I.R.S. ISSUES REGULATIONS REGARDING P.F.I.C. REPORTING REQUIREMENTS

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On December 30, 2013, the I.R.S. released temporary and final regulations regarding P.F.I.C. reporting requirements. In T.D. 9650, the I.R.S. reaffirmed that it would not require any U.S. persons that owned any interest in a P.F.I.C. during 2010, 2011 or 2012 to file an information return on Form 8621 under the new rules *unless* they sold the stock, received a distribution or needed to make a P.F.I.C. election. However, Form 8621 will be required to be filed by any U.S. person that owned at any time during 2013 an interest in a P.F.I.C. Thus the form will filed with the 2013 income tax return that must be filed later this year.

The regulations adopted rules addressing constructive or indirect ownership. The constructive ownership or attribution rules can cause a person to become an owner of an interest in a P.F.I.C. even though no stock is *directly* owned in the P.F.I.C. As a result, ownership of P.F.I.C stock by a corporation, partnership, trust or estate can be attributed to the entity's shareholders, partners or beneficiaries, who then can become subject to the P.F.I.C. rules.

BACKGROUND

U.S. investors must determine if any foreign corporation owned may be classified as a P.F.I.C. A foreign corporation will be classified as a P.F.I.C. if either (i) 75% or more of the corporation's gross income is passive income (such as from interest, dividends or capital gains) or (ii) 50% or more of the corporation's assets are held for the production of passive income (such as stocks, bonds or cash). A typical P.F.I.C. is an offshore investment company or mutual fund although P.F.I.C. status can be a potential issue for any foreign corporation, especially if the corporation has large cash reserves or is in the services business outside the U.S.

P.F.I.C. status imposes a special tax and interest charge on any U.S. person that receives an excess distribution. An excess distribution is a current distribution that exceeds 125% of the average distributions over the prior three years. The excess distribution is deemed attributable to profits earned in an earlier year, as determined under a prescribed formula. In addition, gain on the sale of stock in a P.F.I.C. may be taxed at ordinary income rates and also be subject to an interest charge under the computations that apply to excess distributions.

U.S. tax exempt investors are generally not subject to this tax regime, although the tax reporting rules discussed below may be applicable. Also, if the foreign corporation is classified as a controlled foreign corporation ("C.F.C.") for U.S. tax purposes and the investor owns 10% or more of the corporation's voting stock, the investment would be subject to the C.F.C. rules and not the P.F.I.C. rules. The

C.F.C. rules are designed to discourage the retention of earnings at the level of the C.F.C. Instead of deferral of tax, the C.F.C. rules force a U.S. shareholder owning 10% or more of the voting stock to include in a U.S. tax return the earnings generated from Subpart F Income, typically Foreign Base Company Sales Income and Foreign Personal Holding Company Income. The goal is to tax the income on a current basis, as if it were received directly by the U.S. shareholder.

If P.F.I.C. status applies to a foreign corporation, a U.S. investor may be able to make a qualified electing fund ("Q.E.F.") election under Code §1293 to eliminate application of these P.F.I.C. rules. In their place, the U.S. investor is taxable on a current basis with respect to an allocable share of the P.F.I.C.'s income and gains even if no dividend is received. The ability to make a Q.E.F. election is dependent upon the cooperation of the foreign corporation, which undertakes to provide the investor on a timely basis sufficient information needed to determine the investor's share of the corporation's income and gain. Many foreign corporations refuse to undertake this obligation because of the added expense of compliance with U.S. tax accounting rules.

Alternatively, if the P.F.I.C. stock is marketable stock (*e.g.*, it is traded on a stock exchange), the U.S. investor can make an election under Code §1296 to be subject to a mark-to-market ("M.T.M.") regime with respect to the stock. The M.T.M. regime requires the investor to recognize as ordinary income each year's appreciation in the value of the marketable shares of the Q.E.F. If the value of the shares declines, the shareholder recognizes a loss, but the loss cannot be recognized if it exceeds previously recognized gain.

In 1992, the I.R.S. published proposed regulations providing guidance on, *inter alia*, P.F.I.C. ownership and the taxation of its shareholders.

In 2010, Congress enacted the Hiring Incentives to Restore Employment ("H.I.R.E. Act"). The H.I.R.E. Act has received a lot of attention for enactment of F.A.T.C.A. F.A.T.C.A. focused on U.S. persons investing in offshore accounts who were not paying tax on offshore income. If requires F.F.I.s to advise the I.R.S. of their U.S. investors or risk imposition of a new 30% withholding tax that will become effective on July 1, 2014. However, the H.I.R.E. Act also focused on other offshore investments and specifically added Code §1298(f) It requires any U.S. person who is a shareholder of a P.F.I.C. to file an annual statement with the I.R.S.

Prior to enactment of the H.I.R.E. Act, U.S. persons that owned an interest in a P.F.I.C. only were required to file Form 8621 if they (i) recognized gain on a direct or indirect disposition of P.F.I.C. stock; (ii) received direct or indirect distributions from a P.F.I.C.; or (iii) were making an election on the form. Form 8621 must also be filed to report liability under any Q.E.F. or M.T.M. election. Form 8621 is attached to the investor's income tax return for the year in which the P.F.I.C. interest is held.

In Notice 2010-34, the I.R.S. stated that P.F.I.C. shareholders not otherwise required to file Form 8621 prior to March 18, 2010, will not be required to file an annual report as a result of the addition of Code §1298(f) for taxable years beginning before March 18, 2010.

Subsequently, in Notice 2011-55, the I.R.S. announced that it would issue regulations under Code §1298(f) and release a revised Form 8621. Additionally, the notice suspended the Code §1298(f) reporting requirements under the new expansive reporting regime until the release of the revised Form 8621 for P.F.I.C. shareholders. U.S. persons who were not otherwise required to make a filing prior to the H.I.R.E. Act did not have to make any filing for their 2010, 2011, and later years until further guidance is issued by the I.R.S.

In December 2011, the I.R.S. published the revised Form 8621 with instructions that indicated the suspension of Code §1298(f) reporting requirements pending the publication of a subsequent revised form.

THE REGULATIONS

On December 30, 2013, the I.R.S. released new temporary and final regulations regarding P.F.I.C. constructive ownership and reporting requirements. The new regulations generally adopt the rules under the proposed regulations, subject to certain modifications or clarifications. In particular:

- Constructive Ownership (or Attribution) Rules: The temporary regulations largely adopt the attribution rules of indirect ownership in the 1992 proposed regulations.
    - Ownership through foreign C Corporations: In the case of a foreign C Corporation, that is not itself a P.F.I.C., ownership of a P.F.I.C. subsidiary is attributed back to an indirect U.S. shareholder if the person owns directly or indirectly 50% or more in value of the stock of that foreign C-corporation.
    - Partnerships and S Corporations: In the case of a partnership, or S Corporation, the partner or shareholder is treated as owning its proportionate share of the stock owned by the respective entity. However, the regulations clarify that the attribution rules apply to both domestic and foreign partnerships.
    - Trusts and Estates: In the case of a trust or estate, a beneficiary of the trust or estate is treated as owning a proportionate share of the stock owned by the trust or estate. The regulations clarify that the rules apply to both a domestic and foreign trust or estate. However, if the trust is a grantor trust, the grantor is treated as owning the stock owned by the trust.
        - The regulations further state that, until further guidance is provided on estate and trust attribution rules, beneficiaries of estates and nongrantor trusts that hold P.F.I.C. stock should use a reasonable method to determine their ownership interests in a P.F.I.C. held by the estate or nongrantor trust. Moreover, beneficiaries of estates and nongrantor trusts that are subject to these rules of attribution are exempt from the filing requirements for taxable years in which the beneficiary is not treated as receiving an excess distribution or as recognizing gain with respect to the stock of the P.F.I.C. Finally, the regulations also state that the estate or trust, or the beneficiary, must take excess distributions into account in a reasonable manner. It is unreasonable for the shareholders to take the

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position that neither the beneficiaries nor the estate or trust are subject to the tax and interest charge rules under §1291.

- Reporting: The regulations eliminate the need to file Form 8621 pursuant to the H.I.R.E. Act for any investment held in 2010, 2011, and 2012 unless the stock was sold, a distribution was made to the shareholder or a Q.E.F. or M.T.M. election was made. The first Form 8621 that will be filed under these new rules will relate to 2013. The Form 8621 must be attached to the Federal income tax return filed for 2013, due later this year. A partnership that owns stock in a P.F.I.C. must also file Form 8621 and attach it to the information return filed with the I.R.S.

    - Dealing with Chains of Ownership: The temporary regulations generally require the U.S. person that is at the lowest tier in a chain of ownership, and that is a shareholder (including an indirect shareholder) of a P.F.I.C., to file an annual report on Form 8621. In addition, a U.S. person that owns P.F.I.C. stock through another U.S. person also is required to file an annual report in certain circumstances. One such circumstance involves a U.S. citizen who owns an interest in a domestic partnership, which in turn, owns an interest in a P.F.I.C. The domestic partnership must file an annual report because the domestic partnership is the U.S. person that is at the lowest tier in the chain of ownership. In addition, the U.S. citizen is required to file an annual report when such person is treated as receiving an excess distribution or as recognizing gain that is treated as an excess distribution with respect to the P.F.I.C.

    - Avoiding Duplicative Reporting: In order to eliminate duplicative reporting, the regulations provide an exception applicable to a U.S. person that is required to include an amount in income only under the Q.E.F. or M.T.M. rules because of an ownership interest in another U.S. person. The indirect owner is not required to file Form 8621 if the direct shareholder timely files Form 8621 with respect to the P.F.I.C. This exception does not apply, however, if the U.S. person made a Q.E.F. election with respect to the P.F.I.C. and then transferred the shares of the P.F.I.C. to a domestic partnership or S corporation that did not itself make a Q.E.F. election with respect to the P.F.I.C.

    - Exceptions to Reporting: Certain exceptions were added:

        - Tax-exempt organization: A U.S. shareholder is not subject to Form 8621 filing requirements if the shareholder is a tax-exempt organization under Code §501 (*e.g.*, tax exempt hospital or qualified retirement plan) unless the income derived from the P.F.I.C. would be taxable to the tax-exempt organization as unrelated business taxable income.

        - De Minimis Ownership: A U.S. shareholder is also excepted from the filing requirements if the shareholder is not subject to tax under the P.F.I.C. rules (*e.g.*, the shareholder has not sold their stock, got a distribution from the P.F.I.C. or made a Q.E.F. or M.T.M. election) and either

(i) the value of *all* P.F.I.C. stock owned directly or indirectly by that person is $25,000 or less ($50,000 for joint returns) or (ii) the P.F.I.C. stock is owned by a shareholder indirectly through another P.F.I.C. and the value of the indirectly owned P.F.I.C. stock does not exceed $5,000. The shareholder can rely on annual statements issued by the P.F.I.C to determine the value of their stockholdings unless the shareholder has actual knowledge or reason to know that the value shown does not reflect the actual fair market value of the P.F.I.C. stock.

- Foreign Grantor Trust: A U.S. person that is treated as the owner of any portion of a foreign grantor trust that is a foreign pension fund operated principally to provide pension or retirement benefits is not required to file if, pursuant to an income tax convention to which the United States is a party, income earned by the pension fund is taxed as income of the U.S. person only when and to the extent it is paid to, or for the benefit of, the U.S. person.