Bloomberg Tax

Tax Management
International Journal™

Puzzling PFIC Proposals

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On December 4, 2020, the Treasury and the IRS published a package of final and proposed regulations under the rules applicable to passive foreign investment companies (PFICs).[1] For the most part, the final regulations provide welcome guidance on a range of practical issues needed to apply the PFIC rules, in particular guidance on applying the indirect and constructive ownership rules of §1298(a).[2] Unfortunately, the final regulations did not reconsider the portion of prior proposed regulations[3] that require a tested foreign corporation to own at least 25% of a partnership in order to look through to the character of the partnership's income and assets, which practitioners had assumed for many years was the default regime.[4] We will return to that subject below as part of a broader analysis of the regulation package.

The proposed regulations issued as part of the same December 2020 package, unlike the final regulations, are mostly a puzzle. Apart from trying to address active banking and other special industry issues, the proposed regulations survey a grab bag of mostly unrelated, and some very important, issues in a haphazard way. Much of this portion of the regulations and the preamble thereto has the appearance of having been rushed out without much reflection.

A primary example of this failure to come to grips with an important issue is the approach that the proposed regulations take to working capital.[5] The preamble summarizes the 30-plus years of public criticism of the Notice 88-22 rule that treats all cash as a passive asset on the theory that cash produces interest income, which is passive. Commentators pointed out that active businesses often require working capital, and that other provisions of the Code and regulations recognize this reality by treating working capital as an active business asset. After acknowledging the validity of those comments, the preamble to the proposed regulations retreats to the canard first enunciated in the Notice: "Because the statutory PFIC rules (and FPHCI rules) generally treat an asset held to produce interest as passive, it may not be appropriate to treat an interest bearing instrument held by an operating company as working capital other than as an asset that produces passive income."[6]

Presumably the statutory rule being referred to here is §1297(a)(2), which treats as passive those assets "which produce passive income or which are held for the production of passive income." But working capital, by definition, is never "held for the production of" passive income. It is held for use in a business. Cash might be said to "produce" passive income if actually invested in an interest-bearing account in or-

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[1] The final regulations are at T.D. 9936. The proposed regulations are found in REG-111950-20.

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

[3] REG-105474-18, issued on July 11, 2019.

[4] *See, e.g.*, Blanchard, 6300 T.M., *PFICs*; New York State Bar Association Tax Section, *Report on the Proposed 'PFIC' Regulations Under Sections 1291, 1297 and 1298*, Report #1422 (Sept. 9, 2019).

[5] Part I.A.3 of the Preamble to the proposed regulations, beginning on page 22.

[6] Preamble to the proposed regulations at page 24.

der to earn interest, but the investment of working capital is not an end of itself, and it would be poor governance for a business to hold working capital in a non-interest-bearing account simply to avoid the PFIC rules. A start-up company intent on inventing a new drug, for example, will need to raise a large amount of cash to spend on R&D. It may take years before all the cash is spent and a successful product is produced.[7] During all those years, no layman would imagine that the cash is ''producing'' or being held to produce interest; obviously, it is being held to fund R&D. The statutory language should be interpreted as having a substantive purpose, not merely being words on a page.

The preamble similarly dodges the related issue of goodwill. Goodwill, by definition, is an asset of a going concern; a passive investment company cannot have goodwill. In an attempt to justify the Notice's failure to fully reflect the reality that working capital is an active business asset, the preamble states: ''The Treasury Department and the IRS agree that goodwill should be allocated to business activities but do not agree that goodwill should always be treated entirely as a non-passive asset *because the PFIC rules may treat certain business assets as passive* and it is therefore possible that goodwill would be associated with those assets.''[8]

The preamble does not indicate where or what circumstances the ''PFIC rules'' treat business assets as passive. If this statement is true, then the rules should be changed.

Yet another example of the proposed (and the final) regulations' unfounded and misguided approach to PFICs arises in connection with the §1297(c) look-through rule. That rule, titled ''Look-Thru in the Case of 25-Percent Owned Corporations,'' provides that if a foreign corporation being tested for PFIC status owns, directly or indirectly, at least 25% by value of the stock of another corporation, then the tested foreign corporation *is treated as if it held its proportionate shares of the other corporation's assets and received directly its proportionate share of the other corporation's income*. For many years, taxpayers and practitioners sought confirmation that this articulation of the look-through rule applied upon a sale by the tested corporation of the second corporation's stock. Most believed that the language used in §1297(c) embodied a pure disregard approach, with the result that a sale of stock of a 25%-owned corporation would simply be treated as a sale of that corporation's assets, with any gain recognized on the sale being treated as passive or active depending upon whether those assets were passive or were used in a business. This approach was confirmed in several private letter rulings, including PLR 200015028, PLR 200604020, and PLR 200813036.

It thus came as a surprise that the prior proposed and final PFIC regulations limit the disregarded look-through approach to what the preamble refers to as ''residual gain.''[9] The proposed regulations build on this surprising rule to reject suggestions that all dividends from a 25%-owned corporation be ignored for PFIC testing purposes, proposing to limit the exclusion to cases in which the income out of which the dividend was paid was previously taken into account by the tested foreign corporation. This approach conflates rules that apply to measure gross income — rules that have no application to a non-controlled foreign corporation — with the PFIC rules, which are designed to determine whether a foreign corporation owns passive or active assets or earns passive or active income. The rule for dividends is particularly odd, as it would require the tested foreign corporation to know out of what earnings and profits (E&P) a dividend was paid — and foreign corporations do not keep track of E&P.[10] The preamble to the proposed regulations states that ''The PFIC regulations do not provide rules for determining or adjusting the basis of the stock of a look-through subsidiary.'' Of course they do not! There is no reason to have such a rule, because a look-through subsidiary is disregarded.

The proposed regulations extend this ill-advised approach to §1297(c) to the IRS's even more ill-advised decision to look through partnerships only if 25% or more owned.[11] The refusal to look through partnerships not only makes no sense as a matter of tax law, it violates the canon of statutory construction ''*expressio unius exclusio alterius*.'' In §1297(c), Congress provided an explicit look-through rule for corporations that, absent such a rule, would never be looked through or treated as disregarded. No such rule is nec-

[7] If the PFIC start-up exception of §1298(b)(2) applied more generously, it could cover this type of situation. Unfortunately the exception as written is almost completely useless to cash-intensive businesses with long start-up times like R&D or tech, perhaps because Congress assumed that such businesses would never be treated as PFICs in the first place. In any event, the IRS has provided no guidance under the start-up exception. *See* Blanchard, above n. 4, at III.E.1 (''Congress probably believed that the IRS would promulgate regulations applying the general asset and income tests in a manner that would not sweep in operating companies, and for this reason probably viewed the start-up exception as necessary only for a very short period. Unfortunately, the approach of Notice 88-22 sweeps in so many operating companies that a much broader start-up exception would be needed to afford any real relief.'')

[8] Preamble to the proposed regulations at page 25 (emphasis added).

[9] *See* Reg. §1.1297-2(f)(2).

[10] It was partly for this reason the Congress crafted the default PFIC regime of §1291 to operate without regard to E&P.

[11] Prop. Reg. §1.1297-1(c)(2)(i).

ISSN 0090-4600

essary to look through partnerships, which is why there is no such rule in the statute.

In an effort to understand the IRS's thinking behind some of these puzzling discontinuities with the statute, one turns to the ''Special Analyses'' section at the end of the preambles. This section is designed to protect the government from a regulatory challenge, and often provides glimpses into the IRS's reasoning. Although the Special Analyses sections of the PFIC preambles do not contain much reasoning, there are hints that the government's approach was based in part on its notion that a PFIC is a kind of flow-through entity. If one thinks about a PFIC as a flow-through entity, then it would be important to have rules measuring the PFIC's income, a proportionate portion of which is taxed to its U.S. shareholders.

The preamble to the proposed regulations states that ''A PFIC is not subject to U.S. tax under the PFIC regime; rather, U.S. shareholders of a PFIC are subject to tax *on a current, or current-equivalent, basis in proportion to their ownership share in the PFIC's income*.''[12] It goes on to state that ''A U.S. shareholder of a PFIC is responsible for determining its proportionate share of ownership in the PFIC and the appropriate amount of PFIC income to include on the shareholder's tax return.''[13]

These statements are inaccurate in several ways. To begin with, the default PFIC regime of §1291 is not remotely akin to taxation on the U.S. shareholder's share of the PFIC's income. Section 1291 imposes a tax on a U.S. shareholder of a PFIC who receives ''excess distributions'' or who sells PFIC stock at a gain. The mechanics of §1291 were deliberately designed by Congress to avoid reference to the PFIC's income, because it was assumed that a minority U.S. shareholder would not have access to the information needed to calculate the PFIC's income (or E&P) for U.S. tax purposes. Where a U.S. shareholder makes a QEF election to be taxed instead under §1293, which election can be made only if the foreign corporation agrees to provide annual information about its earnings and capital gains, the U.S. shareholder annually reports its pro rata share of the foreign corporation's ''ordinary earnings'' and ''net capital gains.'' Ordinary earnings for this purpose ties back to E&P. Thus, even the §1293 regime is not a flow-through regime, but a corporate regime.

These and other passages from the Special Analyses suggest that the author thereof believed that a U.S. shareholder of a PFIC is taxed on its share of the PFIC's passive income, with ''passive income'' being in some way related to the definitions in §1297. Nothing could be farther from the truth. A PFIC shareholder is taxed either under the §1291 regime, which has nothing to do with the character or amount of the PFIC's income, or under the §1293 regime, which does not distinguish between ''passive'' and ''active'' earnings.[14] The PFIC rules operate on an all-or-nothing basis and make no distinction between passive and active income. Because the current IRS approach to PFICs can inappropriately render a completely active business a PFIC, the U.S. shareholder is fully subject to tax under the PFIC rules even if 100% of the PFIC's income is non-passive.

Since the PFIC regulations package does not purport to address the calculation of a U.S. shareholder's income, the only possible reason that the Special Analyses would mention a shareholder's proportionate share must be in reference to the attribution rules of §1298, which the PFIC regulations package does address. Comparable language contained in the preamble to the final regulations suggests that the language in the proposed regulations' preamble was simply confused and was in fact meant to refer to the attribution rules:

> The PFIC itself is not subject to U.S. tax under the PFIC regime; rather, only the U.S. owner of a foreign corporation is subject to that regime. The U.S. owner of shares of a foreign corporation consequently must obtain the appropriate information, usually from the corporation, in order to determine whether that corporation is a PFIC (by satisfying these and other tests) and if so what tax is due as a result.[15]

Even this language evidences a misunderstanding of the manner in which Congress designed the PFIC rules. The PFIC rules were built upon the assumption that because there is no control requirement — even a 0.0001% U.S. shareholder is subject to these rules — the U.S. shareholder was not expected to receive *any* information from the foreign corporation itself. Indeed, the PFIC rules must be able to operate in the absence of any corporation information at all.[16]

The preamble to the proposed regulations acknowledges the difficulty faced by U.S. persons in determin-

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[12] Preamble to the proposed regulations at page 54 (emphasis added).

[13] Preamble to the proposed regulations at page 55.

[14] A third regime, the mark-to-market regime of §1296, applies only to a PFIC the stock of which is publicly traded and, in the author's experience, is rarely used, primarily because it does not extend to subsidiaries of a publicly traded corporation.

[15] Preamble to the final regulations at page 115.

[16] The original PFIC legislation in 1986 put the burden of establishing PFIC status on the foreign corporation itself. In 1988, having realized the impracticability and unenforceability of that approach, Congress switched to placing the burden on a U.S. shareholder. Interestingly, Notice 88-22 was issued prior to the 1988 amendments, and assumes that testing is done by the corpo-

ISSN 0090-4600

ing whether stock of a foreign corporation is a PFIC: "Compliance with the PFIC regime requires an ability to negotiate its often-complicated rules and generally means that those willing to invest in potential PFICs are relatively sophisticated taxpayers that have access to professional tax advice in order to navigate the tax complexities presented by the PFIC regime. It is also possible that a less sophisticated taxpayer could invest in a PFIC without a full understanding of the tax treatment of that investment."[17] But this passage evidences the government's lack of understanding of the context of the PFIC rules. Taxpayers who invest in true PFICs will indeed obtain advice and most often will make a QEF election to avoid the punitive §1291 regime. And occasionally an "unsophisticated" taxpayer may find that it has invested in a true PFIC. But by far the most common situation presented by the PFIC rules is that they inappropriately treat operating companies as PFICs, such that the U.S. investor would have no reason to believe it had invested in a PFIC.

No one purposefully flirts with the PFIC rules. As the New York State Bar Association Tax Section put it, "It is rare in our experience in practice to encounter a company that Congress likely would have viewed as a PFIC but that technically is not a PFIC."[18] The rules are simply too onerous, punitive and draconian to admit of any planning. For the PFIC rules to operate effectively, the PFIC regulations should clearly and narrowly define a PFIC by focusing on what is truly passive. They should start by (1) treating working capital and goodwill as non-passive, (2) adopting a pure disregarded look-through rule under §1297(c), and (3) treating all partnerships as look-through aggregates for all purposes of the PFIC rules.

ration — one reason to question the Notice's validity post-1988.

[17] Preamble to the proposed regulations at pages 55-56.

[18] Report #1422, above n. 4, at page 2.

ISSN 0090-4600