Bloomberg Tax

Tax Management
International Journal™

Comments on T.D. 9360: PFIC Purging Elections

By Kim Blanchard[*]
Weil, Gotshal & Manges LLP
New York

On November 9, 2021, the IRS requested comments on T.D. 9360, issued on September 27, 2007. The request for comments relates generically to the usability and relevance of the regulations promulgated in T.D. 9360. These regulations included current Reg. §1.1297-3 and §1.1298-3, as well as minor changes to an older regulation, Reg. §1.1291-9.[1] All of these regulations deal with so-called purging elections that may be made by U.S. shareholders of passive foreign investment companies (PFICs).

As most of our readers will know, unless an exception applies, a foreign corporation is a PFIC if it meets either of two tests set out in §1297(a). Under the income test, a foreign corporation is a PFIC in any year when 75% or more of its gross income is passive income. Under the assets test, a foreign corporation is a PFIC in any year when the average percentage of its assets that produce passive income, or that are held for the production of passive income, is at least 50%.

''ONCE A PFIC . . .''

A foreign corporation's status as a PFIC is relevant only to a U.S. shareholder. If the corporation is a PFIC in the first year of a particular U.S. shareholder's holding period for its stock, the corporation will remain a PFIC as to such shareholder even if it otherwise ceases to meet either the income or the assets test in a later year. This is the ''once a PFIC always a PFIC'' rule of §1298(b)(1). The only way around this rule is for the U.S. shareholder to make a §1295 qualified electing fund (QEF) election for the first year of its holding period that the foreign corporation is a PFIC.[2] If a timely and valid QEF election is made, the U.S. shareholder is taxed on the foreign corporation's income as it arises without the draconian rules that apply to PFICs more generally under §1291.

A well-advised U.S. shareholder of a foreign corporation that has even a remote chance of being a PFIC would nearly always make a timely QEF election for the first year of its holding period. Unfortunately, there are many reasons why a timely QEF election is not in fact made. Probably the most common reason is that the U.S. shareholder does not believe that the foreign corporation is a PFIC. This problem is common, because the definition of a PFIC sweeps in far more than pure passive investment companies in the layman's sense of the word, and also because in a great many cases it is not clear how the PFIC rules apply.

PURGING THE PFIC ''TAINT''

Two sections of the Code provide for escape hatches where a U.S. shareholder has failed to make a timely QEF election; both escape hatches take the form of a purging rule. The first purging rule is found in §1291(d)(2). This type of purging election is used where the foreign corporation remains a PFIC (sometimes referred to below as a ''continuing PFIC'') and

---

[*] Kim Blanchard is a Tax partner in Weil, Gotshal & Manges LLP's Tax, Executive Compensation & Benefits Department and is based in New York. Her practice encompasses a variety of largely international transactions involving corporate acquisitions and mergers, internal restructurings, business formations, and joint ventures. She also advises domestic, foreign, and multinational clients in connection with venture capital investment and fund formation, partnerships, real estate, executive compensation, and exempt organization issues.

This article may be cited as 50 Tax Mgmt. Int'l J. No. 12 (Dec. 3, 2021).

[1] All section references are to the Internal Revenue Code, as amended (''the Code''), or the Treasury regulations thereunder, unless otherwise indicated.

[2] Although a §1296 mark-to-market election can also avoid the once-a-PFIC-always-a-PFIC problem, for various reasons it is seldom available.

ISSN 0090-4600

the U.S. shareholder, having failed to make a timely QEF election for the first year in its holding period for the stock, wishes to make a QEF election in a later year. There are two forms of §1291(d)(2) election: a deemed sale election and, if the PFIC is a controlled foreign corporation (CFC), a deemed dividend election. A U.S. shareholder who makes a deemed dividend election must include in gross income as a dividend her share of the CFC/PFIC's undistributed E&P accumulated during her pre-QEF holding period for the shares. By its terms, the statute limits the deemed dividend election to shareholders of PFICs that are CFCs. The theory of the deemed dividend election is that if the foreign corporation is a CFC, to prevent deferral of gain it is sufficient to require its U.S. shareholder to include in income her share of the foreign corporation's undistributed earnings.

The second purging rule applies where the foreign corporation in question is no longer a PFIC, but had been a PFIC at some time earlier in the U.S. shareholder's holding period. This rule is set out in §1298(b)(1) itself, which turns off the once-a-PFIC-always-a-PFIC rule ''if the taxpayer elects to recognize gain (as of the last day of the last taxable year for which the company was a passive foreign investment company (determined without regard to the preceding sentence)) under rules similar to the rules of section 1291(d)(2).'' This purging election operates solely by way of a deemed sale of the U.S. shareholder's stock in the foreign corporation.

Even before turning to the regulations, the Code's rules for purging elections are very difficult to understand and apply. One principal source of confusion arises because prior to 1997, a foreign corporation could be both a PFIC and a CFC simultaneously. In 1997, the Code was amended to provide that a foreign corporation that was CFC of which the U.S. shareholder was an inclusion shareholder would not be treated as a PFIC with respect to that U.S. shareholder. The new rule was originally contained in §1297(e) but later redesignated as §1297(d). Note that there are two cases where the CFC overlap rule can apply: It can apply to continuing PFICs and to former PFICs. At the time current §1297(d) was enacted in 1997, a continuing PFIC could have suddenly lost its PFIC status by reason of the overlap rule, but a purging election (either a deemed sale or a deemed dividend election) was still necessary to pick up income deferred through the effective date of the CFC overlap rule. How that purging election operated depended on whether the foreign corporation in question continued to be a PFIC or instead had ceased to be described as a PFIC but remained such under the once-a-PFIC-always-a-PFIC rule.

Virtually all of the defined terms and verbiage used in the regulations are arcane and difficult to understand without understanding the history of the PFIC rules going back to 1986. For this reason if not more, the IRS was right to request comments concerning the usability and relevance of these regulations. As I wrote in Bloomberg Portfolio 6300 on PFICs:[3]

> *Warning*: The existing regulatory framework relating to purging elections is a minefield of confusion, owing to piecemeal regulations issued over a long period of time that include regulations issued under now-renumbered Code sections containing erroneous cross-references. Before reading the following subdivisions of this Portfolio, please consult the table below.

The table referred to in the above quote sets out eight distinct types of purging election. First, there is a deemed sale plus QEF election under §1291(d)(2)(A) for continuing PFICs. That election is governed by Reg. §1.1291-10, promulgated in 1996. The second election is also under §1298(b)(1) and is set out at Reg. §1.1298-3(b). It is a deemed sale election for former PFICs. This election was adopted in 2005 and amended by T.D. 9360 in 2007.

Third is the deemed dividend plus QEF election for PFICs that continue to be PFICs but are excluded as a result of being CFCs. The election is made under Reg. §1.1291-9, which was originally promulgated in 1996 prior to the adoption of the CFC overlap rule. The deemed dividend election is available only to U.S. shareholders of CFCs, but this particular purging election does not require the U.S. shareholder to be an inclusion shareholder with respect to the CFC. The theory of the deemed dividend election is that if the foreign corporation is a CFC, it should be able to provide the information necessary for the U.S. shareholder (whether or not an inclusion shareholder) to make a deemed dividend election.

Since the enactment of the CFC overlap rule in 1997, this regulation has been amended several times, including by T.D. 9360. Following the adoption of the §1297(d) overlap rule in 1997, the only continuing relevance of this purging election is for U.S. shareholders of PFICs that are CFCs but as to which the U.S. shareholder is not described in §951(b).

A fourth election is a deemed dividend election for former PFICs that are CFCs, at Reg. §1.1298-3(c). Although §1298(b)(1) does not refer to a deemed dividend election, the regulations provide a means of purging the PFIC taint by extending the deemed dividend mechanism to former PFICs that are CFCs. Former Reg. §1.1291-9(i)(1), which had prohibited any deemed dividend election for former PFICs, was fi-

[3] Kim Blanchard, 6300 T.M., *PFICs*, at X.B.2.c.

Tax Management International Journal

ISSN 0090-4600

nally removed effective as of January 2, 1998 by T.D. 8750. In PLR 200124016, the IRS confirmed that a shareholder of a former PFIC may eliminate the taint by making a deemed dividend election.

Fifth and sixth, Reg. §1.1297-3(b) and §1.1297-3(c) contain two elections — a deemed sale and a deemed dividend election — that a U.S. inclusion shareholder of a CFC can make to purge any PFIC taint. This regulation was part of T.D. 9360. When the 1997 legislation eliminated the overlap between the PFIC and CFC rules for inclusion shareholders by adding the §1297(d) overlap rule, the IRS realized that it needed to write regulations to deal both with the transition issues caused by this change, and to deal with cases in which a U.S. shareholder is covered by the overlap rule in one year but not in another year. These regulations were issued under the authority of §1298(b)(1) and not §1297(d)(2), because the issues presented by the overlap rule are primarily ''once a PFIC, always a PFIC'' issues. Note that the relevant regulations use the term ''Section 1297(e) PFIC'' because they were written before §1297(e) was renumbered as §1297(d).

The last two types of elections are referred to generically as late elections. One type of late election is available to inclusion shareholders of CFCs under Reg. §1.1297-3(e). The other is available for former PFICs and is set out at §1.1298-3(e). There is no late purging election for a PFIC that remains a PFIC and is not covered by the CFC overlap rule.

HOW THE IRS COULD EASE THE BURDEN AND ENCOURAGE COMPLIANCE

Threading through the purging rules is very confusing for taxpayers. The most useful thing that the IRS could do to eliminate the confusion would be to put all of the purging elections related to CFCs in one place, clearly labeling the circumstances in which the different elections apply. In this way, a taxpayer who is a U.S. shareholder of a PFIC that is not and has never been a CFC would not have to work through the most complex portions of the regulations. Where a PFIC is not a CFC, the only election that is available is a deemed sale election. For this type of PFIC, there are only three types of deemed sale election: (1) the ''regular'' deemed sale election under Reg. §1.1291-10 for continuing PFICs, (2) the Reg. §1.1298-3(b) deemed sale election for former PFICs, and (3) the late election for former PFICs at Reg. §1.1298-3(e). Once a taxpayer establishes whether the PFIC in question continues to be a PFIC or not and, if not, whether the taxpayer can satisfy the onerous provisions applicable to a late election, the choice among these three will be clear.

The second thing the IRS should do is to simplify the various iterations of purging elections that apply where the PFIC is or has been a CFC. Many of the regulations covering this type of PFIC are outdated. A project to update and streamline the purging elections for PFICs that are CFCs should be undertaken in connection with the new GILTI regulations (and proposed subpart F regulations) that do not treat less than 10% partners of domestic partnerships as inclusion shareholders for purposes of §958, but continue to apply §951(b) at the entity level.[4]

Finally, the IRS should seriously consider making all purging elections and late QEF elections easier for taxpayers to make. The goal should be to get taxpayers into compliance, not to discourage compliance. Making taxpayers navigate burdensome rules that are not absolutely necessary to accomplish the purpose of the PFIC regulations makes no sense. This is particularly true given that many foreign corporations that fall into PFIC status do so only because the IRS's definitional rules for PFICs are overbroad.

---

[4] *See* 6300 T.M., *PFICs*, at X.B.2.c.; Kim Blanchard, *Whether Treating a Domestic Partnership as an Aggregate Causes Small U.S. Partners to Become Subject to the PFIC Regime*, 48 Tax Mgmt. Int'l J. 621 (Dec. 13, 2019).

ISSN 0090-4600