June 28, 2022

The Honorable Lily Batchelder
Assistant Secretary for Tax Policy
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. William M. Paul
Principal Deputy Chief Counsel and
Deputy Chief Counsel (Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Comments on Proposed Regulations Regarding Passive Foreign Investment Companies & Controlled Foreign Corporations Held by Partnerships & Subchapter S Corporations (REG–118250–20)

Dear Assistant Secretary Batchelder, Commissioner Rettig and Principal Deputy Chief Counsel Paul:

The American Institute of CPAs (AICPA) is pleased to submit written comments to the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) regarding the Proposed Regulations published on January 25, 2022, regarding Passive Foreign Investment Companies (PFICs). We have previously submitted our thoughts[1] regarding PFICs. Specifically, we outline our main concern with the proposed regulations related to the proposed exclusion of domestic partnerships and Subchapter S Corporations ("S corporations") as shareholders due to the proposed adoption of the "aggregate approach."

<u>Overview</u>

The PFIC regime has been a part of the Internal Revenue Code (IRC or "Code") since the Tax Reform Act of 1986 ("the '86 Act") and is highly complex. The PFIC rules were enacted to address certain perceived abuses in the Controlled Foreign Corporations (CFC) area. Since the '86 Act was signed into law, most necessary filings related to PFICs have been required to be made at the level

[1] AICPA comments to Treasury and IRS in May 2014.

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of the first direct US shareholder. Such direct United States (U.S.) shareholders have included domestic partnerships and S corporations.

The proposed regulations would eliminate the treatment of domestic partnerships and S-corporations as direct US shareholders for purposes of PFIC compliance filings and their related elections and therefore remove their ability to make such filings on behalf of their unit holders/shareholders. The stated rationale for this change is Treasury's adoption of the so-called "aggregate approach" to certain deemed dividend and imputed income provisions for CFCs and the desire to have a consistent approach for both PFICs and CFCs.

Recommendations

The AICPA recommends that the Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) retain the current treatment of domestic partnerships and S corporations as shareholders for purposes of PFIC compliance filings and their related elections. If the so called "aggregate approach" is adopted in the final regulations, we suggest that they include a provision to allow domestic partnerships and S corporations to be delegated by the unit holders or shareholders the authority to continue to make all required PFIC filings and elections with the income tax returns filed by the partnership or S corporation. If the final regulations adopt the aggregate approach, consideration should be given to exempting entities that were organized prior to the effective date of the change from the entity approach to the aggregate approach.

Analysis

On a theoretical basis, we understand Treasury's goal of harmonizing the CFC and PFIC regimes such that both employ the aggregate approach. However, from a practical standpoint, retaining the "entity approach" for shareholders of PFICs best serves the interests of both taxpayers and tax administration. Indeed, § 1101 of the Bipartisan Budget Act of 2015 (Public Law No. 114-74) enacted the new centralized partnership audit regime with the express purpose of alleviating some of the complexity and inefficiency regarding assessments to partners in complex partnership structures. The goal should be to have fair, reasonable, and administrable partnership rules that minimize the complexities and burdens for taxpayers and their advisers, and the IRS. Congress conferred the entity approach.

We do not agree with the rationale for imposing the aggregate approach in the PFIC context. Taxpayers affected by the CFC regime are, by definition, 10% or greater shareholders. As such, they are more limited in number than PFIC shareholders. There is no minimum stock ownership threshold for a shareholder of a foreign corporation to be subject to the PFIC rules. In addition, a 10% or greater (CFC) shareholder is in a stronger position to obtain information regarding the foreign corporation than, for instance, a PFIC shareholder whose ownership position is below 1%. As such, PFIC shareholders are in a different class than CFC shareholders. Many, if not most,

PFIC shareholders are small investors who hold indirect interests in PFICs via domestic partnerships.

For a PFIC shareholder to be in the position to file a valid Form 8621, *Information Return for a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund,* for section 1298(f)[2] disclosure purposes and potentially to make a Qualifying Electing Fund (QEF) election, the shareholder must have complete and accurate information about the foreign corporation. Unit holders of domestic partnerships rely on the domestic partnership to provide each unit holder with its share of the PFIC's income, share ownership, etc.

If a U.S. person is a direct or indirect owner of a PFIC, and the requisite PFIC filings and elections are not made, the consequences can be serious. Under section 1298(f), if no Form 8621 is filed for the purpose of disclosing the shareholder's ownership of the PFIC, the statute of limitations on the U.S. person's entire tax return fails to start to toll due to the imposition of section 6501(c)(8).

More importantly, the failure to make a QEF election related to a PFIC renders any subsequent gain on the sale of the PFIC stock ineligible for favorable long-term capital gain treatment. There is currently a federal income tax rate difference of up to 20% between long-term capital gains and ordinary income.

Our members represent millions of U.S. taxpayers who wish to comply with the complex Code. Should the proposed regulations be adopted as final, taxpayers who have no knowledge of the PFIC rules will be exposed to them directly. Such direct exposure to the PFIC regime will dramatically complicate their income tax filings and increase the cost of having their income tax returns prepared (should they be part of the majority of Americans who employ tax professionals to prepare their income tax returns). We do not agree with shifting of the burden of PFIC compliance to individual taxpayers. We also disagree with the assertion in the preamble to the proposed regulations regarding the change to the aggregate approach from the entity approach that "…the Treasury Department and the IRS do not believe that this shift should have a significant economic impact on taxpayers."

The proposed regulations do not consider that investments may have been made in domestic partnerships under the assumption that such partnerships would be able to make the appropriate PFIC filings. Smaller investors or those with smaller retirement accounts may not have invested in certain partnerships had they known that they would be personally responsible to comply with the PFIC filing requirements. Investors in partnerships that have exposure to PFICs may not be able to redeem their partnership interests to divest of the partnership due to prohibitions of such redemptions in the partnership agreement. The proposed regulations "move the goalposts" for

[2] Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (IRC or "Code"), as amended, or to the Treasury Regulations promulgated thereunder.

existing investors from the standpoint of complex international tax reporting. Accordingly, if the final regulations adopt the aggregate approach, consideration should be given to "grandfathering" the entity approach for partnerships formed prior to the date that the final regulations come into effect. As noted above, the PFIC rules have been a part of the Code for over 35 years. Many investment decisions have been made based on the rules in place for this significant duration of time, including the historical ability of domestic partnerships and S corporations to fulfill the PFIC filing obligations on behalf of their owners.

There are potentially millions of small investors in the U.S. who are unaware that they are indirect shareholders in foreign corporations that could be PFICs. Many small investors unwittingly become indirect PFIC shareholders by virtue of the actions taken by their investment advisors. They may entrust their retirement savings to an investment advisor who, for instance, invests some of these funds into a partnership that holds shares in a foreign corporation that may be a PFIC. The investment advisor may not be aware of the existence of PFIC investments held by the fund. The proposed regulations appear to have been drafted under the assumption that a unit holder in a partnership has full knowledge that there may be PFICs in that partnership.

For the reason stated above, as well as the inherent complexity of the PFIC rules, we are concerned that a significant number of PFIC filings will be missed or not made correctly, should the entity approach be eliminated by the final regulations in favor of the aggregate approach. Such missed or improper PFIC filings could have catastrophic consequences for the indirect PFIC shareholders affected.

Tax Administration

If the proposed regulations are adopted as final, many small investors and retirees will be forced to file extensions because the partnerships that they have invested in will no longer be able to issue their Schedules K-1 prior to the initial March 15 deadline. Currently, a domestic partnership may be able to issue its Schedules K-1 to its investors *prior to* having all the PFIC information available to it. This is because the extended deadline for a partnership return is September 15 and the domestic partnership is the party that files Forms 8621, rather than its unit holders.

To perform a PFIC analysis, final financial statements are needed. Performing a PFIC analysis generally involves its own challenges, such as non-English language financial statements, different international accounting standards and the need to perform the asset test utilizing quarterly balance sheets. If the foreign corporation to be analyzed is audited and the audit is not completed well before the initial March 15 deadline, the partnership may not be in a position to perform the PFIC analysis before March 15. Accordingly, should the final regulations dispense with the entity approach and adopt the aggregate approach, it is reasonable to assume that the number of extensions filed will increase. Even if a partnership holds a very minor shareholding in a foreign

corporation, that shareholding could prevent the partnership from issuing Schedules K-1 to its unit holders due to the inability to perform the PFIC analysis.

We are also concerned about the additional administrative burden that the proposed regulations would place upon the IRS. There will be a many-fold increase in the number of Forms 8621 filed. It is not clear how the IRS would manage the inventory of such increased filings. The pandemic has laid bare the IRS' challenges with administering the individual tax return filings and such a dramatic increase in the number of Forms 8621 being filed would potentially "flood the system."

Delegation of Authority to File

We appreciate the fact that the preamble to the proposed regulations contains a request for feedback on whether there should be a mechanism for domestic partnerships and S corporations to be delegated the authority to make PFIC filings at the entity level by their unit holders/shareholders. For the reasons stated above, should the final regulations mandate the change from the entity method to the aggregate method, we strongly recommend that they include the availability of delegation of the authority to make PFIC filings at the entity level as there should be flexibility and more than one mechanism allowed.

Such authority could be delegated to the entity via amending the partnership agreement of a domestic partnership or the operating agreement of a domestic, multi-member LLC. In such a case, the authority and obligation would be granted to the partnership to both (a) make all appropriate PFIC filings; and (b) decide at the entity level which types of elections to make (e.g., QEF or Mark-to-Market).

We also suggest considering the use of an annual consent form that would be provided to partnership unit holders. Such a mechanism is regularly utilized by partnerships that ask their unit holders whether they would prefer if the partnership filed one or more composite state income tax returns at the entity level. Such composite filings at the entity level alleviate the need for unit holders to file non-resident state income tax returns in jurisdictions where the partnership has nexus or is engaged in a trade or business. The consent form would specify that the unit holder delegates to the entity the authority to both file any appropriate elections and to decide at the entity level what type of election to file.

Lastly, should the final regulations eliminate the entity approach, we recommend that consideration be given to allowing unit holders of foreign partnerships to have the same ability to delegate to these foreign partnerships the ability to make the appropriate PFIC filings. If the final regulations mandate the aggregate approach, domestic and foreign partnerships would be in the same position regarding their unit holders being the parties with which the obligation to make PFIC filings would reside. Accordingly, granting unit holders of foreign partnerships the same

ability to delegate the PFIC filings would put them on par with unit holders of domestic partnerships.

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Andrew Mattson, chair, AICPA PFIC Task Force at (408) 558-7666 or andy.mattson@mossadams.com; Arlene Schwartz, AICPA Senior Manager – Tax Policy & Advocacy, at (973) 698-5633 or arlene.schwartz@aicpa-cima.com; or me at (601) 326-7119 or JanLewis@HaddoxReid.com.

Sincerely,

Jan F. Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: Ms. Jennifer N. Keeney, Senior Counsel, Office of the Associate Chief Counsel (Passthroughs and Special Industries), Internal Revenue Service
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