REPORT #759

TAX SECTION

New York State Bar Association

Proposed Statutory Amendments
to the PFC Provisions of the
Tax Simplification Bill of 1993 (H.R. 13)

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New York State Bar Association

April 17, 1993

Harry L. Gutman
Chief of Staff
Joint Committee on Taxation
U.S. House of Representatives
1015 Longworth House Office Building
Washington, D.C. 20515

H.R. 13 Anti-Deferral Legislation[1/]

Dear Mr. Gutman:

There is pending in Congress legislation ("H.R. 13") simplifying the anti deferral rules applicable to passive foreign investment companies ("PFICs") and other foreign corporations. In addition, the I.R.S. and Treasury recently issued proposed and temporary regulations applicable to PFICs. These initiatives are focusing attention on PFICs and their staggering complexity. In these circumstances, we believe that Congress and the Treasury have a unique opportunity to rationalize and simplify the PFIC rules. Therefore, we are submitting this letter to recommend what we believe to be important

1/ This letter was prepared by an Ad Hoc Committee chaired by Stanley I. Rubenfeld and Steven C. Todrys and composed of Michael Bray, Pinchas Mendelson, Jesse R. Rubin and Philip R. West. The letter was drafted by Philip R. West and the statutory language was drafted by Pinchas Mendelson. Helpful comments were received from William L. Burke, Peter C. Canellos, John A. Corry, Charles I. Kingson, Richard L. Reinhold, James K. Schiller and Michael L. Schler.

steps towards rationalizing and simplifying the PFIC rules while adhering to their policy objectives.[2/] First, we recommend modifying H.R. 13 so that almost all U.S. PFIC shareholders are placed on a current inclusion or mark-to-market regime, a measure that would significantly increase taxpayer compliance with the PFIC rules. Second we recommend relaxation of the rules in H.R. 13 governing passive foreign corporation (“pFc”) shareholders that become subject to the mark-to-market regime after they first acquire their PFC stock. Third, we recommend expansion of the relief provision in H.R. 13 governing basis adjustments in the case of certain tiered foreign corporations.

1. Narrowing Applicability of the Interest Charge Regime

a. Background

We believe (although we are not in a position to establish) that there is widespread non-compliance with the PFIC rules by PFIC shareholders who have not made the qualified electing fund (“QEF”) election. We believe that significant reasons for any such non-compliance are the extraordinary complexity of the PFIC rules generally and the interest charge regime in particular, the elective nature of the QEF regime and the inability of the IRS to administer the interest charge rules.[3/]

U.S. shareholders frequently fail to make the QEF election for one or more of the following reasons: (1) they are unable or unwilling to understand the PFIC rules, (2) they are unable to obtain information from the PFIC necessary to make an effective QEF election, or (3) they wish to avoid current tax by not making the QEF election. Under current law, all such shareholders are subject to the complex interest charge regime. . However, it can be expected that they and their heirs may

[2/] Although there are numerous aspects of both H.R. 13 and the proposed PFIC regulations that are worthy of comment, this letter is intended only to recommend a limited number of specific modifications to H.R. 13 which we believe fundamental to the rationalization of the PFIC regime. No inference should be drawn as to our views on other aspects of H.R. 13 and the regulations.

[3/] PFICs are not required to file federal income tax returns and to our knowledge the I.R.S. does not attempt (and may not be able directly) to examine the books and records of PFICs. Therefore, in the absence of a QEF election, the I.R.S. cannot reliably determine, for example, whether there has been an indirect distribution or disposition with respect to PFIC stock.

frequently fail to pay the interest charge and make the required basis reduction under section 1291(e) because, in the case of the shareholders, they do not receive excess distributions or dispose of their stock and, in the case of their heirs, they are unaware that the PFIC rules apply to their inheritance. In these ituations, there is no current tax and the interest charge which substitutes for current tax is permanently lost.

We also suspect that noncompliance with the PFIC rules may, to some extent, be willful. We do not condone non-compliance. We do believe, however, that the following factors may contribute to the noncompliance problem.

To the extent that shareholder noncompliance is willful, it may reflect a belief that the PFIC rules represent a fundamentally unfair extraterritorial application of draconian rules of U.S. tax law to entities not controlled by U.S. persons. One aspect of the unfairness perceived by taxpayers relates to the treatment of tiered PFICs in the proposed regulations. The indirect distribution and disposition rules apply to most chains of PFICs that are comprised solely of interest charge PFICs, even though the interest charge is not avoided in such a context. See Prop. Reg. § 1.1291-2(f), -3(e). Another perceived unfairness relates to the treatment under the proposed regulations of PFIC stock held by a non-resident alien who becomes a U.S. resident and then ceases to be a U.S. person. Such stock is treated as disposed of when the holder ceases to be a U.S. person and the gain subject to U.S. tax under the PFIC rules is not limited to the gain accruing during the period of U.S. residence. Prop. Reg. § 1.1291-3(b)(2). A third aspect of the unfairness perceived by taxpayers is the confiscatory nature of the interest charge as applied to long-term holdings. This may be illustrated by the following basic example. Assume $100,000 invested on January 1, 1988 in a PFIC with a compound annual rate of return equal to 100 basis points over the statutory tax underpayment interest rate. Assume further an underpayment rate equal to the actual rate before 1993 and 9% after 1992. Finally, assume combined Federal and state and local tax rates equal to the actual rates for a New York State and City corporate resident through 1992, 45% for 1993-1994 and 48% thereafter. The deferred tax amount that will be due on a disposition of the PFIC stock after a 25 year holding period will exceed the appreciation in the investment with the disparity continuing to grow in future years.

We submit that there would be much greater compliance with the PFC rules set forth in H.R. 13 if more U.S. shareholders of PFCs were subject to the current inclusion rule or its surrogate, the mark-to-market rule.[4/]

b. Recommendation

Under H.R. 13, shareholders with significant holdings in a PFC on a percentage basis generally would be taxed pursuant to QEF-type rules. Shareholders with significant holdings for this purpose are those who either own 25% of a PFC, own stock in a PFC that meets a section 552 (a) (2)-type stock ownership test or own stock in a PFC that is a CFC. A large number of other shareholders, those who own "marketable stock," would be taxed pursuant to an important surrogate for the current inclusion regime, the mark-to-market regime.

We believe that the mark-to-market regime is a giant step in the right direction, but more can and should be done. With a clarified and expanded definition of marketable stock, H.R. 13 can bring within the tax compliance system what we believe to be a very substantial number of shareholders of PFICs who otherwise would likely escape the consequences of the PFC rules altogether.

[4/] This conclusion is indirectly supported by the Joint Committee Staff Technical Explanation of H.R. 13 (the "Technical Explanation"), which provides in pertinent part:

> It is understood that the interest charge method of the present-law PFIC rules is a significant source of complexity both separately and in its interaction with other provisions of the Code. Even without eliminating the interest charge method, significant simplification can be achieved by minimizing the number of taxpayers that may be subject to the method and by making certain modifications that may reduce the complexity engendered by the interest charge method. Further, because some taxpayers have argued that they would have preferred choosing the current-inclusion method afforded by the qualified fund election, but were unable to do so because they could not obtain required corporate-level information, it is believed that the mark-to-market system provides a fair alternative method for measuring income and imposing an appropriate level of income tax. Staff of the Joint Committee on Taxation, Technical Explanation of The Tax Simplification Act of 1993 (H.R. 13), at 106 (Jan. 8, 1993).

The term “marketable stock” is defined in H.R. 13 to mean:

> (A) any stock which is regularly traded on --
>
> (i) a national securities exchange which is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934, or
>
> (ii) any exchange or other market which the Secretary determines has rules adequate to carry out the purposes of this part, and
>
> (B) to the extent provided in regulations, stock in any foreign corporation which is comparable to a regulated investment company and which offers for sale or has outstanding any stock of which it is the issuer and which is redeemable at its net asset value.

The Technical Explanation provides, in pertinent part:

> Definition of “marketable stock.” -- The mark-to- market method under the bill only applies to passive foreign corporations the stock of which is “marketable.” . . . PFC stock is . . . treated as marketable, to the extent provided in Treasury regulations, if the PFC continuously offers for sale or has outstanding any stock (of which it is the issuer) that is redeemable at its net asset value in a manner comparable to a U.S. regulated investment company (RIC). Technical Explanation, supra at 115.

The redeemable stock prong of the marketable stock definition is apparently intended to include within the mark-to-market regime those PFC shareholders who can determine a value for their PFC stock other than by looking to its trading price. To bring as many PFC shareholders as possible into compliance with the PFC system at the earliest possible time, however, four changes should be made with respect to the redeemable stock prong of the marketable stock definition.[5/]

[5/] We also recommend that the legislative history to H.R. 13 clarify the traded stock prong of the marketable stock definition. In particular, standards for both regular trading and qualifying foreign exchanges should be referenced, such as those found in the “qualified resident” definition under section 884. See Temp. Treas. Reg. S 1.884-5(d)(2), -5(d)(4). The legislative history should make clear that any stock meeting such standards would qualify under the traded stock prong of the marketable stock definition, at least until further guidance is published under the PFC rules.

First, the redeemable stock requirement should be clarified to include stock redeemable “with reference to” net asset value. This would clearly bring within the rule those corporations that charge a percentage redemption fee and those that might attempt to avoid the rule by redeeming stock at a price other than net asset value but with reference to net asset value.

Second, the definition should be modified to delete the requirement that the foreign corporation be “comparable to a regulated investment company.” To qualify as having outstanding “marketable stock,” the foreign corporation should not be required to comply, for example, with the income, “short-short,” or diversification requirements for RIC status, or with the distribution requirement for flow-through tax treatment. In addition to the absence of a policy reason for imposing these requirements, the addition of these or other requirements would effectively make the mark-to-market regime elective.

The above-quoted passage from the Technical Explanation, which is materially identical to the House and Senate reports on the predecessor to H.R. 13, implies that the “comparable to a regulated investment company” requirement has no significance independent of the redeemable stock requirement. He understand, however, that, although not stated in the Technical Explanation, the comparability requirement may have been intended as an assurance of the bona fides of the redemption price. We submit that the marketplace serves as the best assurance of such bona fides. Any PFC that offers to redeem or redeems its stock will be compelled by its investors to do so only at, or with reference to, net asset valued.[6/]

[6/] We are aware of the potential for abuse if this recommendation is adopted. In particular, a PFC could continually offer to redeem its shares at an unrealistically low value, solely to provide its shareholders with a basis for claiming that their mark-to-market gains are less than such gains would be if a bona fide price were used. This potential abuse could be addressed by defining the term “with reference to net asset value” to allow a deviation below actual net asset value only to the extent of a reasonable redemption penalty. The more superficially appealing anti-abuse rule—requiring a minimum number of redemptions—is inconsistent with the purpose of our proposal, i.e., broadening the mark-to-market regime, because such an anti-abuse rule excludes from that regime shareholders of PFCs that have low share turnover.

Third, the statute requires that the PFC offer for sale or have outstanding stock which is redeemable at net asset value. The legislative history requires that the PFC continuously offer or have outstanding such stock. This creates an ambiguity that might be interpreted as a requirement that the stock be continuously redeemable, i.e., redeemable on any business day of the year that the shareholder chooses. We recommend deleting the word “continuously” and adding the word “regularly” immediately before the word “redeemable.” This would eliminate the ambiguity and more accurately describe many PFCs that the rule intends to embrace without undermining the legislative objective.[7/]

Fourth, the definition of marketable stock should be modified to delete the requirement that regulations must be issued before redeemable stock is regarded as “marketable” stock. With the modifications described above, the statute and legislative history would clearly describe the type of PFC stock that would meet the policy objectives of the redeemable stock prong of the marketable stock definition. Therefore, requiring the definition to await the promulgation of regulations would needlessly delay the rationalization and simplification of the PFIC rules.

If H.R. 13 is enacted with these suggested changes, we suspect that a large majority of all PFC shareholders would be subject to current tax under either the QEF or QEF-equivalent regime of proposed section 1292 or the mark-to-market regime of proposed section 1291. Only a relatively small percentage of PFC shareholders would remain subject to the complex and potentially unfair interest charge rules.

[7/] As described above, we understand that the legislative objective is to ensure that the mark-to-market regime applies to PFC stock other than traded stock, but is not manipulated through the use of artificial net asset values. Although this third recommendation may require valuations on days when the PFC stock is not redeemable, we believe that regular redemptions will provide sufficient certainty that the PFC's redemption price is set at, or with reference to, its net asset value. Moreover, to the extent that there is another unstated legislative concern, that shareholders subject to the mark-to-market regime should be able to liquidate their holdings if necessary to pay the tax on their mark-to-market gains, regular redemptions should provide PFC shareholders with the necessary liquidity.

2. Mark-to-Market Transition Rule and Corporations Issuing Marketable Stock that Become PFCs

We enthusiastically support the mark-to-market rule of H.R. 13. However, we believe to be overly broad the rules of H.R. 13 regarding a shareholder who becomes subject to the mark-to-market rules after acquiring an interest in a PFC.

A shareholder who becomes subject to the mark-to-market rules because he holds marketable stock on the effective date of H.R. 13 includes in his income the entire appreciation inherent in his PFC stock even though all or a portion of such appreciation may be attributable to periods prior to the first taxable year of the corporation beginning after 1986, the effective date of the PFIC rules. A shareholder who becomes subject to the mark-to-market rules because he holds marketable stock*of a corporation that becomes a PFC after the effective date of H.R. 13 includes in his income the entire appreciation inherent in his PFC stock even though all or a portion of such appreciation may be attributable to periods prior to the time the corporation was a PFC.

The Technical Explanation is silent as to the reasons for these two rules. The first may be animated by a policy decision to avoid the additional complexity that would result from a more equitable rule. The second may be unintended.

In our view, these transition rules impose penalties that are disproportionate to any transgressions they might be intended to address and to any complexity that a fairer rule would add. The resulting inequities can be avoided to some extent if the transition rules are modified as follows. With respect to marketable stock held on the effective date of H.R. 13, the statute should require only that a shareholder include in his income, in the year he becomes subject to the mark-to-market rules, that portion of the gain in his PFC stock allocable under the rules of the interest charge regime to days in his holding period after the effective date of the PFIC rules. A theoretically more correct result would be to exclude the actual appreciation in his stock that accrued in periods prior to the effective date of the PFIC rules. For reasons of administrative simplicity, however, we recommend instead the exclusion of amounts determined by allocation to such periods.

With respect to marketable stock of a corporation that becomes a PFC after the effective date of H.R. 13, a rule should apply that is similar to the one applicable, under proposed Code section 1291(i)(1), to marketable stock owned by persons who become subject to U.S. tax. Under proposed Code section 1291(i)(1), the basis of stock owned by a nonresident alien who becomes a U.S.

person is treated, solely for purposes of applying the mark-to-market rules in the first year to which they apply to such stock, as being equal to the greater of the stock's fair market value or its adjusted basis on the first day of the taxable year in which he becomes a U.S. person. We recommend that, with respect to marketable stock of a corporation that becomes a PFC after the effective date of H.R. 13, the basis of such stock, solely for purposes of applying the mark-to-market rules in the first year to which they apply to such stock, should be similarly treated as being equal to the greater of the stock's fair market value or its adjusted basis on the first day of the first taxable year in which its issuer is a PFC.[8/]

In the event the foregoing recommendations of this section 2 are not adopted, we recommend broadening the current election allowing PFIC shareholders to purge the interest charge taint applicable to their stock. Specifically, we recommend allowing PFC shareholders who hold marketable PFC stock on the effective date of H.R. 13 and who have not previously made a QEF election to elect to purge the interest charge taint and be taxed solely under the QEF (or, if applicable, the QEF-equivalent) rules of H.R. 13 by making a one-time election to take into income (subject to an interest charge) their share of any post- 1986 earnings and profits of the PFC. Although similar elections exist under current law and H.R. 13, those elections limit the resulting income inclusion to post-1986 earnings and profits only if the PFIC/PFC is also a CFC. Under our proposal, the gain required to be included in the U.S. shareholder's income for the purpose of this one-time election would be limited to post-1986 earnings and profits with no requirement that the PFIC/PFC also be a CFC.

We recognize that this alternative recommendation may be viewed as representing a modification to the PFIC rules that could have been, but was not, adopted when Code section 1291(d)(2)(B) was enacted. The alternative recommendation, unlike current law, would provide that certain holders of non-CFC stock are not required to take into account pre-1986 earnings and profits (or appreciation) to purge the interest charge taint. However, the legislative history to section 1291(d)(2)(B) does not disclose, and we are not aware of, any policy reason for according this preferential treatment to CFCs. Therefore, fundamental fairness strongly favors our recommendation, which mitigates the retroactive aspects of the mark-to-market regime currently proposed in H.R. 13. We have attached proposed statutory language that would implement the recommendations of this section 2.

[8/] Because this recommendation applies only to marketable stock, it creates no special valuation problems.

3. Impact of CFC Basis Adjustments

If a second tier CFC earns subpart F income includible in a U.S. person's income, no provision of current law gives the first tier CFC, through which the second tier CFC is indirectly owned, a basis step-up in the second tier CFC's stock.[9/] Thus, if the first tier CFC later disposes of the stock of the second tier CFC, the U.S. person will again include in income the appreciation attributable to the subpart F income previously taken into account. Because H.R. 13 subjects current inclusion PFICs to the subpart F rules, this technical problem will affect many current-inclusion PFCs.

Proposed Code section 961(c) addresses this problem. We recommend that proposed Code section 961(c) be expanded to apply where a CFC is indirectly or constructively owned through any intermediate entity, not just another CFC. Moreover, we recommend that the rule be expanded to apply to structures involving more than two tiers of entities.

Also, we recommend that the rule be self-executing, and not require regulations before it is implemented. Although Code section 961(a), which proposed Code section 961(c) would modify, is not self-executing, that should not be a bar to Code section 961(c) being self-executing. Proposed Code section 1291(b)(2) is an example of a similar provision that self-executing. The latter provision authorizes basis adjustments with respect to marketable stock actually owned by intermediate entities through which such stock is constructively owned by U.S. persons.
The Technical Explanation indicates that regulations may be appropriate to ensure that basis adjustments are made only where the relevant subpart F income previously has been included in a U.S. person's income.[10/] Even if this is so, we think that if the

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9/ The Technical Explanation states that no provision of current law corrects this problem, and Treasury Regulation section 1.961-1(c) (Example 1) supports this statement by negative implication.

10/ The Technical Explanation offers the following on the need for implementing regulations:

> It is intended that the Secretary will have sufficient flexibility in promulgating regulations under this provision to permit adjustments only in those cases where, by virtue of the historical ownership structure of the corporations involved, the Secretary is satisfied that the inclusions for which adjustments can be made can be clearly identified. Technical Explanation, supra at 129.

U.S. shareholder is itself the taxpayer that included in income the item creating the basis adjustment, or if such U.S. shareholder possesses sufficient documentary evidence to establish that the item was included in a U.S. person's income, then such U.S. shareholder should be able to take into account the appropriate basis adjustment even before regulations are issued.[11/] The statute, or at least the legislative history, should make this clear. While regulations certainly could be promulgated to clarify, for example, the interaction of sections 961 and 959, we simply do not think that promulgation of such regulations should be a prerequisite to the correction of what is so obviously an incorrect result, at least in cases in which there is clear proof of prior inclusion in a U.S. person's income of the item in question.

We would be pleased to meet with your staff to discuss the foregoing and related matters.

Very truly yours,

Peter C. Canellos

Attachment

Identical letter sent to:

Leslie B. Samuels
Assistant Secretary (Tax Policy) – Designate
Department of the Treasury
Room 3120 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Margaret M. Richardson
Commissioner – Designate
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

11/ The current PFIC rules, as well as the proposed PFC rules, contain examples of statutes that do not require implementing regulations, yet condition a certain tax consequence on the satisfaction of one or more requirements. See Code § 1293(c), proposed Code § 1297(c)(1)(A)(ii).

cc:

Harrison J. Cohen
Legislative Counsel
Joint Committee on Taxation
U.S. House of Representatives
1011 Longworth House Office Building
Washington, D.C. 20515

Ann Fisher Attorney Advisor
Office of International Tax Counsel
Department of the Treasury
Room 4222 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Robert E. Culbertson
Associate Chief Counsel (International)
Internal Revenue Service Room 3052 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Janice H. Mays
Chief Counsel & Staff Director
Committee on Ways & Means
U.S. House of Representatives
1102 Longworth House Office Building
Washington, D.C. 20515

Joseph Gale
Chief Tax Counsel,
Majority Office
Senate Finance Committee
United States Senate
205 Dirksen Senate Office Building
Washington, D.C. 20510

Daniel M. Berman
Legislative Counsel
Joint Committee on Taxation
U.S. House of Representatives
1011 Longworth House Office Building
Washington, D.C. 20515

Neil Auerbach
Branch Chief
Office of Chief Counsel
Internal Revenue Service
Room 4617 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Gayle E. Novig, Esquire
Office of Chief Counsel Litigation
Internal Revenue Service
Room 4607 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Proposed Statutory Amendments
to the PFC Provisions of the
Tax Simplification Bill of 1993 (H.R. 13)

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1. Mark-to-Market Transition Rule

Proposed section 1291(i)(2)(A)(i)(I) is amended to read as follows:

> "(I) gain allocable under section 1294(a)(2)(B) and 1293(a) to the period specified in section 1293(a)(1)(B)(ii) shall not be taken into account, and"

2. Corporation Becoming a PFC

New section 1291(i)(4) is added to read as follows:

> "(4) SPECIAL RULE FOR CORPORATION BECOMING A PASSIVE FOREIGN CORPORATION. -- If any foreign corporation becomes a passive foreign corporation in a taxable year beginning after December 31, 1993, solely for purposes of this section, the adjusted basis (before adjustments under subsection (b)) of any marketable stock in such corporation which is owned (or treated under subsection (g) as owned) by a United States person on the first day of such taxable year, shall be treated as being the greater of its fair market value on such first day or its adjusted basis on such first day."

3. Alternative OEF Election

Proposed section 1294(a)(3) is amended by adding thereto the following new subparagraph:

> "(D) TRANSITIONAL ELECTION TO RECOGNIZE GAIN. -- If any marketable stock in a passive foreign corporation is owned (or is treated under subsection (e) as owned) by a United States person on the first day of such person's first taxable year beginning after December 31, 1993,
>
> > (i) the taxpayer may elect to be treated as receiving a dividend on such first day, in the amount and subject to the treatment provided in subparagraph (B), as if the conditions of subparagraph (B)(i) were satisfied; and
> >
> > (ii) such passive foreign corporation shall be deemed to satisfy the requirement of section 1294(a)(1)(B)(ii) with respect to the taxpayer."

4s. Lee Sheppard
235 East 95th Street
Apt. 34G
New York, New York 10128

Mr. Scott Schmedel
Wall Street Journal
World Financial Center
200 Liberty Street
New York, New York 10281

Diane H. Jones
American Bar Association
Section of Taxation
1800 M Street, N.W.
Washington, D.C. 20036

Mr. Herman Ayayo
Tax Notes
6830 N. Fairfax Drive
Arlington, Virginia 22213

Ms. Dorothy Coleman
Daily Tax Report
1231 25th Street, N.W.
Room 517
Washington, D.C. 20037

Mr. Charles Davenport
Tax Notes
6830 N. Fairfax Drive
Arlington, Virginia 22213

Timothy J. McCormally, Esq.
Tax Executives Institute, Inc.
1001 Pennsylvania Avenue, N.W.
Suite 320
Washington, D.C. 20004-2505

Ms. Barbara Coluccio
New York State Bar Association
One Elk Street
Albany, New York 12207

Eric Kracov, Esq.
Silverstein & Mullens
1776 K Street, N.W.
Washington, D.C. 20006