Is Code Sec. 1291(f) Self-Executing?

By Michael J. Miller

While the Subpart F rules applicable to U.S. shareholders of controlled foreign corporations ("CFCs") get most of the press, a second anti-deferral regime, applicable to U.S. investors in passive foreign companies ("PFICs"), is also extremely important. Unfortunately, guidance under the PFIC regime is limited and hence there are unanswered questions. One such question pertains to the treatment of transfers of PFIC stock that would ordinarily not trigger recognition of gain under generally applicable tax principles.

Overview of the PFIC Rules

General Purpose

The PFIC rules, adopted in 1986 with relatively few amendments thereafter, 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.

Definition of PFIC

A foreign corporation is a PFIC for a taxable year (of the foreign corporation) if either (1) 75 percent 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 percent ("asset test").[1] For this purpose, "passive income" is defined as foreign personal holding company ("FPHC") income (within the meaning of Code Sec. 954(c)), subject to certain exceptions.[2] 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.[3]

A look-through rule applies to any subsidiary in which the foreign corporation directly or indirectly owns an interest (measured by value) of at least 25 percent. Code Sec. 1297(c) provides that, for purposes of determining whether a foreign corporation is a PFIC, the foreign corporation is treated as if it "held its proportionate share of the assets" and "received directly its proportionate share of the income" of such 25 percent-owned subsidiary. Thus, for example, a holding company does not become a PFIC merely because its primary (or sole) source of

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income consists of dividends from its 25-percentowned subsidiaries.

In contrast with the Subpart F rules applicable to U.S. shareholders of a CFC, the applicability of the PFIC rules does not depend upon one or more U.S. owners owning a specified percentage interest in the foreign corporation.[4]

Taxation Under the Excess Distribution Regime

U.S. persons who own stock of a PFIC are not required to pay tax currently on any portion of the PFIC's income.[5] However, a U.S. investor that receives an "excess distribution"[6] from a PFIC, or recognizes gain on a disposition of PFIC shares, is subject to tax in a manner designed to remove the benefit of any deferral, and to prevent the conversion of ordinary income to capital gain. Under this "excess distribution regime," the amount of such excess distribution or gain is allocated over the shareholder's holding period for the stock.[7] Any amounts allocable to the current year and any portion of the shareholder's holding period before the foreign corporation became a PFIC 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.[8]

Concern with Tax-Avoidance Through Certain Dispositions—Code Sec. 1291(f)

Congress was concerned that, in certain instances, taxpayers could improperly avoid the application of the PFIC rules by disposing of PFIC shares with a built-in gain in transactions that, under generally applicable tax principles, do not trigger recognition of the built-in gain. Accordingly when PFIC rules were enacted in 1986, the statute included Code Sec. 1291(f), which provided as follows:

> **(f) Nonrecognition provisions.**
>
> To the extent provided in regulations, gain shall be recognized on any disposition of stock in a passive foreign investment company.

In 1988, Code Sec. 1291(f) was amended by TAMRA to provide as it currently reads, which is as follows:

> **(f) Recognition of gain.**
>
> To the extent provided in regulations, in the case of any transfer of stock in a passive foreign investment company where (but for this subsection) there is not full recognition of gain, the excess (if any) of—
>
> (1) the fair market value of such stock, over
> (2) its adjusted basis,
>
> shall be treated as gain from the sale or exchange of such stock and shall be recognized notwithstanding any provision of law. Proper adjustment shall be made to the basis of any such stock for gain recognized under the preceding sentence.

Accordingly, regulations issued under Code Sec. 1291(f) could, for example, tax a U.S. owner's gift of appreciated PFIC stock to a foreign family member on the built-in gain to the same extent as if the stock had been sold for fair market value. Alternatively, regulations issued under Code Sec. 1291(f) could tax a U.S. owner's exchange of appreciated PFIC stock for non-PFIC stock in a transaction that otherwise qualifies for nonrecognition treatment, *e.g.*, under the rules applicable to tax-free reorganizations.[9]

Proposed Reg. §1.1291-6(b)(1) provides that a U.S. owner of PFIC stock "recognizes gain on any direct or indirect disposition" of PFIC stock, without regard to whether the disposition is a "nonrecognition transfer" as defined in Proposed Reg. §1.1291-6(a)(2). For this purpose, a "nonrecognition transfer includes, but is not limited to, a gift, a transfer by reason of death, a distribution to a beneficiary by a trust or estate (other than a distribution to which section 643(e)(3) applies), and a transfer in which gain or loss is not fully recognized pursuant to any of the following provisions: Sections 311(a), 332, 336(e), 337, 351, 354, 355, 361, 721, 731, 852(b)(6), 1036, and 1041." Proposed Reg. §1.1291-6(a)(2).

These proposed regulations were never finalized, however, and proposed regulations do not qualify as "real" regulations. Thus, the question arises as to whether Code Sec. 1291(f) is effective in the absence of implementing regulations, *i.e.*, self-executing.

Is Code Sec. 1291(f) Self-Executing?

Since Code Sec. 1291(f) applies "To the extent provided in regulations," and no regulations have been issued under that provision, a straightforward interpretation would suggest that Code Sec. 1291(f) currently has no application. Moreover, there are some cases that potentially support this position.[10]

In *C.F. Alexander*,[11] the Tax Court considered whether the at-risk rules of Code Sec. 465(b)(3) apply to certain "additional activities" specified in Code Sec. 465(c)(3)(A) (in addition to the activities specified in Code Sec. 465(c)(1)), where Code Sec. 465(c)(3)(D) provides for the application of Code Sec. 465(b)(3) "only to the extent provided in regulations prescribed by the Secretary."

The Tax Court's opinion provides in pertinent part as follows:

> Section 465(c)(3)(D) unambiguously provides that section 465(b)(3) "shall apply only to the extent provided in regulations prescribed by the Secretary," to an activity described in section 465(c)(3)(A). Regulations have not been prescribed by the Secretary. Accordingly, we hold that section 465(b)(3) does not apply to the activities of the limited partnerships. [Footnote reference omitted.]

The above reasoning, which is both short and sweet, could easily be applied to conclude that Code Sec. 1291(f) is inapplicable in the absence of implementing regulations. Moreover, *Alexander* should carry extra weight, as the opinion in that case was a unanimous reviewed opinion of the full Tax Court.

Nevertheless, the result in *Alexander* may be distinguished, if one feels so inclined. First, one could draw a distinction between Code Secs. 465(c)(3)(D) and 1291(f), because the former applies "only to the extent provided in regulations" and the latter applies "To the extent provided in regulations," without the word "only."

Second, while the above-quoted portion of the Tax Court's opinion begins and ends with the statute, seemingly suggesting an exceedingly straightforward analysis, the opinion also includes a footnote stating that the Tax Court considered the legislative history to support its interpretation:

> The legislative history to the Revenue Act of 1978, Pub. L. 95-600, 92 Stat. 2763, supports our interpretation of section 465(c)(3)(D). After discussing section 465(b)(3), the House Committee Report states:
>
> Although this rule will continue to apply without change to the four specified activities, the bill provides that, in the case of the activities which are newly made subject to the at risk provision by the bill, this automatic nonrecourse provision shall apply only to the extent provided in regulations prescribed by the Treasury. The regulations may make this provision applicable to activities involving tax shelter characteristics, such as the presence of property the value of which is subject to substantial uncertainty, activities of a speculative nature, the unavailability of similar financing on similar terms from unrelated lenders and the presence of terms or conditions under which either the loan becomes nonrecourse in later taxable years or the taxpayer can convert the obligation from a recourse obligation to a nonrecourse (or guaranteed) obligation in later years.[12]

The fact that Tax Court needed (or at least chose) to consider the legislative history, even if only in a footnote, opens the door for a different conclusion to be reached in some other case where the legislative history indicates that Congress wanted or expected some particular result.

Another key Tax Court case in this area is *15 West 17th Street LLC*.[13] This case is noteworthy, among other reasons, because it is relatively recent and because it was reviewed by the entire Tax Court, even though the decision was not unanimous.

In *15 West 17th Street LLC*, the Tax Court considered whether the taxpayer was entitled to a charitable contribution deduction, notwithstanding the failure to obtain a contemporary written acknowledgement ("CWA"), as normally required by Code Sec. 170(f)(8)(A). Code Sec. 170(f)(8)(D) provides that Code Sec. 170(f)(8)(A) "shall not apply to a contribution if the donee organization files a return, on such form and in accordance with such regulations as the Secretary may prescribe, which includes the information described in subparagraph (B) with respect to the contribution."

Regulations had not been issued under Code Sec. 170(f)(8)(D), but the donee organization had filed a Form 990 (*Return of Organization Exempt from Income Tax*), albeit an amended one, including the prescribed information, so the question before the Tax Court was whether Code Sec. 170(f)(8)(D) applied on its own to "turn off" the CWA requirement.

After dealing with certain preliminary matters, the Tax Court's majority opinion noted that "Most of our cases have dealt with delegations of mandatory rulemaking authority (mandatory delegations) where the statute is 'framed in terms of commanding the Secretary to prescribe regulations.' First Chicago Corp. v. Commissioner, 88 T.C. 663, 676 (1987), aff'd, 842 F.2d 180 [61 AFTR 2d 88-902] (7th Cir. 1988); Grewal, supra, at 47 ('The major cases deal largely with mandatory delegations, which the courts usually deem self-executing.')."

The Tax Court drew a sharp contrast of such mandatory delegations with "discretionary delegations," that "authorize the Secretary to issue regulations, without directing or mandating that he do so." The Tax Court noted that such discretionary delegations "appear in many verbal forms" and listed quite a few, including "to the extent provided in regulations" and "only to the extent provided in regulations" seemingly treating the two formulations as equivalent.

The Tax Court observed that *Alexander* appears to be the only case in which it has addressed the issue of whether a statute including a permissive delegation is self-executing. The Tax Court added that it has "consistently distinguished Alexander in subsequent opinions dealing with mandatory delegations."

Focusing its attention specifically on Code Sec. 170(f)(8)(D) (referring to "such form and such regulations as the Secretary may prescribe"), the Tax Court noted that "By its terms, the delegated rulemaking authority is permissive: It grants the Secretary permission to prescribe regulations governing this matter, but it does not mandate that he do so."[14]

As with *Alexander*, however, the Tax Court did not stop with the statute. Notwithstanding the attention bestowed on the distinction between statutory delegations that are phrased as mandatory versus those that are phrased as discretionary (or permissive), the Tax Court proceeded to address the legislative history of Code Sec. 170(f)(8)(D). "The legislative history shows that Congress, by phrasing this delegation of rulemaking authority in discretionary terms, intended that subparagraph (D) not be self-executing in the absence of regulations." The Tax Court then addressed, at some length, the statute's legislative history in support of this conclusion. Having found that Code Sec. 170(f)(8)(D) was not self-executing, the Tax Court denied the taxpayer's charitable contribution deduction.

Accordingly, just like *Alexander*, *15 West 17th Street LLC*, seems to leave open the possibility that even a statute with discretionary-delegation language may be self-executing if the legislative history suggests this is what Congress intended. One judge joined with the majority's opinion, but wrote separately to suggest that it may never be appropriate for the courts to issue "phantom regulations" in cases where an agency has ignored an invitation or command by Congress to write regulations. The concurring judge recognized that it was not necessary to revisit the issue to decide the case at hand and, moreover, acknowledged this would likely be a minority position. Accordingly, it seems prudent to consider the legislative history of Code Sec. 1291(f).

Legislative History

The pertinent legislative history from the original enactment of Code Sec. 1291(f) in 1986 says very little. The Committee Report provides as follows:

> The agreement also provides the Secretary the authority to disregard any nonrecognition provision of present law on disposition of PFIC stock.

The 1986 Bluebook (which may or may not qualify as legislative history) similarly provides as follows:

> The Act also provides the Secretary the authority to disregard any nonrecognition provision of present and prior law on dispositions of PFIC stock. For example, regulations may treat a gift of stock in a nonqualified fund to a non-taxpaying entity, such as a charity or a foreign person, as a disposition for purposes of those rules in order that the deferred tax and interest charge attributable to that stock not be eliminated.

To the extent that the 1986 Bluebook is considered reflective of Congressional intent, it suggests that Congress specifically had gifts to non-taxpayers (including foreign persons and charities) in mind, but it also states that regulations "may" treat such gifts as taxable dispositions, with no indication that Congress necessarily wanted or expected them to do so.

As noted above, however, Code Sec. 1291(f) was amended by TAMRA in 1988. The amendment did not change the statutory language at issue, but the accompanying Conference Report did add some color commentary on Congressional intent:

> First, in connection with the agreement's provision that gives regulatory authority to deny the benefits of nonrecognition treatment in the case of a transfer of stock in a passive foreign investment company (PFIC), *the conferees intend this regulatory authority to be exercised in cases where the deferred tax and interest inherent in the appreciation of PFIC stock are potentially avoidable*. For example, if *appreciated stock in a PFIC is given by a U.S. person to a foreign person*, the deferred tax and interest inherent in the appreciation of the stock would not be collected on the eventual disposition of the stock unless the gift is treated as a taxable sale at the time of the gift. On the other hand, the conferees do not intend this

regulatory authority to be exercised in cases where there is no potential to avoid the deferred tax and interest. For example, the conferees generally do not believe that an otherwise nontaxable reorganization of a PFIC should give rise to a recognition event where a US person exchanges stock in a PFIC for stock in another PFIC and no step-up in basis occurs.

In contrast with the legislative history from 1986, the 1988 Conference Report clearly states that Congress intended the regulatory authority granted under Code Sec. 1291(f) to be exercised. In particular, the 1988 Conference Report provides that Congress intended that Treasury exercise its regulatory authority to trigger built-in gains in cases where taxpayers could potentially avoid the application of the excess distribution regime, such as gifts of appreciated PFIC stock to foreign persons. The 1988 Conference Report also describes a class of dispositions of PFIC stock that Congress did *not* consider to have the potential for tax avoidance and thus did not expect to be taxed under Code Sec. 1291(f), *i.e.*, exchanges of PFIC stock for other PFIC stock in a reorganization, where the basis of the taxpayer's new PFIC stock is no greater than its basis in the old PFIC stock.

Based on the 1988 legislative history, and the absence of any bright-line rule in *Alexander* or *15 West 17th Street LLC*, a judge might well conclude that Code Sec. 1291(f) is self-executing, at least in certain circumstances, on the ground that this is what Congress wanted.

Even if Code Sec. 1291(f) is self-executing in some instances, its scope is still open for debate. For example, even if Code Sec. 1291(f) currently applies to gifts of appreciated PFIC stock to a nonresident alien family members—precisely the transaction described in the 1988 Conference Report—it may not apply to donations of appreciated PFIC stock to domestic charities.

Of course, charitable donations also present an opportunity for avoidance of the excess distribution regime, but a court might not deem this factor to be determinative. The 1988 Conference Report refers specifically to gifts to foreign persons and not charitable donations. The absence of any reference to charitable contributions may be a mere oversight,[15] but that is only one possibility. It is also possible that Congress thought the treatment of charitable contributions was a matter for Treasury to decide, *e.g.*, as a more lenient rule might be warranted in light of the policy of encouraging charitable giving.

If the courts determine that Code Sec. 1291(f) is indeed self-executing to some extent, it will be most interesting to see where they draw the line.

ENDNOTES

1 Code Sec. 1297(a). Except as otherwise indicated, all "section" and "Sec." references are to the Internal Revenue Code of 1986, as amended.

2 Code Sec. 1297(b).

3 Code Sec. 954(c).

4 Code Sec. 1297(d) does, however, supply an "overlap rule" pursuant to which a foreign corporation that is both a CFC and a PFIC is treated as a non-PFIC with respect to a U.S. shareholder if certain requirements are satisfied.

5 However, a U.S. person who directly or indirectly owns PFIC stock may choose to make certain elections under Code Sec. 1295 or Code Sec. 1296, each of which certain amounts to be included in income each year, if certain requirements are satisfied.

6 *See* Code Sec. 1291(b)(2)(A), regarding the portion of any distribution that may be "excess."

7 Code Sec. 1291(a)(1)(A) and (2).

8 Code Sec. 1291(a)(1)(C) and (c).

9 *See* Code Sec. 354(a)(1). Another possibility is that the non-PFIC stock received in the exchange could be treated as PFIC stock, in order to preserve the application of the PFIC rules, pursuant to Code Sec. 1291(e).

10 It seems prudent, even if a bit cynical, to assume that the IRS will reflexively presume Code Sec. 1291(f) to be self-executing. Notably, two old LTRs reflect this view without even a hint that anyone could think implementing regulations are needed. LTR 8946048 (Aug. 22, 1989) ("[U]nless otherwise provided in regulations under section 1291(f), a gift of appreciated stock of a PFIC will result in the donor's recognition of gain."); LTR 9007014 (Nov. 16, 1989) ("[P]ursuant to section 1291(f), gain generally is recognized to a shareholder on the transfer of stock of a PFIC to which section 1291 applies notwithstanding section 332 or 337 or any other applicable nonrecognition provision."). In fairness, the IRS may understandably worry about its ability to combat tax-avoidance if anti-abuse provisions that contemplate the issuance of heretofore unissued regulations are not self-executing. For example, Code Sec. 1298(a)(4) generally treats options to purchase PFIC stock as if they had been exercised—"To the extent provided in regulations." In considering its position under Code Sec. 1291(f), the IRS would need to carefully consider the implications for other provisions, including Code Sec. 1298(a)(4).

11 *C.F. Alexander*, 95 TC 467, Dec. 46,946 (1990).

12 H. Rept. 95-1445, at 71 (1978), 1978-3 CB 181, 245.

13 *15 West 17th Street LLC*, 147 TC 557 (2016).

14 The Tax Court also found the discretionary nature of the delegated authority to be "underscored by comparing the text of subparagraph (D) with the text of subparagraph (E)," which provides that the Secretary "shall prescribe regulations" specifying that "some or all of the requirements of this paragraph do not apply in appropriate cases."

15 This may seem less likely in light of the specific reference to such transactions in the 1986 Bluebook, which was available to the drafters of the 1988 Conference Report.