MEMORANDUM

Cleansing the PFIC Taint Just Got Easier: New Regulations Permit Purging Elections for Closed Years

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Major References:

I.R.C. §1297; T.D. 9231, 70 Fed. Reg. 72914 (12/8/05); T.D. 9232, 70 Fed. Reg. 72908 (12/8/05).

INTRODUCTION

The passive foreign investment company (PFIC) rules are a mess. It is much too easy for a foreign corporation to become a PFIC, and the price for owning PFIC shares is much too high. On December 8, 2005, the Treasury Department and IRS issued new regulations that may considerably ease the PFIC burden for some shareholders.[1] As discussed below, the new regulations allow certain shareholders to cleanse the PFIC "taint" by making "purging elections" for closed years.

OVERVIEW OF PFIC RULES

Purpose

The PFIC rules are intended to prevent a taxpayer from enjoying a tax deferral (or converting ordinary income into capital gain) by earning passive income through a foreign corporation. As explained below, the PFIC rules accomplish their purpose with a vengeance.

Definition of a PFIC

Preliminarily, it should be noted that whether a foreign corporation is or is not a PFIC is determined on a year by year basis, so that a foreign corporation may be a PFIC for one or more of its taxable years and not for others. As discussed below, however, a foreign corporation that is PFIC in one year, but ceases to be a PFIC thereafter, may nevertheless continue to be *treated* as a PFIC as to certain shareholders.

A foreign corporation will be a PFIC for a taxable year (of the foreign corporation) if either (1) 75% or more of its gross income for the year is passive income ("income test"), or (2) during that year, the average percentage of its assets that produce (or are held for the production of) passive income is at least 50% ("asset test").[2] For this purpose, "passive income" is defined as foreign personal holding company (FPHC) income (within the meaning of §954(c)), subject to certain exceptions.[3] FPHC income generally includes, among other things, interest, dividends, rents, royalties, and net gains from sales of property that give rise to such passive income.[4]

Unfortunately, no exception excludes interest on working capital from passive income. Therefore, interest earned on funds accumulated during a start-up period (or in preparation for expansion) is treated as passive income, even though the accumulations undeniably may be needed for the conduct of an active business.[5]

A look-through rule applies to any subsidiary in which the foreign corporation owns an interest (by value) of at least 25%.[6] Thus, for example, a holding company does not become a PFIC merely because its primary (or sole) source of income consists of dividends from its subsidiaries.

In contrast with the anti-deferral rules applicable to 10% U.S. shareholders[7] of a controlled foreign corpo-

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[1] T.D. 9231, 70 Fed. Reg. 72914 (12/8/05); T.D. 9232, 70 Fed. Reg. 72908 (12/8/05).

[2] §1297(a). Unless otherwise noted, all section references are to the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

[3] §1297(b).

[4] §954(c)(1).

[5] Section 1298(b)(2) provides a start-up exception pursuant to which a foreign corporation will be treated as not a PFIC during its "start-up year" if certain requirements are satisfied. This start-up exception is fairly stingy, however, as it applies only to the first taxable year in which the foreign corporation has gross income. Thus, for example, if funds are contributed to a newly formed foreign corporation on Dec. 29, and the foreign corporation earns even $1 of interest income before the close of business on Dec. 31, the start-up exception will not apply to the following year. In such case, the start-up exception would cover less than one week.

[6] §1297(c).

[7] For purposes of the "Subpart F" rules applicable to "United States shareholders" of a CFC, §951(b) defines the term "United States shareholder" as any U.S. person who owns shares possessing 10% or more of the total voting power of all classes of voting stock of the CFC. To avoid any confusion, U.S. owners of such 10% interests in CFCs are referred to herein as 10% U.S. shareholders.

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ration (CFC),[8] the applicability of the PFIC rules does not depend upon a particular U.S. owner (or all U.S. owners collectively) owning a specified percentage interest in the foreign corporation. Thus, for example, a foreign corporation may be a PFIC even if U.S. persons own, in the aggregate, substantially less than 1% of the corporation's outstanding shares.

Taxation Under the PFIC Regime

Shareholders of a PFIC are not subject to current taxation on their respective shares of the PFIC's income (unless they make a "QEF election" described below). However, a shareholder that receives an "excess distribution"[9] from a PFIC, or disposes of any PFIC shares, is subject to tax in a manner designed to remove the benefit of any deferral of U.S. tax on the income of the PFIC (and to prevent the conversion of ordinary income to capital gain). Under the PFIC regime, the amount of such excess distribution or gain is allocated over the shareholder's holding period for the stock.[10] Any amounts allocable to the current year or the portion (if any) of the shareholder's holding period before the foreign corporation became a PFIC (or before the PFIC rules took effect in 1987) are treated as ordinary income in the current year. Any remaining amounts are taxed at the highest rates applicable to ordinary income for the years to which they are allocated and, in addition, subject to an interest charge at the rate applicable to underpayments of tax.[11] Particularly in the case of individuals (who would otherwise enjoy preferential rates for long-term capital gains), the cost of the PFIC regime is quite steep. Individuals and corporations alike can suffer sticker shock when interest at the underpayment rate compounds over a period of many years.

Under proposed regulations, particularly onerous rules would apply to "indirect dispositions" of PFIC shares. For example, suppose that U.S. resident, USR, owns all of the shares of F1, and that F1 owns all of the shares of F2; both F1 and F2 are PFICs. Suppose further that F2 issues shares to a new investor so that F1's interest in F2 is reduced from 100% to 50%. USR would be considered to indirectly own shares of F2, and F2's issuance of shares to the new investor would be treated as a deemed disposition of 50% of USR's indirect interest in F2.[12] Such deemed disposition would be subject to the full force of the PFIC rules described above, including ordinary income treatment and an interest charge. The proposed regulations would prescribe similarly painful rules for indirect excess distributions.[13]

The proposed regulations also would require mark-to-market treatment for a citizen or resident alien shareholder who becomes a nonresident alien for U.S. tax purposes.[14] This particularly harsh rule would not be limited to citizens or long-term residents (as are the rules applicable to "expatriates" under §877), and thus could apply, for example, to an employee of a multinational corporation who is transferred to the United States for one year.[15]

Fortunately, the IRS has neglected to finalize the proposed regulations for 14 years. Until and unless these regulations are issued in final (or temporary) form, it appears that they should have no effect.[16] Of course, if such final (or temporary) regulations are promulgated, they well may be given retroactive effect; and gambling on when or whether this will happen hardly would seem prudent.[17]

Shares of a PFIC generally are not eligible for a basis step-up at death under §1014.[18] In addition, dividends from a PFIC do not qualify for the 15% rate applicable to dividends from a "qualified foreign corporation" as defined in §1(h)(11)(C).

[8] A foreign corporation is a CFC if 10% U.S. shareholders, in the aggregate, own more than 50% of the stock (measured by vote or value) of the foreign corporation.

[9] A shareholder's total excess distribution for a taxable year generally equals the excess of total distributions received by the shareholder for the taxable year over 125% of the average amount of distributions received by the shareholder during the three preceding taxable years. §1291(b)(2)(A). If a shareholder receives more than one distribution during a taxable year and the shareholder has a total excess distribution for such year, then a portion of each distribution will treated as an excess distribution.

[10] §1291(a)(1)(A), (2).

[11] §1291(a)(1)(C), (c).

[12] *See* Prop. Regs. §1.1291-3(c)(2), (3), *Ex. 3*.

[13] *See* Prop. Regs. §1.1291-2(f).

[14] *See* Prop. Regs. §1.1291-3(b)(2).

[15] Note that most or all of the appreciation may have accrued economically prior to the employee's move to the United States. A nonresident alien who moves to the United States generally does not receive a basis step-up for his or her assets (although this may well be possible to achieve through careful tax planning). *But see* §1296(l) (allowing elective basis step-up for certain marketable PFIC shares owned by individual who becomes U.S. person after 1997).

[16] Section 1291(f) provides that, in the case of a disposition of PFIC shares that otherwise qualifies for nonrecognition treatment, gain shall be recognized "[t]o the extent provided in regulations." This provision does not appear to be self-implementing and, moreover, would not appear to apply in the absence of an actual disposition of PFIC shares. Section 1298(f) provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the PFIC rules. It is difficult to see how this generic grant of regulatory authority could be interpreted as a self-implementing rule for indirect dispositions.

[17] Pursuant to Regs. §1.1291-1(j), the proposed regulations generally would take effect as of Apr. 11, 1992.

[18] *See* §1291(e). The step-up is not disallowed, however, if the decedent was a nonresident alien at all times during his or her holding period for such shares.

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Exception for CFC Overlap

A special overlap rule applies if the PFIC is also a CFC and if the PFIC shareholder is a 10% U.S. shareholder of the CFC.[19] In that event, the foreign corporation is treated as not a PFIC for the "qualified portion" of the shareholder's holding period. The qualified portion is the portion of such holding period that is *after* December 31, 1997, and during which the shareholder was a 10% U.S. shareholder of the CFC.[20] Thus, for example, the foreign corporation would still be treated as a PFIC for any portion of the shareholder's holding period preceding 1998. Due to the "once a PFIC, always a PFIC rule" (described below), the overlap rule generally does not allow a shareholder to escape the PFIC regime if the first year of the shareholder's holding period in which the foreign corporation is a PFIC ("first PFIC year") is not included in the qualified portion of its holding period.[21]

"Once a PFIC, Always a PFIC" Rule

As noted above, a foreign corporation's status as a PFIC or non-PFIC is determined on a year by year basis, so that a foreign corporation may be a PFIC for one year but not another. The significance of determining PFIC status year by year is relatively limited, however, due to the once a PFIC, always a PFIC rule.

If a foreign corporation is a PFIC at any time during the holding period of a particular shareholder, §1298(b)(1) generally provides that the foreign corporation will forever be treated as a PFIC *with respect to that shareholder*, even if the foreign corporation thereafter becomes sufficiently active that it never again satisfies either the income test or the asset test of §1297(a). This rule generally is known as the once a PFIC, always a PFIC rule.[22] If a foreign corporation has ceased to be a PFIC, but its shares are treated as PFIC shares as to a particular shareholder under the once a PFIC, always a PFIC rule, such shares are sometimes referred to as bearing a PFIC "taint."[23] As discussed below, in certain circumstances a shareholder may be permitted to make one or more of several different elections to "purge" the PFIC taint and thereby avoid the unfavorable PFIC regime.

Elections

Mark-to-Market Election

In the case of "marketable stock," a PFIC shareholder may elect to mark the PFIC shares to market based on the fair market value of such shares as of the close of each taxable year (of the shareholder).[24] All mark-to-market gains under the mark-to-market regime are treated as ordinary income,[25] and mark-to-market losses generally are allowed to the extent of prior mark-to-market gains.[26]

Shares for which the mark-to-market election is in effect are not subject to the PFIC regime.[27] Avoiding the PFIC rules in this way can be extremely costly, however, since the marking to market triggers all unrealized appreciation in the PFIC shares (as well as the shareholder's proportionate share of the PFIC's earnings), and the inclusions are taken into account as ordinary income. In addition, if the mark-to-market election is made for a taxable year after the first PFIC year, the first mark-to-market inclusion generally is subject to the PFIC rules, including the imposition of an interest charge on amounts allocated to prior years.[28]

It does not appear that the mark-to-market election is particularly popular.

QEF Election

A shareholder otherwise subject to the PFIC regime may elect to be taxed instead under the qualified electing fund (QEF) regime, provided that the foreign corporation is willing to allow the shareholder to inspect and copy its books and records.[29] Under the QEF regime, the shareholder is required to include in income, for each year in which the foreign corporation is a PFIC (or is treated as a PFIC as to that share-

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[19] §1297(e). The overlap rule was added to the Code by the Taxpayer Relief Act of 1997, P.L. 105-34.

[20] §1297(e)(2). It is not obvious why this rule could not have been more generous.

[21] As discussed below, however, a shareholder to whom the overlap rule applies may make an election to purge the PFIC taint under §1298(b)(1).

[22] It must be emphasized that the once a PFIC, always a PFIC rule only applies to the particular shareholder whose holding period includes all or a portion of a year during which the foreign corporation was a PFIC. As to any other shareholder, the foreign corporation simply would not a PFIC and would not be treated as a PFIC for any purpose.

[23] Note that the once a PFIC, always a PFIC rule will trump the overlap rule of §1297(e) if the shareholder's first PFIC year is not included in the qualified portion of its holding period. In that event, the foreign corporation would still be treated as a PFIC with respect to that shareholder unless the shareholder makes a purging election under §1298(b)(1). Such purging elections are discussed below.

[24] §1296(a).

[25] §1296(c)(1)(A).

[26] §1296(c)(1)(B).

[27] Regs. §1.1291-1(c)(3).

[28] §1296(j)(1)(A). No such inclusion is required, however, if the shareholder has had a "QEF election" (described below) in effect since its first PFIC year.

[29] *See* §1295(a)(2); Regs. §1.1295-1(g). Many foreign corporations are not willing to allow such access and, therefore, many PFIC shareholders are unable to make the QEF election.

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holder under the once a PFIC, always a PFIC rule), the shareholder's pro rata share of the ordinary earnings and net capital gain of the foreign corporation.[30] A distribution of amounts previously taxed under the QEF regime is treated as a tax-free return of capital.[31]

If a shareholder makes a QEF election for its first PFIC year, then the foreign corporation is referred to as a "pedigreed QEF" and the standard PFIC regime described above will not apply to that particular shareholder.[32] Thus, for example, gain from the sale of shares of a pedigreed QEF may qualify as capital gain and will not be subject to an interest charge.

If a shareholder makes a QEF election for a year after its first PFIC year, then the standard PFIC regime still will apply (although amounts previously taxed under the QEF regime will not be taxed again). Therefore, depending upon the circumstances, a failure to make a QEF election for the first PFIC year may have serious consequences.

In general, a shareholder that wishes to make a QEF election for a taxable year must file the election no later than the due date (including extensions) of the shareholder's income tax return for that year.[33] The regulations provide a limited amount of relief permitting shareholders to make a "late" QEF election for a taxable year after the normal deadline.

In most circumstances, a shareholder may file a late QEF election for a taxable year only if it reasonably believed the foreign corporation was not a PFIC and filed a protective statement with its return for that year.[34] Where these (and other applicable) requirements are satisfied, the QEF election may be made even for a closed year. Obviously, this rule will be of no help in the many situations in which a shareholder (and its advisors) were simply unaware of the PFIC rules.

A "qualified shareholder" may make a late QEF election for any open year, even if it does not satisfy the reasonable belief requirement and has not filed a protective statement.[35] To be a qualified shareholder, a shareholder must never have owned (directly, indirectly, or constructively) stock possessing 2% or more of the total vote or value of the foreign corporation.[36] In addition, the foreign corporation, or its U.S. counsel, must have made a statement in a public filing (or other notice to U.S. investors) to the effect that the foreign corporation reasonably believes that it should not be a PFIC or, alternatively, reasonably believes that, more likely than not, it ultimately will not be a PFIC.[37] The qualified-shareholder rule adequately may protect public holders of small interests in large PFICs that receive appropriate "non-PFIC" disclosure, but clearly will not apply to anyone else.

The regulations also provide a "special consent" procedure, pursuant to which a shareholder that does not meet the above requirements may nevertheless be permitted to make a late QEF election — even for a closed year.[38] The IRS may grant relief under the special consent procedure only if: (1) the shareholder reasonably relied on a "qualified tax professional;" (2) if necessary to avoid prejudice to the interests of the IRS by reason of the shareholder's inability to file amended returns for closed years, the shareholder enters into a closing agreement pursuant to which the shareholder pays an amount to the IRS; (3) the shareholder requests consent before the IRS raises the PFIC issue on audit; and (4) the shareholder satisfies certain procedural requirements.[39]

The special consent rule provides meaningful relief in certain situations, but its availability is extremely limited. For example, the regulations provide that a shareholder will not be considered to have relied on a qualified tax professional if the shareholder knew, or should have known, that such person (1) was not competent to render tax advice with respect to the ownership of shares of a foreign corporation or (2) did not have access to all relevant facts and circumstances.[40] Therefore, an investor that does not consult a tax professional with appropriate cross-border expertise (or, for that matter, any tax professional) or is deemed to have provided insufficient access to information will not receive special consent for a late QEF election.

Moreover, the procedural requirements of the regulations will be satisfied only if the shareholder and the

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[30] §1293(a); Regs. §1.1295-1(c)(2).

[31] §1293(c).

[32] *See* §1291(d)(1); Prop. Regs. §1.1291-1(c)(1). Note also the once a PFIC, always a PFIC rule does not apply to a shareholder with respect to which the foreign corporation is a pedigreed QEF. *See* §1298(b)(1). Therefore, if a foreign corporation is a pedigreed QEF as to a particular shareholder, and the corporation ceases to be a PFIC, that shareholder will no longer be required to include any amounts in income under the QEF regime.

[33] Regs. §1.1295-1(e).

[34] Regs. §1.1295-3(b).

[35] Regs. §1.1295-3(e). Note, however, that the election may not be made for a closed year. Absent any additional relief, a shareholder whose first PFIC year has closed would still be subject to the once a PFIC, always a PFIC rule even if it made the QEF election for its earliest open year. If a qualified shareholder satisfies certain additional requirements, however, the regulations appear to *treat* the shareholder as if it had made the QEF election for its first PFIC year; consequently, the foreign corporation is *deemed* to be a pedigreed QEF as to such shareholder. *See* Regs. §1.1295-3(e)(1).

[36] Regs. §1.1295-3(e)(2)(i).

[37] Regs. §1.1295-3(e)(2)(ii). A shareholder cannot rely on such statement if the shareholder knew or had reason to know that the statement was inaccurate. Regs. §1.1295-3(e)(3).

[38] Regs. §1.1295-3(f).

[39] Regs. §1.1295-3(f)(1).

[40] Regs. §1.1295-3(f)(2)(i).

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individuals having knowledge or information about the failure to make a timely QEF election submit affidavits signed under penalties of perjury. These individuals must include the qualified tax professional who advised the shareholder, as well as any other individual involved in the preparation of the shareholder's return; and each affidavit must describe the individual's engagement and responsibilities, as well as the advice given to the shareholder. Thus, relief is available under the special consent rule only if the qualified tax professional provides an affidavit stating, under penalties of perjury, that he or she failed to provide proper advice regarding the PFIC rules. Practitioners may not always be eager to provide such written admissions.

Deemed-Sale Election for Nonpedigreed QEF

As noted above, a shareholder that makes a QEF election for a taxable year after its first PFIC year generally still will be subject to the unfavorable PFIC regime by reason of the once a PFIC, always a PFIC rule. Pursuant to §1291(d)(2)(A), however, a shareholder that makes a QEF election for a later year and wishes to purge the PFIC taint may elect to treat its PFIC shares as sold for fair market value (as of the first day of the year to which the QEF election applies), if the shareholder can establish such value to the satisfaction of the IRS. The deemed sale restarts the shareholder's holding period so that the shareholder then will have had a QEF election in effect since its first PFIC year.[41] The PFIC therefore will be treated as a pedigreed QEF with respect to that particular shareholder with the result that the PFIC regime will not apply to that shareholder.[42]

Any gain arising from the deemed-sale election is considered an excess distribution subject to the PFIC regime described above. Accordingly, the deemed-sale election may be fairly painless if the QEF election is made early in the shareholder's holding period, assuming modest appreciation since purchase, but may be extremely costly later, when the amount of gain triggered may be substantially greater. Given its interdependence with the QEF election, and the potentially costly "buy in," the deemed-sale election often is not a viable means of escaping the PFIC regime.

Deemed-Dividend Election for Nonpedigreed QEF

An alternative purging election is available if the PFIC is also a CFC. Pursuant to §1291(d)(2)(B), a shareholder that has made a QEF election for a year after its first PFIC year may elect to purge the PFIC taint (i.e., to cause the PFIC to become a pedigreed QEF by starting a new holding period) by including in income, as a deemed dividend, the shareholder's proportionate share of the CFC's post-1986 earnings and profits.[43] The amount of such deemed dividend is considered an excess distribution subject to the PFIC regime described above. In comparison with the deemed-sale election, the deemed-dividend election particularly can be favorable, since unrealized appreciation and pre-1987 earnings are not taken into account. A shareholder need not be a 10% U.S. shareholder of the PFIC/CFC to make the deemed-dividend election.

Deemed-Sale and Deemed-Dividend Elections for Former PFICs and PFICs to Which the Overlap Rule Applies

Section 1298(b)(1) also permits other purging elections that have nothing to do with the QEF election. These elections may be made to escape the PFIC regime (otherwise rendered applicable by the once a PFIC, always a PFIC rule) where a foreign corporation (1) ceases to be a PFIC generally, because it no longer satisfies the income test or the asset test of §1297(a), or (2) ceases to be treated as a PFIC as to a particular 10% U.S. shareholder (for a portion of its holding period), pursuant to the PFIC/CFC overlap rule of §1297(e).

Pursuant to §1298(b)(1), the once a PFIC, always a PFIC rule:

> shall not apply 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 once a PFIC, always a PFIC rule])) under rules similar to the rules of §1291(d)(2).

Temporary regulations were adopted in 1988 to provide guidance regarding the §1298(b)(1) election.[44] Pursuant to these regulations, a shareholder of a foreign corporation that was a PFIC at some point during the shareholder's holding period, but later ceased to be a PFIC, can purge the PFIC taint by electing to treat the shares as having been sold for fair market value on the last day of the last taxable year for which the foreign corporation was a PFIC (the "termination date").[45] The election was required to be made by filing an amended return for the taxable

[41] Regs. §1.1291-10(g).

[42] *See* §1291(d)(1); Regs. §1.1291-10(a).

[43] §1291(d)(2)(B).

[44] T.D. 8178, 53 Fed. Reg. 6770 (3/2/88). Note that, in 1988, the rules of present §1298(b)(1) were set forth in §1297(b)(1). Former §1297 was redesignated as §1298 by the Taxpayer Relief Act of 1997, P.L. 105-34.

[45] 1988 Regs. §1.1297-3T(a). Note that the 1988 temporary regulations did not address (and could not have addressed) circumstances in which a foreign corporation ceased to be a PFIC

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year including the termination date within three years of the due date (as extended) of such return.[46] These regulations were extremely helpful, but, unfortunately, nothing could be done once three years passed following the due date of the return for the year including the termination date. Thus, for example, if the PFIC issue was not discovered until four years after the termination date, the §1298(b)(1) purging election could not be made.

These temporary regulations were liberalized somewhat in 1998.[47] Under the 1998 temporary regulations, a shareholder of a former PFIC that was also a CFC could choose instead to make a deemed-dividend election under the rules of §1291(d)(2)(B) instead of a deemed-sale election under the rules of §1291(d)(2)(A).[48] Under such deemed-dividend election, the amount treated as an excess distribution was limited to the shareholder's proportionate share of the CFC's post-1986 earnings and profits. Although not clearly provided for under the 1998 temporary regulations, the IRS also has allowed a 10% U.S. shareholder of a CFC that is treated as a non-PFIC for a portion of the shareholder's holding period pursuant to the PFIC/CFC overlap rule to make a deemed-sale or deemed-dividend election.[49]

The 1998 temporary regulations "sunset" in 2001.[50] However, even in their absence, the IRS has allowed shareholders to make the various purging elections described above.

THE NEW REGULATIONS

On December 8, 2005, the Treasury Department and the IRS adopted new regulations that not only reinstate the 1988/1998 temporary regulations, but also go much further to provide relief for shareholders who may have "missed the boat" on purging the PFIC taint and thus remain subject to the PFIC regime pursuant to the once a PFIC, always a PFIC rule. As explained below, the principal innovation here is that purging elections may be made for closed years.

for a portion of a shareholder's holding period under the PFIC/CFC overlap rule, because the overlap rule was not added to the Code until 1997.

[46] 1988 Regs. §1.1297-3T(b).

[47] T.D. 8750, 63 Fed. Reg. 6 (1/2/98).

[48] 1998 Regs. §1.1297-3T(c).

[49] Inasmuch as the PFIC/CFC overlap rule was added to the Code in 1997, it is not clear why the 1998 temporary regulations were not updated in this respect.

[50] Pursuant to the "sunset" rule of §7805(e)(2), adopted by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA), P.L. 100-647, any temporary regulation shall expire within three years after the date of issuance (unless finalized). Temporary regulations in existence prior to the adoption of TAMRA, however, were "grandfathered."

Terminology

The new regulations provide different but similar purging elections to permit a shareholder to escape the PFIC regime (otherwise rendered applicable by the once a PFIC, always a PFIC rule) where a foreign corporation (1) ceases to be a PFIC generally, because it no longer satisfies the income test or the asset test of §1297(a), or (2) ceases to be treated as a PFIC as to a particular 10% U.S. shareholder (for a portion of its holding period), pursuant to the PFIC/CFC overlap rule of §1297(e).

A foreign corporation in the first category is referred to as a "former PFIC."[51] The last day of the last taxable year of the foreign corporation during which it was a PFIC is referred to as the "termination date."[52]

A foreign corporation in the second category is referred to as a "§1297(e) PFIC."[53] The first day of the qualified portion of the shareholder's holding period (i.e., the first day on which the foreign corporation is a CFC and the shareholder is a 10% U.S. shareholder of the CFC) is referred to as the "CFC qualification date."[54]

Rules for Former PFICs

The new regulations allow a deemed-sale election or, if the PFIC is also a CFC, a deemed-dividend election, to be made on an original or amended return for the taxable year of the shareholder that includes the termination date.[55] In general, the election must be filed within three years of the due date (including extensions) of such return.[56]

To this point, the new regulations are not terribly interesting, although it is, of course, always nice when the IRS gets around to reinstating expired guidance.

The new regulations go much further than their predecessors, however, by permitting a shareholder to request special consent for a "late" purging election. Under the new regulations, the IRS may permit a deemed-sale or deemed-dividend election to be made for a former PFIC after the time generally prescribed, if:

[51] Regs. §1.1291-9(j)(2)(iv).

[52] Regs. §1.1298-3(d). The once a PFIC, always a PFIC rule does not apply for this purpose.

[53] Regs. §1.1291-9T(j)(2)(v).

[54] Regs. §1.1297-3T(d).

[55] Regs. §1.1298-3(b), (c). Under the 1988 and 1998 temporary regulations, the election could not be made on an original return. This oversight has been corrected in the new regulations.

[56] Regs. §1.1298-3(b)(3), (c)(4).

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1. For any request made after June 30, 2006, the shareholder requests consent *before* the IRS raises upon audit the PFIC status of the foreign corporation for any taxable year of the shareholder;
2. The shareholder agrees in a closing statement to eliminate any prejudice to the interests of the U.S. government arising from the shareholder's inability to file amended returns for the taxable year that includes the termination date, or any earlier closed taxable year in which the shareholder took an inconsistent position; and
3. The shareholder satisfies certain procedural requirements, including the filing of new IRS Form 8621-A, *Return by a Shareholder Making Certain Late Elections to End Treatment as a Passive Foreign Investment Company.*[57]

Rules for §1297(e) PFICs

The new regulations permit a 10% U.S. shareholder of a §1297(e) PFIC to make a deemed-sale or deemed-dividend election on an original or amended return for the taxable year of the shareholder that includes the CFC qualification date.[58] In general, the election must be filed within three years of the due date (including extensions) of such return.[59]

However, the new regulations provide relief for those that might otherwise "miss the boat" by allowing a shareholder to request special consent for a late purging election.[60] The requirements for such special consent are the same as those described above for shareholders of former PFICs.

Comments on the Special Consent for Late Purging Elections

One of the (numerous) problems with the PFIC rules is that it's all too easy to have a PFIC without knowing it. Accordingly, many shareholders find out late in the game (if ever) that the foreign corporation in which they own an interest is, or may be, a PFIC, a former PFIC or a §1297(e) PFIC. By the time this information comes to light, there may be no good solution.

A QEF election made for a year after the shareholder's first PFIC year, for example, has only limited benefits due to the once a PFIC, always a PFIC rule. Such a QEF election can be combined with a purging election, but the tax cost of making the purging election after many years of appreciation may well be too steep to merit serious consideration.

In some circumstances, a late QEF election may be the answer. Indeed, the late QEF election can be an ideal solution, but, as discussed above, the requirements are very strict. In many circumstances, relief will be available only if the taxpayer sought advice from a qualified tax professional who was given access to all relevant facts, who failed to provide adequate advice regarding the QEF election, and who is willing to admit to all of this in an affidavit signed under penalties of perjury.

Against this bleak backdrop, the possibility of a late purging election for a former PFIC or §1297(e) PFIC starts to look pretty good. In this regard, it is particularly noteworthy that the election appears to be available as of right, provided that the shareholder (1) requests consent before the IRS raises the PFIC issue (or before July 1, 2006), and (2) is willing to make the IRS whole for any tax revenue otherwise lost due to the lateness of the election. Thus, in contrast with the uncertainty attendant to a request for relief to file a late QEF election, a shareholder that meets these requirements presumably can rest easy that the desired relief will be granted.[61]

With regard to the amount required to be paid to eliminate any prejudice to the interests of the U.S. government, the regulations expressly provide that prejudice will be considered to exist "if granting relief would result in the shareholder having a lower tax liability (other than by a *de minimis* amount), taking into account applicable interest charges . . . than the shareholder would have had if the shareholder had properly made the §1298(b)(1) election [in the time generally prescribed]." The regulations further provide that "[t]he time value of money shall be taken into account for purposes of this computation."

The following example illustrates the utility of the new relief.

In December 1990, a U.S. corporation ("USco") invested in a new venture, purchasing a 5% interest in a foreign corporation, Tug Scrub Ltd., formed to scrape the barnacles off the bottom of garbage scows in Eastern Europe. The other 95% interest in Tug Scrub was purchased by several nonresident aliens who are unrelated to USco.

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[57] Regs. §§1.1298-3(e), -3T(e).

[58] Regs. §1.1297-3T(b), (c). The excess distribution arising from either purging election is taken into account on the CFC qualification date (which may or may not be the first day of the taxable year of the foreign corporation). Regs. §1.1297-3T(b)(2), (c)(2).

[59] Regs. §1.1297-3T(b)(3), (c)(4).

[60] Regs. §1.1297-3T(e).

[61] Query what recourse may be had if the shareholder complies with all of the requirements of the regulations, but the IRS nevertheless refuses consent.

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Tug Scrub took a while to get underway, and thus did not earn any active business income until 1992. Tug Scrub did earn a small amount of (passive) interest income in 1990 and 1991, however, and thus became a PFIC for those years (since all of its gross income was passive).[62] Furthermore, pursuant to the once a PFIC, always a PFIC rule, Tug Scrub continued to be treated as a PFIC as to USco, even though Tug Scrub was engaged in an active (if not glamorous) business that never again satisfied the income test or the asset test of §1297(a).

Unfortunately, USco never consulted a tax professional regarding the possible application of the PFIC regime. USco's chief financial officer (who is not a tax professional) was vaguely aware that special rules apply to investments in a foreign mutual fund, and perhaps other passive foreign investments, but assumed that a genuinely active business — such as barnacle scrubbing — could not be problematic. Neither the CFO nor anyone else discussed this investment with USco's accountant (who knows nothing about investments in foreign corporations) or any other tax professional.

In 2006, the CFO had lunch with a tax lawyer acquaintance and the discussion turned to PFICs. Following that disturbing conversation, the CFO did some diligence and learned that, notwithstanding all the scrubbing, Tug Scrub was a PFIC in 1990 and 1991 and, therefore, continued to be treated as a PFIC as to USco in 2006 under the once a PFIC, always a PFIC rule.

Unfortunately, a late QEF election was not a possibility. As noted above, relief generally is available only for a shareholder that filed a protective election. Obviously, USco did not do this. A "qualified shareholder" may make a late election, but this too was not a viable option, e.g., because USco was not a qualified shareholder.[63] Finally, USco did not qualify for the special consent procedure for late QEF elections. As stated above, only a taxpayer who has relied on a qualified tax professional qualifies for the special consent; and USco did not consult a qualified tax professional. Accordingly, USco would not be allowed to make a late QEF election for 1990.

The new regulations would allow USco to elect to purge the PFIC taint by making a deemed-sale election as of December 31, 1991, provided, of course, that USco requests consent for the late election before the IRS raises the PFIC issue on audit. Assuming that the business did not appreciate significantly from December 1990 to December 31, 1991, the amount of gain taken into account (as ordinary income) may be relatively insubstantial, even when the interest charge (which ought not to be overlooked) is taken into account.

CONCLUSION

As a general rule, shareholders subject to the PFIC regime have had few good options, even if the foreign corporation ceased long ago to be a PFIC. Generally, the best the regulations could offer was a costly purging election that would subject many years of appreciation (realized and unrealized) to ordinary income treatment and a hefty interest charge. In many cases, the regulations allowed no relief of any kind.

Indeed, the popular response when confronted with this impossible situation has been to "stick one's head in the sand" and hope the problem just will go away. Now, at least for certain shareholders of former PFICs and §1297(e) PFICs, there may be a better solution.

But it should be emphasized that the relief afforded under the new regulations is subject to a significant limitation. Only those that come forward before the IRS raises the issue on audit will qualify to make a late purging election under §1298(b)(1). Therefore, shareholders of foreign corporations should actively assess their PFIC exposure and, if necessary, request consent for a late election as soon as possible. Once the IRS raises the issue, it will be too late.

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[62] For purposes of the hypothetical, assume that Tug Scrub had no cost of goods sold in 1990 or 1991. In PLR 9447016, the IRS (generously) ruled that a foreign corporation with interest income had no gross income, and thus was not a PFIC, where its cost of goods sold exceeded the sum of its sales revenues and interest income.

[63] Among other requirements, a qualified shareholder must own a less-than-2% interest and must have received certain "anti-PFIC" disclosure in a public filing.

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