6. Treatment of certain passive foreign investment companies (sec. 1235 of the Act and secs. 532, 542, 551, 851, 904, 951, 1246, and 6503 and new secs. 1291, 1293, 1294, 1295, 1296, and 1297 of the Code)[22]

Prior Law

U.S. taxation of foreign persons

Although U.S. corporations are subject to current U.S. taxation on worldwide income, foreign corporations generally are subject to U.S. taxation only on their U.S. source income and income from a U.S. business. Foreign corporations generally are exempt from U.S. taxation on foreign source income.

Taxation of U.S. shareholders of foreign corporations

The United States generally imposes tax on a U.S. shareholder of a foreign corporation only when the shareholder receives the foreign corporation's earnings in the form of a dividend. That is, a U.S. shareholder of a foreign corporation generally defers tax on that income until receipt of dividends.

The subpart F provisions of the Code provide an exception to this general rule of deferral. Under these provisions, income from certain "tax haven" or other activities conducted by corporations controlled by U.S. shareholders is taxed currently to the corporation's U.S. shareholders without regard to whether they actually receive the income currently in the form of a dividend. However, the subpart F rules applied under prior law only if more than 50 percent of the voting power in the foreign corporation was owned by U.S. persons each of whom owned (directly or indirectly) at least a 10-percent interest in the corporation. Moreover, even if ownership is so concentrated that the subpart F rules apply, the rules only apply to those U.S. persons who are considered to own (directly or by attribution) 10 percent or more of the voting power in the foreign corporation. Thus, a less than 10-percent shareholder in a controlled foreign corporation can avoid current recognition of income under these provisions.

Two other similar sets of rules, the personal holding company rules and the foreign personal holding company rules, also subjected foreign corporations or their U.S. shareholders to either a penalty tax or current taxation on passive investment income or futures trading income, but these rules applied only if five or fewer individuals owned (directly or indirectly) more than 50 percent in value of the stock of a foreign corporation. Thus, these provisions could be avoided by dividing ownership evenly between U.S. and foreign individuals (in the case of the foreign personal holding company rules) or by dispersing majority ownership among more than five individuals (in the case of either set of rules).

---

[22] For legislative background of the provision, see: H.R. 3838, as reported by the House Committee on Ways and Means on December 7, 1985, sec. 625; H.Rep. 99-426, pp. 406-412. H.R. 3838, as reported by the Senate Committee on Finance on May 29, 1986, sec. 925; S. Rep. 99-313, pp. 392-399; and H.Rep. 99-841, Vol. II (September 18, 1986), pp. 640-645 (Conference Report).

Shareholder level tax on disposition

Code rules attempt to prevent U.S. shareholders of foreign corporations from repatriating earnings of those corporations at prior law's lower capital gains rates after deferring tax on those earnings. For example, gains derived by a U.S. person who is a 10-percent shareholder (at any time during a five-year period) in a controlled foreign corporation (as defined in the subpart F rules) on the disposition of that corporation's stock generally are subject to ordinary income (dividend) treatment rather than capital gains treatment to the extent of that person's share of the post-1962 earnings and profits of the controlled foreign corporation (Code sec. 1248). These rules allow, however, a corporate shareholder to claim an indirect foreign tax credit for its share of the foreign income taxes paid on those earnings by the controlled foreign corporation that are treated as a dividend to the shareholder.

However, section 1248's scope is limited. Wide dispersal of a foreign corporation's stock ownership can avoid controlled foreign corporation status. Even if the foreign corporation is controlled by U.S. shareholders, a less than 10-percent shareholder may dispose of his investment and potentially receive capital gain treatment for the increase in value of his investment.

Another provision, the foreign investment company provision (sec. 1246), was enacted in 1962 along with the subpart F rules to prevent U.S. investors from receiving capital gains treatment on disposition of their stock when U.S. ownership in the foreign corporation was widely dispersed but total U.S. ownership exceeded 50 percent and the foreign corporation primarily invested in securities. As amended, the provision generally applies under present and prior law to any foreign corporation that is either (1) registered under the Investment Company Act of 1940 either as a management company or as a unit investment trust or (2) owned at least 50 percent by U.S. persons and engaged primarily in the business of investing or trading in securities (as defined in section 2(a)(36) of the Investment Company Act of 1940) or commodities or interests therein. In the latter case, a foreign investment company is considered to be 50 percent owned under this provision if 50 percent or more of its stock (by value or by voting power) is held (directly or indirectly) by U.S. persons. When a U.S. person disposes of stock in a foreign investment company, the person is subject to ordinary income treatment to the extent of his share of the foreign investment company's post-1962 accumulated earnings and profits, but not to exceed the person's gain on the disposition.

Under prior law, it was unclear whether sections 1248 and 1246 could have applied to the same factual situation. For example, if a controlled foreign corporation had a 10-percent owner and the corporation was in the business of investing in securities, both provisions potentially applied in the event the 10-percent owner disposed of his or her stock. Under prior law, since an inclusion under section 1248 brought with it a deemed-paid credit for taxes paid by a foreign corporation but a section 1246 inclusion did not, the deemed-paid foreign tax credit was not available in such circumstances if section 1246 took priority.

Reasons for Change

Congress did not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. Since current taxation generally is required for passive investments in the United States, Congress did not believe that U.S. persons who invest in passive assets should avoid the economic equivalent of current taxation merely because they invest in those assets indirectly through a foreign corporation. Congress further believed that the nationality of the owners of controlling interests of a corporation which invests in passive assets should not determine the U.S. tax treatment of its U.S. owners. In Congress' view, the absence of U.S. control did not necessitate preferential U.S. tax treatment to U.S. persons who invest in passive assets through a foreign corporation. Moreover, Congress recognized that U.S. persons who invested in passive assets through a foreign corporation obtained a substantial tax advantage vis-a-vis U.S. investors in domestic investment companies because they not only were able to avoid current taxation but also were able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income.

Although Congress believed current taxation was more appropriate than continuation of deferral of tax on income derived from passive assets, Congress recognized that current taxation of U.S. investors in passive foreign investment companies could create difficulties for certain investors in cases where the U.S. investors did not have the ability to obtain relevant information relating to their share of the funds' earnings and profits, did not have enough control to compel dividend distributions, or did not have sufficient liquidity to meet a current tax liability before actual income was realized from their investment. For these reasons, Congress considered it appropriate to adopt two taxing mechanisms. One provides for current taxation on the U.S. owners' shares of all of the company's actual income, subject to an election to defer payment of tax on that income until a distribution from the company or a disposition of the stock, with an appropriate interest charge. The other allows U.S. investors both to compute their income from the passive investment based upon certain reasonable assumptions and to delay payment of their tax liability until they actually realize cash from their investment through distributions or dispositions, provided that any such delayed tax payment is subject to an interest charge. In this regard, Congress intended that if current taxation were not required in all cases, then at least the economic equivalent of current taxation would be approached in all cases.

In those cases where Congress recognized that it would be difficult for U.S. investors who invest in foreign corporations to obtain sufficient information with which currently to compute their correct tax liability, Congress believed that attributing income over the holding period of the investment, together with the imposition of an interest charge, would eliminate the economic benefit of deferral without imposing an administrative burden on those U.S. investors and on the Internal Revenue Service. Congress also believed that using the highest statutory rate of tax for an investor

in computing the deferred tax amount is appropriate because of the low top rates the Act provides.

Under prior law, a U.S. investor may never have been fully taxed on his or her share of a foreign investment company's accumulated earnings. Congress noted that if similar income were generated by a domestic investment company or was otherwise currently subject to U.S. tax, the U.S. investor would have been taxed on the full amount of the income. In Congress' view, if current taxation of a passive foreign investment company's actual income is required, U.S. investors should be taxed on their entire share of the company's earnings, regardless of whether the earnings are distributed. Similarly, in those cases where current taxation of a passive foreign investment company's actual income is required, Congress believed that it is appropriate to allow U.S. investors to receive flow-through treatment for their share of the company's capital gain income if the Internal Revenue Service has adequate access to the company's books and records.

Because the Act's provisions approximate the economic equivalent of current taxation, Congress did not believe that a passive foreign investment company should be subject to two penalty provisions contained in the Code: the accumulated earnings tax provision and the personal holding company tax provision. Congress believed that those penalty provisions generally were designed to prevent either the conversion of income from dividend income to capital gain income or the deferral of income or both, and that the Act reduces these concerns for corporations that are subject to the Act's new rules.

Explanation of Provision

Overview

The Act defines passive foreign investment companies (PFICs) and establishes a set of rules for each of two types of PFICs. One set of rules applies to PFICs that are "qualified electing funds", where the Act requires each U.S. shareholder to include currently in gross income his or her share of a PFIC's total earnings, with an election to defer payment of tax, subject to an interest charge, on income not currently received. The second set of rules applies to PFICs that are not qualified electing funds ("nonqualified funds"), whose U.S. shareholders are required to pay tax on income realized from a PFIC and to pay an interest charge which is attributable to the value of deferral.

Definition of passive foreign investment company

General definition

A passive foreign investment company (PFIC) is defined by the Act to mean any foreign corporation if 75 percent or more of its gross income for the taxable year consists of passive income, or any foreign corporation if 50 percent or more of the average value of its assets consists of assets that produce, or are held for the production of, passive income. For example, corporate stock generally is intended to be a passive asset for this purpose. Passive income generally is defined for these purposes to mean income that is includible

in the new passive income separate foreign tax credit limitation provided in section 1201 of the Act (new Code sec. 904(d)(2)(A)), without regard to the exceptions contained therein (i.e., without regard to the exceptions to passive income for income included in other separate foreign tax credit limitations, export financing interest, high-taxed income, and foreign oil and gas extraction income). Thus, passive income generally includes dividends, interest and its equivalents, passive rents and royalties, annuities, gains from the disposition of stocks and securities and certain other assets, certain gains from commodity trading, and certain foreign currency exchange gains.

The Act excludes from the definition of a PFIC any foreign investment company described in Code section 1247 (i.e., foreign investment companies that made an election before 1963 to distribute their income currently).

Exceptions to passive income

Except as provided in regulations, passive income for this purpose does not include income derived by bona fide banks and insurance companies. Any foreign bank licensed to conduct a banking business under the laws of the United States or of any State generally is considered a bona fide bank for this purpose. Income of a bona fide insurance company that is not treated as passive income is that income which would be subject to taxation under subchapter L if the income were derived by a domestic insurance company. Congress believed that bona fide underwriters of securities would be excluded from classification as PFICs both under the asset test (because the majority of their assets, particularly securities held for sale to the public, are assets that do not give rise to subpart F FPHC income by virtue of the dealer exception in sec. 954(c)) and under the income test (because a substantial amount of their income is commission income, which is not subpart F FPHC income). The Act provides regulatory authority to expand the exception to passive income for income derived by a foreign bank licensed to do business in the United States to any other foreign corporation engaged in the active conduct of a banking business, as well.

As indicated, the Act provides regulatory authority to restrict the exception for income derived by bona fide banks and insurance companies where it is necessary to prevent U.S. persons from earning what is essentially investment income in a tax deferred entity. For example, Congress contemplated that regulations will be prescribed to provide circumstances where income derived by a bank licensed to do business in the United States is not automatically excluded from passive income. Further, it was intended that entities engaged in the business of providing insurance may derive passive income and, thus, qualify as PFICs in the event the entities maintain financial reserves in excess of the reasonable needs of their insurance business. Additionally, a foreign corporation established to acquire insurance coverage on behalf of related persons (a captive insurance company) may qualify as a PFIC in the event there is no shifting of risk to the foreign entity. In these captive arrangements, since there is no shifting of risk, the company is not an insurance company. The investment income generated by this cap-

tive-type company from its capital will be treated as passive income, thereby possibly subjecting the company to PFIC status. It is intended that income derived by foreign banks and other financial or insurance businesses that operate as incorporated investment vehicles on behalf of shareholders or other related parties be treated as passive income for purposes of these rules.

Exception for active businesses

Congress did not intend that foreign corporations that own subsidiaries primarily engaged in active business operations be treated as PFICs. To this end, the Act provides look-through treatment to classify these corporations. In determining whether a corporate shareholder is a PFIC, the Act attributes a proportionate part of a subsidiary's assets and income to the corporate shareholder. Under this look-through rule, amounts such as interest and dividends received from foreign or domestic subsidiaries are to be eliminated from the recipient's income in applying the Act's income test and the shareholder's stock investment is to be eliminated from its assets in applying the Act's asset test. For example, a foreign holding company that receives dividends or interest from a subsidiary is not treated as receiving passive income unless the subsidiary derives passive income. A corporation is a "subsidiary" of an upper-tier corporation for these purposes if at least 25 percent of the value of the corporation's stock is owned by the upper-tier corporation. It was intended that attribution be made to lower-tier corporations where 25 percent direct or indirect ownership is held and not only to a first-tier corporation.[23]

The Act further excludes from the definition of a PFIC a foreign corporation that receives passive income in its first year of operation but which engages in an active business following the start-up year, and a foreign corporation that would be a PFIC in the year following the cessation of an active business but which becomes active again in the year following the year in which it otherwise would be classified as a PFIC. The start-up exception provides that a foreign corporation is not considered a PFIC for the first year the corporation receives gross income if (1) no predecessor of the corporation was a PFIC; (2) the corporation satisfies the Secretary that it will not be a PFIC for either of the first two taxable years following the start-up year; and (3) the corporation is not in fact a PFIC for either of these years. The exception for existing corporations that change their active businesses provides that a corporation is not treated as a PFIC if (1) it (and all predecessors) was not a PFIC for any prior taxable year, (2) it establishes to the Secretary's satisfaction that substantially all of its passive income is attributable to proceeds from the disposition of one or more active businesses and it will not be a PFIC in any of the two taxable years after the current year, and (3) it is, in fact, not a PFIC for either of the two taxable years after the current taxable year.

[23] A technical correction may be needed so that the statute reflects this intent.

General rule—nonqualified funds

General rule

The Act requires that U.S. shareholders in PFICs that are not "qualified electing funds" (defined below) pay U.S. tax and an interest charge based on the value of tax deferral at the time the shareholder disposes of stock in the PFIC or on receipt of an "excess" distribution (new Code sec. 1291). Under this rule, gain recognized on disposition of stock in a PFIC or on receipt of an "excess" distribution from a PFIC is considered to be earned pro rata over the shareholder's holding period of his or her investment. The U.S. tax due in the year of disposition (or in the year of receipt of an "excess" distribution) is the sum of (1) U.S. tax computed using the highest statutory rate of tax for the investor (without regard to other income or expenses the investor may have in those years) on the income attributed to the years of his holding period (other than the current year and other than years before the foreign corporation was a PFIC), plus (2) interest computed (using the rates and methods provided in sec. 6621) from the due date of the returns (without regard to extensions) for the years to which income is attributed to the due date of the return (without regard to extensions) for the year of disposition (or year of receipt) imposed on the deferred tax, plus (3) U.S. tax on the income attributed to the year of disposition (or year of receipt) and to the years in which the foreign corporation was not a PFIC that precede the year of disposition (for which no interest is due). This rule provides that all gain recognized on the disposition of PFIC stock and all excess distributions must be treated as ordinary income. The portions of distributions that are not characterized as "excess" distributions are, of course, subject to tax in the current year under general Code rules.

The Act provides that distributions from nonqualified funds are not eligible for a deemed paid foreign tax credit under section 902. For purposes of claiming any withholding tax as a foreign tax credit, however, the total amount of the distribution, including any "excess" distribution amount, is included in gross income in the year of receipt. In claiming a foreign tax credit in the year of receipt of an excess distribution, the amount of any withholding tax may be applied against, for example, the total amount of deferred tax and interest computed on the excess distribution and the amount of tax computed on the distribution that is attributed to the current year and any pre-PFIC years.

Definition of excess distribution

The Act defines an "excess" distribution as any current year distribution in respect of a share of stock that exceeds 125 percent of the average amount of distributions in respect of the share of stock received during the three preceding years (or, if shorter, the total number of years of the taxpayer's holding period prior to the current taxable year).

The determination of an excess distribution can be illustrated in the following example: assume an investor acquires 1000 shares of stock in a PFIC on January 1, 1987, and 1000 shares of stock in the PFIC on January 1, 1988. The PFIC uses a calendar year as its tax-

able year. Further assume that on December 31, 1987, the investor receives a distribution of $500; on December 31, 1988, the investor receives $1000, and on December 31, 1989, and December 31, 1990, the investor receives $1000. Finally, assume that on April 1, 1991, the investor receives $1,500 and on October 1, 1991, the investor receives $500. Under the Act, none of the distributions received prior to 1991 are excess distributions since the amount of each distribution with respect to a share of stock is 50 cents. With respect to the distributions received during 1991, however, the total distribution with respect to each share of stock is $1 such that the total excess distribution with respect to each share of stock is 37.5 cents ($1 minus (1.25 times 50 cents)).

Accordingly, the total excess distribution for the PFIC taxable year ended December 31, 1991 is $750 (37.5 cents per share times 2,000 shares). This excess distribution must be allocated ratably between the two distributions during the PFIC's taxable year. Thus, $562.50 (75 percent of the excess distribution) is allocated to the April 1, 1991 distribution and $187.50 is allocated to the October 1, 1991 distribution. These amounts are then ratably allocated to each block of stock outstanding on the relevant distribution date. For the distribution on April 1, 1991, $281.25 of the excess distribution is allocated to the block of stock acquired on January 1, 1987 and $281.25 is allocated to the block of stock acquired on January 1, 1988. The $187.50 excess distribution on October 1, 1991 is also divided evenly between the two blocks of stock outstanding on the date of the distribution. The excess distribution is finally allocated over the relevant holding period of each block of stock as provided in section 1291(a)(1).

The Act provides that regulations are to be prescribed making proper adjustments for stock splits and stock dividends, determining the amount of excess distributions in cases where investments are acquired or disposed of at varying times in a taxable year, determining the excess distribution amount when distributions are received in currencies other than the U.S. dollar, and aggregating stock ownership for shares with the same holding period.

Anti-avoidance rules

The Act generally incorporates the anti-avoidance rules in present and prior law section 1246 (relating to foreign investment companies) and applies these rules to U.S. persons who hold stock in nonqualified funds. These rules (1) require stock with a substituted basis to inherit the attributes of PFIC stock, (2) require stock held in certain entities which are not PFICs but which own PFIC stock to be treated as PFIC stock, (3) deny a basis step-up for PFIC stock acquired from a decedent (other than from a foreign decedent), and (4) require 5 percent owners of PFICs to report certain information required by the Secretary.

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.

Qualified electing funds

General rule

For any U.S. investor whose PFIC agrees to supply appropriate information to the IRS, the Act provides a current taxation system: every U.S. person who owns stock in a "qualified electing fund" must include currently in gross income his or her pro rata share of the PFIC's total earnings and profits. This inclusion rule requires current payment of tax, absent a shareholder-level election to defer tax (as described below). Amounts currently included in income are added to an investor's stock basis, and amounts distributed that have previously been included in income decrease an investor's stock basis. The Act provides that if an investor provides to the Secretary's satisfaction that amounts distributed have been previously included in his or her income, then these amounts may be treated as nontaxable distributions. The amount currently included in income is divided between an investor's pro rata share of the ordinary income of a PFIC and net capital gain income of a PFIC. The characterization of income and the determination of earnings and profits are intended to be made pursuant to general Code rules. The Act provides that U.S. corporate shareholders which own 10 percent of a PFIC are able to claim an indirect foreign tax credit for their share of the foreign income taxes paid by the PFIC.

Election to defer current payment of tax

The Act provides that U.S. investors in qualified electing funds may, subject to the payment of interest, elect to defer payment of U.S. tax. This election is available only for the U.S. tax attributable to the amounts currently included in income but for which no current distributions are received. An election to defer tax is not available, however, if any amounts are required to be currently included in income under the foreign personal holding company (FPHC) rules (sec. 551) or the subpart F rules (sec. 951). An election to defer tax is treated as an extension of time to pay tax for which a U.S. shareholder is liable for interest.

Under the Act, certain events cause an extension of time to pay tax on undistributed earnings to terminate. First, any distribution from a PFIC that includes earnings for which an extension to pay tax was made terminates that extension. Second, any disposition of stock in a PFIC terminates all previous extensions of time to pay tax with respect to the earnings attributable to that stock. Further, all extensions of time to pay tax on earnings attributable to all stock held in a PFIC terminate if the PFIC ceases to be a qualified electing fund, or if the corporation ceases to be a PFIC. Any event which terminates an extension causes the deferred tax and interest to be payable on the due date of the investor's tax return (without regard to extensions) for the year in which the termination occurs. A shareholder may, of course, pay any deferred tax and interest prior to a distribution or disposition. Disposition for this purpose is intended to mean any transfer of ownership, regardless of whether the transfer constitutes a realization or recognition event under general Code rules. For example, a transfer at death or by gift of stock of a qualified electing fund is to be treated as a disposition for these purposes.

Definition of qualified electing fund

The Act defines a "qualified electing fund" as any PFIC which properly elects with the Secretary and which complies with the requirements the Secretary prescribes to determine the ordinary income of the fund and its capital gain income, to ascertain its stock ownership, and to ascertain any other information necessary to carry out the purposes of these rules. It is anticipated that the Internal Revenue Service will require the reporting of information similar to that required of domestic investment companies, such as U.S. investors' pro rata shares of a fund's ordinary income and capital gain income, based on U.S. tax principles. It is also anticipated this information reporting will be limited to U.S. investors. Verification of investors' tax status (i.e., as a U.S. person or a foreign person) in the fund will also be required in the manner prescribed by the Secretary.

Election to be qualified electing fund

The election to be a qualified electing fund for any taxable year must be made before the 15th day of the third month of the taxable year following the year for which the election is being made. Once an election is made, it continues until the year the corporation ceases to be a PFIC or the year the election is revoked with the consent of the Secretary. Congress intended that revocation be granted only in circumstances where compliance with the Act's provisions is assured. It was not intended that a fund that intentionally fails to meet its compliance obligations will revoke its qualified electing fund election. As indicated above, any revocation, or the loss of PFIC status, will, however, cause all prior extensions of time to pay tax to terminate and will cause the investor to be subject to the deferred tax and interest charge rules of section 1291 on eventual disposition of his or her stock.

Special rules applicable to both types of funds

Coordination of section 1291 with taxation of shareholders in qualified electing funds

Gain recognized on disposition of stock in a PFIC by a U.S. investor is not taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986 and which include any portion of the investor's holding period. This provision allows any unrealized appreciation in the stock of a qualified electing fund to be taxable as capital gain income (if the stock is a capital asset) and without the imposition of an interest charge.

Distributions received from a PFIC in a year the PFIC is a qualified electing fund are also not taxed under section 1291 if the PFIC is a qualified electing fund for each of the fund's taxable years which begin after December 31, 1986, and which include any portion of an investor's holding period.[24] This provision prevents a fund from retaining its annual income, electing to be a qualified

[24] A technical correction may be needed so that the statute reflects this intent.

electing fund in a subsequent year, and then distributing the accumulated income without the imposition of an interest charge.

Any U.S. shareholder who owns stock in a PFIC which previously was not a qualified electing fund for a taxable year but which becomes one for the subsequent taxable year may elect to be taxed on the unrealized appreciation inherent in his or her PFIC stock up through the first day of the subsequent taxable year, pay all prior deferred tax and interest, and acquire a new basis and holding period in his or her PFIC investment. Thereafter, the shareholder will be taxed under the rules applicable to qualified electing funds. Absent this election, U.S. investors will be taxed under both the provisions applicable to qualified electing funds and section 1291, and will, consequently, pay deferred tax and interest not only on gain attributable to the years in which the PFIC is not a qualified electing fund but also on gain attributable to the period during which an investor is taxed currently on his or her share of a PFIC's earnings.

Time for determination of PFIC status

The Act provides that a shareholder in a PFIC which is not a qualified electing fund is treated as holding stock in a PFIC if at any time during his or her holding period the corporation was a PFIC. Consequently, on disposition of stock in a corporation which is a PFIC in the year of disposition or was previously a PFIC at some time when the shareholder held the stock, any gain on the disposition of the stock will be subject to the deferred tax and interest charge rules of section 1291. The Act allows, however, a shareholder to purge his or her stock of its classification as PFIC stock if the corporation ceases to be a PFIC in a subsequent taxable year and if the shareholder elects to recognize gain in the amount of the unrealized appreciation of the shareholder's stock through the close of the year in which the corporation ceases to be a PFIC and pays all prior deferred tax and interest.

For a fund that was a qualified electing fund for all of its years, the Act provides that stock in a PFIC automatically ceases to be classified as PFIC stock when the foreign corporation ceases to be a PFIC. As indicated above, a consequence of a corporation ceasing to be a PFIC is that all prior elections to defer payment of tax and interest by all U.S. investors in the PFIC terminate and, thus, the investors are required to pay all prior deferred tax and interest.

Attribution of ownership

In determining stock ownership, a U.S. person is considered to own his or her proportionate share of the stock of a PFIC owned by any partnership, trust, or estate of which the person is a partner or beneficiary (or, in certain cases, grantor), or owned by any foreign corporation if the U.S. person owns 50 percent or more of the value of the corporation's stock. However, if a U.S. person owns any stock of a foreign corporation which is also a PFIC, the person is considered to own his proportionate share of any PFIC stock owned by the foreign corporation, regardless of the percentage of his or her ownership of the foreign corporation. In attributing stock ownership, the Act does not treat a U.S. person who is considered to own stock of another entity as actually owning the stock of the

entity for purposes of reattributing the stock to another person, except to the extent provided in regulations. It may be necessary in the case of a U.S. partnership for regulations to treat stock considered to be owned by the partnership as actually owned by the partnership so as to attribute the stock to the partnership's partners. In attributing stock owned by a trust, it is intended that the general rules of subchapter J apply. That is, in the case of a grantor trust, any stock owned by the trust generally shall be attributed to the grantor of the trust, and any stock owned by a trust which is not a grantor trust shall be attributed to the beneficiaries of the trust.

Anti-avoidance rules

The Act provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act's provisions and to prevent circumvention of the interest charge.

As an example where regulations may be required, the ownership attribution rules of the Act attribute the ownership of PFIC stock (in the event of an intervening corporation) only to a U.S. person that owns 50 percent of the intervening corporation. A foreign corporation engaged in an active trade or business generally will not be a PFIC. If such a corporation issues a separate class of stock and uses the proceeds to invest in a PFIC or to invest directly in passive assets, the corporation will still probably not be a PFIC under the general definition. However, in these instances, it may be necessary for regulations to treat the separate class of stock as a separate corporation for this purpose. In that event, the separate corporation will in all likelihood be a PFIC and the attribution rules will attribute any lower-tier PFIC stock to the ultimate U.S. investors.

Another instance where regulations may be necessary to carry out the purposes of the Act's provisions is where the ownership attribution rules attribute stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. Congress intended, however, that regulations treat the disposition of interests in the intervening entity as a disposition of the PFIC stock in appropriate cases. Similarly, if necessary to avoid circumvention of the Act's interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.

For purposes of the Act, a person is treated as disposing of his or her stock in a PFIC if the stock is used as security for a loan.

Coordination with other current inclusion and disposition rules

The Act adopts rules to coordinate the PFIC provisions with the subpart F and FPHC current inclusion rules in the case of qualified electing funds. Under these coordination rules, amounts required to be included in income currently under either section 951 or 551 shall be included first under those rules and then any additional amounts shall be included currently under section 1293. It

was intended that if income is included currently by a U.S. person under the subpart F provisions and the foreign corporation is also a PFIC which is not a qualified electing fund, the amounts previously included in income under that provision should not also be subject to the Act's interest charge rules on subsequent receipt of an excess distribution or on subsequent disposition of stock.[25]

Under the Act, if stock in a PFIC which is also a foreign investment company under section 1246 is disposed of, the Act's PFIC provisions apply and section 1246 does not apply to the earnings and profits of the company for any taxable year beginning after 1986. Accordingly, if the PFIC is a qualified electing fund for all of its years of existence, any gain recognized on a disposition of the PFIC stock will be treated as gain from the disposition of a capital asset if the stock is a capital asset in the hands of the shareholder, except to the extent the gain is attributable to pre-1987 years' earnings and profits. If the PFIC is not a qualified electing fund for all of its years of existence, or if the election to recognize gain by the shareholder at the time the PFIC became a qualified electing fund was not made, any gain will be treated as ordinary income and will be subject to the deferred tax and interest charge rules of section 1291. If stock in a PFIC which is not a qualified electing fund but which is also a controlled foreign corporation is disposed of, the Act's PFIC provisions apply, not section 1248, to the earnings and profits of the company. Further, if stock in a foreign investment company which is also a controlled foreign corporation but is not also a PFIC is disposed of, prior law section 1246 is amended to provide in these circumstances that the gain is to be taxed under section 1248 in the case of 10-percent corporate shareholders.

Other rules

The Act further provides that PFICs are not to be treated as personal holding companies or to be subject to the accumulated earnings tax.

PFIC inclusions are also resourced as U.S. source if the PFIC is a United States-owned foreign corporation (under sec. 904(g)) and the PFIC receives U.S. source income.

Effective Date

The provision is effective for taxable years of foreign corporations beginning after December 31, 1986.

The Act provides that pre-effective date earnings of foreign corporations that become PFICs under the Act are to be taxed as under prior law, but only with respect to the Act's interest charge provision. For example, assume that a U.S. person has owned stock in a foreign corporation since January 1, 1984. The corporation is a PFIC under the Act but is not a qualified electing fund. The U.S. person disposes of his stock on December 31, 1988, at a gain of $1000. The income that is attributed to years 1984-1986 ($600) will not be subject to the interest charge. However, all of the gain will be treated as ordinary income.

---

[25] A technical correction may be needed so that the statute reflects this intent.

Revenue Effect

The provision is estimated to increase fiscal year budget receipts by $10 million in 1987, $17 million in 1988, $16 million in 1989, $18 million in 1990, and $20 million in 1991.