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Status Changes of Corporations Owning PFIC Shares

By Kimberly S. Blanchard, Esq.
Weil, Gotshal & Manges LLP
New York, New York

Last August, the New York State Bar Association Tax Section submitted a report concerning proposed changes to the ''next day rule'' and other related rules under the consolidated return regulations.[1] Those rules deal with short taxable years arising from status changes, such as when a corporation leaves or joins a consolidated group. The Preamble to those proposed regulations asked for comments regarding the treatment of certain foreign items, including cases in which the target of a status change owns stock of a passive foreign investment company (PFIC). As the members of the working group on the NYSBA report (including yours truly) discovered, this is an area fraught with uncertainty, and possibly very serious traps for the unwary. So I thought I'd try to sketch some of it out in this commentary.

The Current Consolidated Return Rules

The current consolidated return rules, which apply for all U.S. income tax purposes, generally provide that when a target joins or leaves a consolidated group, its tax year terminates at the end of the change date; this general rule is referred to as the ''end of the day rule.''[2] Items of taxable income or loss that ''arise'' on the date of the status change are generally allocated to the pre-change year. An item of income that might typically ''arise'' on the status change date would be income on the sale of inventory. However, there is an exception where such an item is properly allocable to the portion of that day that occurs after the event triggering the status change: the ''next day rule.''[3] The next day rule tells us, for example, that if the buyer causes the target to sell an asset other than in the ordinary course of business after the closing, the tax attributable to that sale is reported in the post-change period.

Different rules apply where the target is an S corporation that is joining a consolidated group. In that case, the target's S election terminates at the end of the day preceding the status change, and the target is included in the new group for the entire day of the triggering event (the ''beginning of the day rule'').[4] In this case, then, an item of income that ''arises'' on the closing date would be allocable to the post-change year.

Tax items are generally allocated between the pre- and post-change periods using a closing of the books method.[5] However, the current regulations generally allow the parties to elect to allocate on a per diem basis as long as the tax item is not an ''extraordinary item.''[6] Where the target is an S corporation, the per

[1] New York State Bar Association Tax Section Report No. 1328, *Proposed Amendments to Treasury Regulations Section 1.1502-76* (Aug. 20, 2015).

[2] Reg. §1.1502-76(b)(1)(ii)(A)(*1*).

[3] Reg. §1.1502-76(b)(1)(ii)(B).

[4] Reg. §1.1502-76(b)(1)(ii)(A)(*2*).

[5] Reg. §1.1502-76(b)(2)(i).

[6] Reg. §1.1502-76(b)(2)(ii).

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diem election is not available.[7] Presumably, this is because the sellers are reporting items of income on their individual as opposed to corporate returns.

The regulations provide that deemed inclusions from PFICs that are qualified electing funds (QEFs) pursuant to §1293 are extraordinary items.[8] Thus, the seller and buyer cannot elect the per diem method with respect to such items. Presumably, such deemed inclusions ''arise'' as provided under the PFIC rules, described below.

The term ''extraordinary item'' also includes the ''deferred tax amount'' (DTA), as defined in §1291(c), calculated in respect of an excess distribution by a §1291 PFIC as described further below. This reference appears to be a bust. As described below, a DTA is not only not an item of income, it is not income at all. The §1291 rules operate wholly independently of whether or not a PFIC shareholder has income.

One more current rule is worth noting here, because we will revert to it in the discussion of QEFs below. Under the regulations, if the target is a partner of a partnership, it is treated as selling its partnership interest on the change date, whereupon tax items are allocated based on the rules in §706.[9] Under those rules, the partnership's year closes on the close of the closing date with respect to the deemed selling target, and the target takes into account its distributive share of partnership income for the short year ending on the date of the sale.[10]

The Proposed Consolidated Return Rules

The proposed §1502 regulations[11] would apply the next day rule if and only if the tax item is an extraordinary item. If the item arises simultaneously with the triggering event, the general end of the day rule applies, such that it is allocated to the pre-change period. If target is an S corporation, a new ''previous day rule'' would apply to an extraordinary item that occurs on the change date before or simultaneous with the triggering event, such that it would be allocated to the pre-change period. In effect — and without acknowledging it — the proposals would repurpose the extraordinary item characterization from one that merely had to do with whether a per diem election could be made into one that governs whether an item may be included in a pre-change or post-change period.

Application of the Rules to PFICs

The discussion that follows assumes that the U.S. target owns stock in a PFIC. Because a foreign corporation that is a controlled foreign corporation in a U.S. shareholder's hands cannot be a PFIC,[12] the discussion assumes that the target owns 50% or less of the PFIC's shares.

Where the PFIC is a QEF. If a U.S. shareholder of a PFIC makes a valid QEF election for the first year in his holding period, the rules of §1293, rather than §1291, apply. Under §1293, the shareholder includes in income, for his year in which the PFIC's taxable year ends, his share of the PFIC's ordinary earnings and net capital gain. Note that the statute explicitly ties the inclusion to the PFIC's taxable year. When stock of a target is sold outside a consolidated group or the target joins a new consolidated group, the target's year will end at the close of the closing date, but the PFIC's year will not end. Therefore, it would seem to follow that any §1293 inclusions for the year of the status change ''arise'' in the post-change period, and will be allocated to the target on the buyer's watch.

This result seems wrong. Due to the operation of §1297(d), in some fact patterns the foreign corporation owned by the target may be a PFIC in its hands, and cease to be a PFIC in the buyer's hands, or vice versa. Pushing off the §1293 inclusion into the post-change period may result in double counting or double non-inclusion of income. Moreover, if the target had actually sold the PFIC shares on that date, it would pay tax only on its ratable share of the PFIC's earnings.[13] A better rule would be to adopt the partnership model referred to above, and treat the target as if it had sold the PFIC shares on the change date, allocating the §1293 inclusions between the pre-and post-change periods. Given that the QEF regime functions similarly to a partnership regime, adopting the partnership rule makes sense.

The situation is even more confounding where the target is an S corporation that becomes a C corporation by reason of the sale and purchase, or where the target was a C corporation but the buyer(s) are able to make an S election for the target following the purchase. In these cases, the identity of the PFIC's U.S. shareholder changes. That is because the §1291 regulations treat the individual shareholders of an S corporation as the relevant U.S. shareholders for PFIC purposes, not the S corporation itself.[14] If the §1293 inclusion were allocated to the post-change period, the shareholders of a target that was an S corporation prior to the change date would never have to include in income their share of the PFIC's earnings. And if the target was a C corporation that became an S cor-

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[7] Reg. §1.1502-76(b)(2)(v).

[8] Reg. §1.1502-76(b)(2)(ii)(C)(*11*).

[9] Reg. §1.1502-76(b)(2)(vi)(A).

[10] Reg. §1.706-1(c)(2)(ii).

[11] REG-100400-14, 80 Fed. Reg. 12,097 (Mar. 6, 2015).

[12] §1297(d).

[13] §1293(b); Reg. §1.1294-1T(b)(3)(ii) *Ex.* 1. Contrast the rule in Subpart F, which artificially allocates Subpart F income to the buyer even on an actual sale of CFC stock.

[14] Reg. §1.1291-1T(b)(7), §1.1291-1T(b)(8)(iii)(B).

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poration following the change date, the S corporation's shareholders would be required to include income that is properly attributable to the target's C-corporation period.

A second problem encountered in coordinating the rules applicable to S corporations involves the fact that, as noted above, the consolidated return beginning of the day rule provides that the S corporation's year ends at the close of the day before the status change. But the PFIC rules treat a shareholder's holding period as ending only at the close of the date that the shares of the PFIC are disposed of.[15] Therefore, even if the rules were modified to treat the target as having sold the PFIC shares on the closing date, the resulting items of income would fall in the wrong period.

Yet a third problem involving S corporations is that the PFIC regulations appear to deny the shareholders of a target that newly elects S corporation status to begin a new holding period — even though they will become the applicable U.S. shareholders of the PFIC in lieu of the target. The PFIC regulations provide that the holding period of an S corporation shareholder includes the period in which the S corporation was a C corporation.[16] That regulation may or may not make sense where the same person owned the stock of the former C corporation that makes an S election. However, it makes no sense in the case in which the C corporation was purchased and a new S election made. At the least, the rule should be limited to PFICs that are not QEFs in the hands of the relevant shareholders. For additional quandaries posed where an S corporation owns stock of a §1291 PFIC, see below.

Where the PFIC is a §1291 Fund. The §1291 regime is not tied to income, but to distributions, including deemed distributions equal to gain realized on the sale of PFIC shares. This regime depends for its application on counting days within a U.S. shareholder's holding period. When a PFIC shareholder receives an ''excess distribution,'' the amount thereof is allocated to each day in her holding period. Amounts allocated to days before the foreign corporation was a PFIC, and to days in the current year, are taxed at ordinary income rates. Amounts allocated to days in previous years in which the foreign corporation was a PFIC are, strictly speaking, not taxed as income. Instead, these amounts form the basis for a mathematical computation leading to the DTA, which is added to the shareholder's tax bill.[17]

The consolidated return regulations refer to the DTA, treating it as an extraordinary item. While this reference is a bust, it should probably be interpreted to refer to an excess distribution, which forms the basis for the DTA. There are two types of excess distributions. The first is any distribution by a PFIC that exceeds 125% of a base period distribution amount. The second is simply gain on the sale of PFIC shares. It would appear that actual excess distributions paid on the date of a status change should normally be allocated to the pre-change period, but that if the buyer causes the PFIC to declare a distribution to the target after the closing, it should instead be treated as arising in the buyer's period under the next day rule.

Absent a deeming rule not contained in any regulation, the sale of C corporation target stock should normally not result in gain treated as an excess distribution, because the target continues to hold its historic PFIC shares. If the purchaser(s) make an S election for the target, as noted above the regulations suggest that they do not receive a new holding period. In this case, to avoid a windfall, the best rule would be to allow them a new holding period going forward, but treat any gain that the target would have realized upon a sale of the PFIC shares as an item of §1374 built-in gain.

If target is an S corporation, the PFIC indirect disposition rule would apply such that its shareholders are treated as disposing of their PFIC shares. Certainly, any gain treated as an excess distribution should be taxable only to them and not to the target. Moreover, the target, upon becoming a C corporation, should receive a new holding period in respect of its PFIC stock — although no such rule appears in the current PFIC regulations.

Summary and Suggestions

For the change of status rules to work properly in the context of PFICs, regulations should be issued forcing the PFIC's year to end — or at least its shareholders' holding periods to end — when a target owning a PFIC leaves or enters a consolidated group. In cases involving S corporations, a new holding period should begin the next day.

In the case of targets that were and remain C corporations, and that own §1291 stock, it is worth considering the adoption of a rule that would force a deemed sale of the target's PFIC shares as of the close of the closing date. Such a rule would give rise to an excess distribution where there is gain on the shares, which would be taken into account by the selling group in the pre-change period. An investment adjustment should be allowed for any DTA. If this rule were adopted, the new target should start a new holding period for the PFIC shares on the day following the closing.

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[15] Prop. Reg. §1.1291-1(h).

[16] Prop. Reg. §1.1291-1(h)(4)(iii).

[17] Because a DTA is not income, it cannot give rise to an investment adjustment within a consolidated group. It therefore appears that if a C corporation target receives an excess distribution, the selling group will receive no basis credit, resulting in duplicate taxation.

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None of these rules should turn on whether a given PFIC item is an ''extraordinary item.'' The extraordinary item rule is too blunt an instrument to deal with the complex issues encountered in the overlap between the PFIC rules and the rules discussed in this commentary.

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