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Final Regulations Released Regarding PFIC Ownership Determination and Annual Reporting Requirements

January 20, 2017

On December 27, 2016, the Treasury Department (Treasury) and Internal Revenue Service (IRS) released final regulations regarding the determination of ownership of a passive foreign investment company ("PFIC") and regarding certain exceptions to the annual PFIC reporting requirements (the "PFIC Regulations"). The PFIC Regulations adopt, with certain changes, proposed regulations published on December 31, 2013 (also released as temporary regulations), implement certain guidance initially set forth in Notice 2014-28 and Notice 2014-51 and remove the corresponding temporary regulations.

Determination of Ownership of a PFIC

The PFIC Regulations revise rules initially set forth in proposed regulations released in 1992 (withdrawn and reissued as the 2013 temporary regulations) regarding when a U.S. person who directly or indirectly owns 50 percent or more in value of the stock of a foreign corporation that is not a PFIC is considered to own a proportionate amount (by value) of any PFIC stock owned directly or indirectly by that foreign corporation. In general, a U.S. person that owns directly or indirectly 50 percent or more in value of the stock of a foreign corporation that is not a PFIC is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by the non-PFIC foreign corporation (the "50 percent rule"). Treasury was concerned that this rule might be manipulated by a U.S. person using a domestic C corporation to hold part of the U.S. person's interest in the non-PFIC foreign corporation in order to reduce the ownership of the U.S. person in the non-PFIC foreign corporation below 50 percent, thereby avoiding the look-through rule. The PFIC Regulations accordingly provide that, for purposes of the 50 percent rule, a person who owns 50 percent or more in value of a domestic C corporation is considered to own a proportionate amount (by value) of any stock owned directly or indirectly by that corporation.

In order to avoid the possibility that this aspect of the 50 percent rule could result in overlapping ownership by two or more U.S. persons in the same PFIC stock, the PFIC Regulations also have a "non-duplication rule," under which PFIC stock held through a domestic C corporation will not be attributed to the U.S. person holding stock in the domestic C corporation if such PFIC stock is directly or indirectly held by another U.S. person (i.e., the domestic C corporation).

The PFIC Regulations also clarify that, under the indirect ownership rules, the stock of a PFIC owned by an S corporation is treated as not owned by the S corporation (except for reporting purposes) but is treated as owned proportionately by its shareholders.

In addition, the PFIC Regulations implement the guidance set forth in Notice 2014-28, providing that U.S. persons holding PFIC stock through certain tax-exempt organizations or accounts (including certain deferred compensation accounts or individual retirement accounts ("IRAs")) are not treated as PFIC shareholders with respect to that stock, consistent with the principle of deferred taxation provided by the IRAs.

PFIC Reporting Requirements

The PFIC Regulations provide certain exceptions to the general rule that a U.S. person holding PFIC stock must file an annual report (Form 8621, "Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund") with the IRS, regardless of whether such U.S. person has received a distribution from, disposed of an interest in, or made an election in respect of such PFIC.[1] Under the PFIC Regulations, the following categories of U.S. persons are not required to file annual reports with respect to their ownership of PFIC stock:

- Certain U.S. persons that own PFIC stock that is marked to market under a mark-to-market provision other than the one provided under the PFIC rules in Section 1296;[2]
- Tax-exempt entities or accounts unless the income derived with respect to the PFIC would be taxable;
- Domestic partnerships wholly owned by a combination of foreign persons (that have no U.S. person treated as indirectly owning the stock of the PFIC) and tax-exempt entities or accounts (or by other domestic partnerships wholly owned by such foreign persons, tax-exempt entities or accounts);

U.S. persons who are beneficiaries of non-U.S. pension funds holding PFIC stock where, pursuant to a U.S. income tax treaty, the income of such pension fund may be taxed to the U.S. person only when and to the extent the income is paid to, or for the benefit of, the U.S. person, even if such non-U.S. pension funds are not treated as "foreign trusts" under Section 7701(a)(31)(B) (which classification had been a requirement to qualify for the exclusion under the prior temporary regulations);

- Non-resident alien taxpayers with respect to the U.S., as determined under U.S. income tax treaty "tie-breaker" rules, who are otherwise resident aliens under the Code for reporting purposes (so-called "dual resident" taxpayers);[3]
- Certain shareholders with respect to PFICs that were owned for a short period of time (30 days or less) during which no PFIC taxation was imposed on the shareholders (because there were no excess distributions or amounts realized and treated as excess distributions);[4] and
- Certain bona fide residents of U.S. territories (namely the U.S. Virgin Islands, Guam and the Northern Mariana Islands, but not Puerto Rico or American Samoa) who do not have a U.S. income tax obligation and are not otherwise required to file a U.S. income tax return.

Certain Other Aspects of the PFIC Regulations

The PFIC Regulations retain the reporting exception thresholds set forth in the temporary regulations (i.e., $25,000 or less in aggregate PFIC holdings (or $50,000 in the case of filing a joint return), or for indirect ownership where the value of the indirectly owned stock is $5,000 or less). The PFIC Regulations also do not permit consolidated PFIC reporting (i.e., reporting with respect to multiple PFICs held by the same U.S. person on one form). Both of these points were raised in comments to the temporary regulations. As the current instructions to Form 8621 permit a PFIC shareholder to provide information on additional PFICs it holds on an attachment to the initial Form 8621, it is unclear whether the explicit refusal to allow consolidated PFIC reporting that Treasury set forth in the preamble to the PFIC Regulations will result in a change to that aspect of the instructions.

In addition, the PFIC Regulations clarify how a U.S. person should file a Form 8621 when such U.S. person is not otherwise required to file a U.S. income tax return (or information return, if applicable), and adopt the temporary regulations with respect to the removal of the requirement under Sections 6038 and 6046 that certain U.S. persons file Form 5471 ("Information Return of U.S. Persons With Respect to Certain Foreign Corporations") in circumstances where the U.S. person qualifies for the constructive ownership exception.

Conclusion

The PFIC Regulations provide some additional clarity regarding the application of the indirect ownership rules and also provide welcome exceptions to the generally applicable annual reporting requirements.

The PFIC Regulations generally are effective for tax years ending on or after December 31, 2013, the date that the temporary regulations were published.

[1] This general rule is set forth in Section 1298(f). All Section references herein are to the U.S. Internal Revenue Code of 1986, as amended (the "Code").

[2] This exclusion was previously included in Notice 2014-51.

[3] Previously, a dual resident taxpayer, as a non-resident alien, would not be subject to U.S. tax under the PFIC rules, but as a resident alien under the Code would still have been subject to the filing requirement.

[4] This reporting exception is intended to address situations where a U.S. shareholder owns shares of an upper-tier PFIC that acquires a lower-tier PFIC which is liquidated into the upper-tier PFIC a few days after acquisition.

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