commodities or interests therein.¹²⁷ The FIC could elect prior to December 31, 1962, to distribute 90 percent

121. I.R.C. § 956 (1986).

122. See discussion of Subpart F *supra* Part IV.C; I.R.C. §§ 1246-1247 (1986).

123. H.R. REP. NO. 87-1447, at 72 (1962).

124. See discussion of RICs *infra* Part IV.E.

125. I.R.C. § 1246(a)(1) (repealed 2004).

126. I.R.C. § 1246(b) (repealed 2004).

127. *Id.*

or more of its taxable income each year, in which case the FIC provisions would not apply,¹²⁸ except that a U.S. shareholder of the FIC had to include in income the shareholder's share of the capital gains, whether or not distributed.¹²⁹ Although the FIC provisions were repealed for taxable years of foreign corporations beginning after December 31, 2004,¹³⁰ they were the forerunner to the PFIC rules and thus are important to understand for purposes of the analysis herein.

E. Regulated Investment Company

A U.S. investment company is taxed under regular corporate federal income tax rules, unless it makes an election for alternative tax treatment under Subchapter M of the Internal Code of 1986, as amended, to be treated as a regulated investment company ("RIC").¹³¹ As a RIC, the investment company does not have to pay corporate-level federal income taxes on any income that is distributed to its shareholders from the RIC's earnings and profits.¹³² To qualify as a RIC, the corporation must be registered with the Securities and Exchange Commission as an investment company, distribute 90 percent of its earnings (not including capital gains) to its shareholders, and meet certain source-of-income and asset diversification requirements.¹³³ The RIC is subject to U.S. federal income tax at regular corporate income tax rates on any income or capital gains not distributed (or deemed distributed) to its shareholders, and is further subject to a four-percent nondeductible federal excise tax on certain undistributed amounts.¹³⁴ Foreign investment companies are not subject to the asset diversification and income distribution requirements for RICs.

F. Comparison to PFIC Rules

In spite of the numerous anti-deferral rules described above, the rules did not prevent the favorable tax treatment for U.S. investors in foreign investment companies, which were not hamstrung by the RIC-required distribution rules. The FIC rules were designed to give the same treatment as a RIC to the U.S. shareholder of a FIC if the FIC

128. I.R.C. § 1247(a)(1) (1986).

129. I.R.C. § 1247(d)(2) (1986).

130. AJCA, *supra* note 95, at § 413(a)(2).

131. I.R.C. §§ 851-855 (1986).

132. I.R.C. § 852 (1986).

133. I.R.C. § 851(b) (1986).

134. I.R.C. § 4982 (1986).

elected to distribute at least 90 percent of its income. The FIC rules, however, only reached foreign corporations that had at least 50 percent U.S. ownership, and this could readily be avoided by the foreign corporation limiting U.S. ownership. FPHCs were foreign corporations that had five or fewer individuals owning more than 50 percent of the foreign corporation, a requirement that could be manipulated as easily as FIC ownership, and the reach of PHCs is limited to domestic corporations.

The FPHC and FIC rules have since been repealed, and the Subpart F rules that remain have a much more limited reach than do the PFIC rules. The Subpart F income-inclusion rules reach only foreign corporations that are CFCs and U.S. shareholders that own more than 10 percent of the CFC's voting power. The PFIC rules apply to all U.S. persons who own interests in a foreign corporation that is a PFIC. In addition, the Subpart F rules only apply to certain kinds of easily manipulated income; PFIC rules result in taxation to the U.S. owner of all of the income earned by the PFIC.

Without the PFIC rules, a foreign corporation would not only avoid tax on its earnings if formed in a tax haven, but a U.S. investor therein would only be taxed when he or she received a dividend from the fund or sold his or her shares in the fund. In addition, if there were no distributions from the fund, the investor's return would all be taxed as capital gain upon a sale of the shares in the foreign investment company. These differences in taxation, and the failure of the Subpart F rules to reach all U.S. investors in foreign corporations, were seen as advantages for U.S. investors in foreign investment companies versus U.S. investors in U.S. investment companies. In order to fill the gap in these other anti-deferral regimes, and equate taxation of U.S. investors in foreign investment companies with U.S. investment companies,¹³⁵ the PFIC rules were enacted.

V. REASONS FOR PFIC LEGISLATION

The PFIC rules were enacted to eliminate "the economic benefit of deferral."¹³⁶ Part IV discussed the history of attempts to stop the

135. In fact, the PFIC rules generally result in worse tax consequences for a U.S. investor in a foreign investment company than in a U.S. investment company. As noted in *The PFIC Rules: The Case of Throwing the Baby out with the Bathwater*: "These rules go beyond equating the tax treatment of RICs and foreign investment corporations and make it disadvantageous to invest in a foreign investment corporation that is a PFIC." Kevin M. Cunningham, *The PFIC Rules: The Case of Throwing the Baby Out with the Bathwater*, 21 VA. TAX REV. 387, 407 (2002).

136. H.R. REP. NO. 99-841, at II-641 (1986) (Conf. Rep.).

economic benefit of deferral, beginning with the PHC and FPHC rules. The FPHC rules have been repealed, and the PHC rules are antiquated and in need of revamping or repealing.¹³⁷ One of the abuses at which the major piece of anti-deferral legislation—the Subpart F rules¹³⁸—was directed was delaying taxation on passive income. On this point, both the House and Senate stated: “Your committee . . . sees no need to maintain deferral of U.S. tax where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In such cases, there is no competitive problem justifying postponement of tax until the income is repatriated.”¹³⁹ To be subject to these rules that tax a U.S. shareholder on his or her pro rata share of Subpart F income, a U.S. taxpayer must meet the definition of “U.S. Shareholder,”¹⁴⁰ i.e., a 10-percent owner by vote, in a CFC.¹⁴¹ A U.S. taxpayer who owns shares in a foreign corporation is not subject to the Subpart F rules if either the taxpayer is not a “U.S. Shareholder” or the foreign corporation is not a CFC.

The FIC rules applied to passive income earned by any U.S. person who owned shares of a foreign investment company, provided that the FIC was owned more than 50 percent by vote or value by U.S. persons. But these rules were not enough for Congress, as a U.S. shareholder of a foreign investment fund that was not owned more than 50 percent by U.S. persons would avoid the anti-deferral Subpart F and FIC rules.¹⁴² The Senate committee stated: “The committee understands that the abuses the Congress was concerned with in 1962 when the foreign investment company provisions were enacted have advanced to a point where present law is basically inoperative. The committee is aware that present foreign corporations that invest in passive assets limit U.S. ownership in such funds so that section 1246 [the FIC provision] rarely applies.”¹⁴³

137. Rep. Dave Reichert (R-WA) and Rep. Jim McDermott (D-WA) introduced H.R. 6660 in December 2012—The Personal Holding Company (PHC) Tax Parity and Reinvestment Act. The bill was reintroduced on May 7, 2014, as H.R. 4589. If enacted, this law would eliminate dividends from CFCs as PHC income. Although this would be a good start to correcting the PHC rules, the best approach would be an overall repeal of the PHC regime as the reasons for its enactment are no longer valid. Alas, a topic for another day.

138. See discussion of Subpart F rules *supra* Part IV.C.

139. H.R. REP. NO. 87-1447, at 62 (1962); S. REP. NO. 87-1881, at 83 (1962).

140. See I.R.C. § 951(b) (1986).

141. See I.R.C. § 957(a) (1986).

142. At the time of the enactment of the PFIC rules in 1986, another set of anti-deferral rules was in effect—foreign personal holding company rules, which have since been repealed. See discussion *supra* Part IV.B.

143. S. REP. NO. 99-13, at 393 (1986).

Congress took the next step and enacted the PFIC legislation “to eliminate the tax advantages that U.S. shareholders in foreign investment funds have heretofore had over U.S. persons investing in domestic investment funds.”¹⁴⁴ Congress greatly expanded the reach of anti-deferral rules with the PFIC legislation by eliminating any minimum U.S. ownership requirement. Further, as described above, domestic investment companies are taxed on their income unless 90 percent of the income is distributed. Since foreign investment companies are not subject to this distribution requirement, they can be formed in countries with no income tax and avoid any taxation at the fund level. The U.S. owner of the foreign investment company would then not be subject to tax on any earnings of the funds until the fund makes a dividend distribution, which the fund could delay indefinitely. If the fund makes no dividend distributions, the U.S. owner could convert ordinary income of the fund into capital gains when the U.S. owner sold the fund.¹⁴⁵ Congress felt that U.S. persons who invested in foreign investment companies should not have such tax advantages over those investing in domestic investment companies.¹⁴⁶

The QEF rules described above¹⁴⁷ met the objectives of Congress: taxpayers were taxed as the foreign fund earned income, a result similar to an investment in a domestic investment company. But, even if the QEF taxation reached the intended result, Congress recognized that it might not be possible for a U.S. investor to obtain the information required regarding a foreign fund’s earnings and profits.¹⁴⁸ If a PFIC provided the U.S. investor with the required information, however, the investor likely could not force the fund to distribute funds sufficient for the investor to pay tax on the investor’s share of the PFIC’s income.¹⁴⁹ If the investor had invested in a domestic investment company, the investment company would have been compelled to distribute its income, or be taxed itself on the undistributed income. Congress therefore provided for an alternative taxing regime for PFICs, with taxation only when the fund was sold or there was an excess distribution. The excess distribution was an acknowledgment to the RIC rules, i.e., if the foreign investment company distributed most of its earnings each

144. 86 BLUEBOOK, *supra* note 57, at 1023.

145. I.R.C. § 1248 (1986) converts capital gain into ordinary income upon the sale of stock in a foreign corporation, to the extent of earnings and profits attributable to the selling shareholder’s ownership, but this rule only applies when the foreign corporation is a CFC.

146. 86 BLUEBOOK, *supra* note 57, at 1023.

147. See discussion of QEFs *supra* Part III.B.

148. 86 BLUEBOOK, *supra* note 57, at 1023.

149. *Id.*

year, there would be no punitive PFIC taxation to the U.S. investor.¹⁵⁰

The legislative history is limited to discussions of perceived abuses involving foreign investment companies and the need for parity with domestic investment companies:

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-à-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.¹⁵¹

VI. UNEXPECTED PFIC TAX CONSEQUENCES AND PROPOSED SOLUTIONS

The need of Congress to correct the perceived abuse of U.S. taxpayers investing in foreign investment companies and obtaining “deferral” was the impetus behind the complicated¹⁵² set of PFIC tax rules. The consequences of these rules go far beyond the motivating factors behind the legislation, consequences that must not have been anticipated. Not only are companies that are not foreign investment companies affected by the PFIC rules, but a whole host of harmful and unfair consequences can result, leaving one with the impression of a situation that PFICs have gone wild.

The following discussion of unexpected PFIC tax consequences focuses on two aspects of the PFIC overreach and proposes solutions to these issues: (1) extension of the PFIC rules to start-up and operating companies, and (2) taxation on transfers of PFIC stock that would otherwise not be subject to tax. These two areas just touch the surface of the many defects in the PFIC provisions.¹⁵³ As expressed by one PFIC author: “The rules stand as living witness to the danger of trying to solve

150. S. REP. NO. 99-13, at 394 (1986).

151. 86 BLUEBOOK, *supra* note 57, at 1032.

152. Christopher H. Hanna’s article on deferral recognizes the complexities that arise from attempts to stop tax deferral: “Unfortunately, the focus on tax deferral and time value of money increases the complexities of the tax system to almost nightmarish proportion.” Christopher H. Hanna, *The Virtual Reality of Eliminating Tax Deferral*, 12 AM. J. TAX POL’Y 449, 451 (1995).

153. The New York City and State Bar associations have examined the PFIC rules in depth and proposed numerous solutions to improve the law. See N.Y. ST. BAR ASS’N, *supra* note 38; NYC BAR COMM., *supra* note 71.

a little problem and ending up with a much bigger one in its place.”¹⁵⁴

A. Start-Up and Operating Companies

1. Start-Up Companies

a. Problem

The main problem with the PFIC regime is that its reach extends far beyond foreign investment companies to start-up and operating companies. A company in the start-up phase of its operations may initially only have cash that generates interest. If this is the company's only income, or at least 75 percent of the company's gross income, it will be a PFIC. As discussed above in Part II, there is a start-up exception. This exception is available, however, only if: (1) no predecessor of the corporation was a PFIC, (2) it is established to the satisfaction of the Secretary that the corporation will not be a PFIC for either of the two subsequent years following the start-up year, and (3) the corporation is not in fact a PFIC during those two subsequent years.¹⁵⁵ The start-up year is the first taxable year in which the PFIC has gross income.¹⁵⁶

Due to the start-up exception applying only to the PFIC's first taxable year, it is of limited utility. The start-up period can be a period from one to 365 days, which is not a very long time in which a company must begin operating. This is especially problematic for a foreign mining company that is in the exploration phase. Such a corporation will have to expend large sums of capital in the exploration and development of mining properties and will have little or no active mining income for many years. It will, however, generally have interest or other passive income from the cash it needs to continue the exploration activity.

b. Proposed Solution

Several changes would solve the start-up company problem: (a) change the method for counting cash (and other liquid investments) as passive assets generating passive income, and (b) determine the start-up phase according to the specific facts and circumstances.

154. Fuller, *supra* note 39, at 899.

155. I.R.C. § 1298(b)(2) (1986).

156. *Id.*

- **Cash.** According to I.R.S. Notice 88-22,¹⁵⁷ cash and cash equivalents are passive assets because they produce passive income. This is particularly harsh guidance and one at odds with other provisions of international tax. In determining whether income is effectively connected with a U.S. trade or business, interest from cash held to meet the present needs of the business is considered trade or business income.¹⁵⁸ Further, in determining if a corporation is a U.S. real property holding corporation, cash is considered a business asset if it is used or held for use in the corporation's trade or business.¹⁵⁹ A similar requirement should be put in place for cash or cash equivalents in determining if a PFIC has passive assets or passive income. If the cash or cash equivalent is held for use in the corporation's trade or business, it should not be considered a passive asset that generates passive income.

- **Start-up Period.** The start-up period during which the PFIC tests are not applied could be linked to the definition of "start-up expenditures" under Section 195 of the Internal Revenue Code. Under this section, start-up expenditures cannot be deducted unless an election is made.¹⁶⁰ The Secretary is given authority to issue regulations regarding when an active trade or business begins;¹⁶¹ no regulations have been issued to date. Further, neither the Internal Revenue Code nor regulations provide what a "trade or business is," and courts have provided limited guidance. The U.S. Supreme Court has stated that in order to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity, with the primary purpose of obtaining a profit.¹⁶² Despite the limited guidance available, taxpayers have taken positions regarding what constitutes a start-up expense. The PFIC rules should allow the start-up period to include all periods during which start-up expenses are incurred by tying in the PFIC start-up exception to the start-up expenditures of Section 195 of the Internal Revenue Code.

157. 1988-1 C.B. 489. This Notice is the Treasury's principal pronouncement on the PFIC rules.

158. Treas. Reg. § 1.864-4(c)(2).

159. I.R.C. § 897(c) (1986); Treas. Reg. § 1.897-1(f)(1)(iii).

160. I.R.C. § 195 (1986).

161. I.R.C. § 195(c)(2)(A) (1986).

162. *Comm'r v. Grotzinger*, 480 U.S. 23, 23 (1987).

2. Operating Companies

a. Problem

Besides the PFIC problems resulting from companies in a start-up phase, companies that are actually operating companies can nevertheless fall within the definition of a PFIC. This can result, for example, because of a company's needs for large amounts of cash. Another scenario would involve an operating company becoming a PFIC in a year that it has little active business income due to a particularly unprofitable year, yet has a large amount of passive income. Service companies and sales subsidiaries that have very few assets can also fall into the PFIC trap. An operating company could become a PFIC, and the "once a PFIC, always a PFIC" rule¹⁶³ would apply so that its taint remains, even when the PFIC tests are not met in a particular year.

b. Proposed Solution

The PFIC rules were never intended to reach an operating company. The legislative history of the PFIC rules specifically states: "A foreign corporation engaged in an active trade or business generally will not be a PFIC."¹⁶⁴ The rules were intended only to reach foreign investment companies. In order to avoid operating companies becoming inadvertent PFICs, the definition of PFIC should be the same as was in existence for FICs. FICs were required to be either (1) registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or (2) engaged primarily in the business of investing or trading in securities or commodities or interests therein.¹⁶⁵ FICs required more than 50 percent U.S. ownership. This U.S. ownership requirement could be eliminated, but the requirement that a company be engaged primarily in the business of investing or trading in securities or commodities should be an absolute requirement. Alternatively, the PFIC rules could be applied only to an "investment company" as defined for purposes of Section 351(e) of the Internal Revenue Code.¹⁶⁶ Whatever the chosen definition is, there affirmatively

163. See I.R.C. § 1298(b)(1) (1986); see also *supra* text accompanying note 31.

164. 86 BLUEBOOK, *supra* note 57.

165. *Id.*

166. I.R.C. § 351(e) (1986) does not define "investment company." Treas. Reg. § 1.351-1(c)(1) provides that a transfer of property is a transfer to an investment company if (i) the transfer results, directly or indirectly, in diversification of the transferors' interests, and (ii) the transferee is (a) a RIC, (b) a real estate investment trust ("REIT"), or (c) a corporation, of which more than 80 percent of the value of its assets are held for investment and are readily marketable stocks or

needs to be one so that start-up and operating companies are not subject to the PFIC rules.

B. Transfers of PFIC Stock

1. Tax-Deferred Reorganizations

a. Problem

Section 1291(f) of the Internal Revenue Code provides that gain is recognized with respect to PFIC stock even if a nonrecognition provision applies “[t]o the extent provided in regulations.” In general, the proposed regulations require that gain be recognized when Section 1291 fund stock is exchanged under a nonrecognition provision for stock in another corporation, such as an I.R.C. Section 351 transfer to a controlled corporation or an I.R.C. Section 368 tax-deferred reorganization.¹⁶⁷ This provision can put a U.S. shareholder of a PFIC in a very bad position in the case of an otherwise tax-deferred reorganization: the shareholder may have no control over whether the exchange of stock takes place yet will be burdened with a tax obligation and no cash proceeds from the exchange to pay the tax. There is an exception such that no tax results if stock in a Section 1291 fund is exchanged in an otherwise nontaxable transaction for stock in another PFIC.¹⁶⁸

b. Proposed Solution

The harsh treatment of requiring recognition of gain in a reorganization or capital contribution where Section 1291 fund stock is exchanged for non-PFIC stock is not necessary. Instead, the PFIC attributes of the stock could carry over to the non-PFIC stock obtained, such that upon a taxable disposition of the new stock, the Section 1291 fund rules could apply only to any deferred gain from the period that the stock owned was stock in a PFIC.

A major problem with the situation at present regarding exchanges of stock in a reorganization involving a Section 1291 fund is the

securities, or interests in RICs or REITs.

167. Prop. Treas. Reg. § 1.1291-6, 57 Fed. Reg. 11029 (Apr. 1, 1992).

168. Prop. Treas. Reg. § 1.1291-6(c)(1), 57 Fed. Reg. 11029 (Apr. 1, 1992). The stock received must qualify under I.R.C. § 1296(a) as a PFIC for its taxable year that includes the day after the nonrecognition transfer. *Id.*

uncertainty of the proposed regulations.¹⁶⁹ The regulations are still not finalized after more than 20 years, yet have an effective date of the date of publication of the proposed regulations. The regulations should be thoroughly reviewed and revised as necessary, with an effective date of the date the final regulations are published. In addition, if PFIC status is limited as discussed above in Part VI.A, there will be much less concern about the potential recognition of gain on an exchange of PFIC stock under a nonrecognition provision, as only investment companies would be implicated, and a reorganization of a pure investment company would not be a likely occurrence.

2. Gifts

a. Problem

Any disposition of stock in a PFIC by a U.S. shareholder is taxed under the override of nonrecognition rules described above. This includes gifts.¹⁷⁰ Thus, if a gift of Section 1291 fund is made, the transferor is generally subject to income tax on the deferred gain under the Section 1291 fund rules on the difference between the stock's fair market value and the transferor's basis in the stock. There is an exception if immediately after the gift the stock is owned by a U.S. person, provided that: (1) the U.S. transferee's basis in the Section 1291 fund stock is no greater than the basis the transferor had in the stock, (2) the U.S. transferee's holding period for the Section 1291 fund stock is at least as long as the transferor's holding period immediately before the transfer, and (3) the total indirect ownership of the transferor and U.S. transferee immediately after the transfer (not counting any of the Section 1291 fund stock held by the U.S. transferee before the transfer) is at least as great as the transferor's proportionate ownership immediately before the transfer.¹⁷¹ If, however, a U.S. shareholder of a Section 1291 fund makes a gift of stock in the fund to a U.S. person and incurs gift tax on the transfer, the U.S. shareholder would not recognize gain, but would be liable for the "deferred tax amount,"¹⁷² as if the shareholder recognized gain in the amount of the gift tax that is added to the basis of the transferred stock under I.R.C. Section 1015(d).¹⁷³ The adjusted basis

169. See *supra* discussion of proposed regulations at text accompanying notes 71-73.

170. Prop. Treas. Reg. § 1.1291-3(b)(1), 57 Fed. Reg. 11029 (Apr. 1, 1992) and Prop. Treas. Reg. § 1.1291-6(a)(2), 57 Fed. Reg. 11029 (Apr. 1, 1992).

171. Prop. Treas. Reg. § 1.1291-6(c)(2), 57 Fed. Reg. 11029 (Apr. 1, 1992).

172. See *supra* text accompanying note 50.

173. Prop. Treas. Reg. § 1.1291-6(c)(5), 57 Fed. Reg. 11029 (Apr. 1, 1992).

of the PFIC stock is increased by the amount of the gift tax paid.¹⁷⁴

b. Proposed Solution

Although a gift may result in U.S. gift tax, there is no other type of gift that is subject to income tax under the Internal Revenue Code. Singling out gifts of PFIC stock to attract income tax is an unnecessarily harsh result. If the concern is to ensure appropriate treatment upon the transferee's disposition of the stock, the regulations should be changed such that the PFIC attributes carry over to the transferee, just as the transferor's basis generally carries over to the transferee in the case of a gift.¹⁷⁵

3. Transfers upon Death

a. Problem

Just as for gifts, a transfer of Section 1291 fund stock upon death is considered to be a taxable disposition under proposed regulations.¹⁷⁶ There is an exception if the transfer is to a domestic estate or directly to a U.S. person.¹⁷⁷ Even if no gain has to be recognized upon a transfer upon death, however, there is no step-up in basis for Section 1291 fund stock as there is for all other property.¹⁷⁸

b. Proposed Solution

The solution for this problem is simple—transfers on death should not be treated as dispositions and there should be a step-up in basis in the PFIC stock upon death. If the corporation no longer qualifies as a PFIC at the date of death, yet is taxed as one because it was previously a PFIC, the recipient should not be burdened with the PFIC rules going forward. Although the PFIC stock attributes would be extinguished to the recipient, this is what happens to all other property that is transferred

174. Prop. Treas. Reg. § 1.1291-6(c)(2)(v), 57 Fed. Reg. 11029 (Apr. 1, 1992).

175. I.R.C. § 1015(a) (1986).

176. Prop. Treas. Reg. §§ 1.1291-3(b)(1), 1.1291-6(a)(2), 57 Fed. Reg. 11029 (Apr. 1, 1992).

177. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(A), 57 Fed. Reg. 11029 (Apr. 1, 1992). The exception for a transfer to a domestic estate does not apply, however, if the will allows the stock to be transferred to a foreign person or to a trust. Prop. Treas. Reg. § 1.1291-6(c)(2)(iii)(B), 57 Fed. Reg. 11029 (Apr. 1, 1992). A U.S. shareholder who inherits Section 1291 fund stock from a U.S. decedent who was within this exception for gain recognition can take a deduction from gross income when he or she disposes of the PFIC stock, in an amount equal to a portion of the decedent's estate tax paid on the PFIC stock. Prop. Treas. Reg. § 1291-3(j), 57 Fed. Reg. 11029 (Apr. 1, 1992).

178. I.R.C. §§ 1014, 1291(c).

upon death: the transferee takes a step-up in basis and everything starts anew. There is no reason to treat PFIC stock differently than all other property.

4. Immigration/Expatriation

a. Problem

A nonresident alien becomes subject to the PFIC rules the day he or she becomes a U.S. resident.¹⁷⁹ Thus, any gain attributable to pre-U.S. residency periods is not subject to the PFIC interest charge. If a nonresident alien becomes a U.S. resident at the time he or she owns PFIC stock, in spite of the lack of interest charge on pre-U.S. residency periods, the immigrant can still be subject to stiff tax burdens when the PFIC stock is disposed of. If the PFIC stock is marketable, the mark-to-market rules provide that for purposes of such rules, the adjusted basis of the stock is the greater of the shareholder's adjusted basis or fair market value on the first day of the taxable year that the person became a U.S. resident.¹⁸⁰

For a U.S. resident or citizen who ceases to be a U.S. resident or citizen, he or she is deemed to dispose of all Section 1291 fund stock he or she owns on the last day that the shareholder is a U.S. person.¹⁸¹ This is a particularly burdensome provision and seemingly unnecessary with the enactment of Section 877A of the Internal Revenue Code, which taxes built-in gain of certain individuals upon giving up U.S. citizenship or certain U.S. permanent residents.¹⁸²

b. Proposed Solution

To solve the gain problem for immigrants, there should be a deemed sale of all property prior to the immigrant becoming a U.S. resident, such that the new resident obtains a basis in property equal to the property's fair market value on the date he or she becomes a resident. This deemed sale should apply to all property, not just PFIC stock, as there is little justification for taxing an immigrant on gains that occurred prior to becoming a U.S. person. Alternatively, if this would be an unacceptably broad change to Congress, the step-up in basis to fair

179. Treas. Reg. § 1.1291-9(j)(1).

180. I.R.C. § 1296(l) (1986).

181. Prop. Treas. Reg. § 1.1291-3(b)(2), 57 Fed. Reg. 11029 (Apr. 1, 1992).

182. Section 877A was enacted by the Heroes Earning Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, § 301, 122 Stat. 1624.

market value for stock subject to the mark-to-market rules should apply to all PFIC stock.

For individuals expatriating, the provision in the proposed regulations requiring a deemed disposition should not be included in final regulations, and reliance should instead be placed on the provisions of Section 877A of the Internal Revenue Code. Any deemed disposition under Section 877A of PFIC stock would result in taxation of gain of any gain under the PFIC regime applicable to the expatriating taxpayer.

VII. PUNITIVE TREATMENT OF PFIC INVESTMENT

The immediately preceding section discusses solutions to limit the reach of the PFIC rules and the taxation of transfers of PFIC stock. These fixes would be a vast improvement over the present state of the law for PFICs. Further, the application of the PFIC legislation to normally tax-free transactions could be ameliorated by limiting the reach of the statute to what it was intended to combat—foreign investment companies.

But the question still remains whether the limitation of the application of the PFIC rules to foreign investment companies goes far enough. Some have argued that “[e]very effort can and should be made to eliminate deferral and character conversion for investments in foreign entities that serve the same purpose as a U.S. investment company.”¹⁸³ Further, the legislative history of the PFIC provisions proceeds on the premise that it is wrong to allow a foreign investment company to be taxed more favorably than a domestic investment company. The question is rarely, if ever, asked as to whether the legislative purpose in itself is valid.

A U.S. investor can choose to invest, for example, directly in stock in companies, or invest in a certificate of deposit or invest in real property. Should the U.S. tax law penalize someone who gets a better tax result than one gets from an investment in a U.S. investment company? Should a U.S. taxpayer who sells appreciated real property be required to have the gain prorated over his holding period and an interest factor applied? That is just what the PFIC rules do when the investment is stock in a PFIC. Foreign investment companies have been singled out for particularly harsh treatment to the point that a U.S. investor would not invest in a PFIC knowing what the tax results would be.

183. Blanchard, *supra* note 40, at 70.

Consider a U.S. investor who chooses to invest in a corporation instead of an investment company. The corporation is an operating company, and it is publicly traded so it is not a CFC, and does not meet the income or asset tests of a PFIC. The corporation is a software company; it reinvests its earnings in developing and running its business, accumulates a sizeable amount of cash, and does not pay a dividend for the first 28 years of its existence. The U.S. investor holds the stock for those 28 years and then sells it at a \$2 million gain before any dividend is paid. The result currently would be a 20 percent tax on the gain, or \$400,000 in U.S. federal income tax. That company is Microsoft Corporation. From its formation in 1975 until 2003, a period of 28 years, Microsoft did not pay a dividend.¹⁸⁴ During most of those years, dividends would have been taxed at ordinary income tax rates and not at the current preferential capital gain rate of 20 percent. The U.S. investor reached a very good tax result by holding stock in a non-dividend-paying company, complied with all U.S. tax laws and successfully deferred U.S. federal income tax until the shareholder sold the stock.

Now suppose Microsoft were instead a French corporation. The U.S. investor would have the same U.S. tax result as in the previous example—capital gain taxed at 20 percent on the \$2 million gain on the stock. No U.S. tax laws were violated, and income tax deferral was successfully achieved. If instead, however, the French Microsoft had been owned by a foreign investment company, the PFIC rules would have applied and disastrous consequences to the U.S. investor would have resulted.

The legislative impetus behind the PFIC legislation should be examined in light of the global economy that presently exists in the world, more than 20 years after the PFIC legislation was enacted. Congress must free itself of considering foreign investments as tax schemes and rationally examine the punitive PFIC legislation it enacted in 1986.

VIII. CONCLUSION

The PFIC rules were enacted to put U.S. investors in foreign investment companies on a tax par with U.S. investors in domestic investment companies. It is clear that this purpose was more than accomplished, as a U.S. shareholder of a PFIC who does not make a

184. See Press Release, Microsoft, *Microsoft Declares Annual Dividend and Announces Two-for-One Split on Common Stock*, MICROSOFT, Jan. 16, 2002, available at <http://www.microsoft.com/en-us/news/press/2003/jan03/01-16ds.aspx>.

QEF or mark-to-market election will generally be in a worse position than an investor in a U.S. investment company.

The main problem with the PFIC rules is that they apply to U.S. shareholders of foreign corporations that are not investment companies. As discussed above, they can apply to foreign start-up companies and operating companies. Further, transactions like gifts of stock, transfers of stock upon death, relinquishment of U.S. citizenship or residency, or exchange of stock in a tax-deferred reorganization can result in onerous consequences that would not result if the stock owned by the U.S. taxpayer were not stock in a PFIC. Congress tried to solve the limited perceived problem of some wealthy taxpayers deferring U.S. income tax by investing in foreign investment companies and wound up with a mess of poorly understood rules that are ill-defined, unclear, and overly complex. The rules can bring about unfair results and are full of traps for the unwary.

The conclusion of this article is that the PFIC rules should be repealed. Not only are they overly complex, reach companies that the legislation was not intended to, and result in extremely harsh consequences for transactions that are treated favorably for other types of investments, but they unfairly single out one type of investment vehicle for punitive treatment. Congress is unlikely to repeal the legislation, however, in an environment where political gain can be made by proselytizing about the evils of foreign investments, as well as the loss of revenue that will result to a U.S. government drowning in its deficit. If the PFIC rules cannot be eliminated entirely, however, they must at least be limited to the purpose for which they were enacted—to prevent more favorable tax treatment to an investor in a foreign investment company than an investor in a U.S. investment company.

