American Institute of CPAs
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The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, N W
Washington, DC 20224

The Honorable Mark Mazur
Assistant Secretary (Tax Policy)
1500 Pennsylvania Avenue, NW.
Washington, DC 20220

RE: Treatment of Shareholders of Certain Passive Foreign Investment Companies

Dear Messrs. Koskinen, Wilkins and Mazur:

The American Institute of Certified Public Accountants (AICPA) offers the following comments and recommendations for changes concerning the treatment of shareholders of certain passive foreign investment companies (PFICs), either through administrative, regulatory or statutory actions. These comments were developed by the Passive Foreign Investment Company Task Force of the International Taxation Technical Resource Panel, and approved by the Tax Executive Committee.

The AICPA is the world's largest member association representing the accounting profession, with over 394,000 members in 128 countries and a 125-year heritage of servicing the public interest. Our members advise clients on federal, state and international tax matters and prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

Background

The PFIC rules were enacted as a part of the Tax Reform Act of 1986 (TRA) "to eliminate the tax advantages that US shareholders in foreign investment funds have heretofore had over (United States) US persons investing in domestic investment funds."[1] These rules generally limit the ability of US persons to make investments through foreign corporations in order to avoid the equivalent of current taxation.

[1] HR Rep. No. 841, 99th Cong., 2d Sess. II-641 (Conf. Rep. 1986).

In the twenty-seven years since the TRA was enacted, world gross domestic product (GDP) has grown dramatically while the US share of economic output has shrunk. As a result, the international operations and investments of US multinational companies and their shareholders who are subject to US taxation ("US persons"), have grown significantly. This increased economic activity outside of the US has exposed a significantly greater number of US persons to the PFIC rules.

The PFIC rules are highly complex and in most cases apply equally to direct shareholders and minor, indirect shareholders. Therefore, an indirect shareholder with a small investment in a PFIC must prepare calculations and incur compliance costs that can, at times, far exceed the underlying tax potentially imposed by the PFIC rules.

The Department of the Treasury ("Treasury") has been granted broad delegated rule-making authority in the PFIC area by Internal Revenue Code (IRC) section 1298(g).[2] We understand that some of the changes we recommend below are regulatory in nature, while others may require a statutory change. In either case, we have provided our comments and recommendations below on a variety of key issues in an effort to minimize costs of compliance, as well as, limit the impact of the PFIC rules to situations where the PFIC investor has a significant interest.

The AICPA recommends that Treasury revise regulations and/or support statutory changes in order to address the following issues: (1) start-up exception under section 1298(b)(2); (2) time period for making a qualifying electing fund (QEF) election under section 1295; (3) eligibility rules on making a retroactive QEF election; (4) relaxation of QEF documentation; (5) simplification of the computation of the section 1291 deferred tax amount; (6) de minimis exception for the application of the section 1291 interest computation; (7) annual aggregations of PFIC stock purchases for purposes of section 1291; (8) automatic QEF treatment for money market funds; (9) consolidated filings; and (10) de minimis amounts of excess distribution income from indirectly held PFICs.

1. Expand Start-Up Exception under Section 1298(b)(2)

Current Law and Analysis

According to the General Explanation of the Tax Reform Act of 1986, Congress did not intend for the PFIC rules to apply to companies that engage in active operations.[3] Per section 1298(b)(2), if a foreign corporation is otherwise a PFIC in its start-up year, it is not treated as a PFIC in that taxable year provided:

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[2] All section references in this letter are to the Internal Revenue Code of 1986, as amended, or the Treasury regulations promulgated thereunder.
[3] Title XII, Section D. 6, page 1026, General Explanation of the Tax Reform Act of 1986 (H.R. 3838, Public Law 99-514).

a) No predecessor corporation was a PFIC;
b) It is established to the satisfaction of the Internal Revenue Service (IRS or "Service") that the corporation is not a PFIC in either of the two succeeding years; and
c) The corporation is not, in fact, a PFIC for either of the first two years following the start-up year.

In many situations, the start-up exception does not provide relief to operating companies since it is limited to one year which is narrowly defined as the first year that the corporation has gross income. A corporation that is organized late in the year may have a tax year that is as short as one day. In this circumstance, the corporation would not have time to generate income (investment or otherwise) but could fail the PFIC asset test because it has not yet invested its initial cash funding. Consequently, the PFIC classification would apply to the corporation for its entire life, under the "once a PFIC, always a PFIC" rule of section 1297(a).

<u>AICPA Recommendation</u>

In order to provide relief to operating companies, as intended by Congress, we believe Treasury should recommend that Congress make a statutory change to broaden the start-up exception under section 1298(b)(2) by eliminating the gross income requirement in the start-up year. Alternatively, you may consider recommending to Congress that the definition of the start-up year be extended to a period of at least six months, which would allow time for the generation of gross income.

2. Expand the Time Period for Making a QEF Election under Section 1295 in the case of a Start-up Entity

<u>Current Law and Explanation</u>

During the start-up year of a foreign corporation, a US shareholder may not know if the corporation has met the "not a PFIC in either two succeeding tax years" condition of section 1298(b)(2) following the start-up year.

In order to make a determination regarding classification as a PFIC, the PFIC asset test is performed quarterly. It is possible that only two measurement quarters, out of the eight required measurement quarters, will have elapsed before a US person files its extended tax return. In these instances, the US shareholder would have to make an assumption, as to whether or not the foreign start-up corporation will meet the start-up exception.

If the US person incorrectly assumes the foreign start-up corporation will meet the start-up exception, and it does not, then the US person may not have made a timely[4] QEF election. In this case, the US person is subject to the excess distribution regime of section 1291, and is ineligible for long-term capital gains treatment upon the subsequent disposition of the stock.

AICPA Recommendation

We recommend an expansion of the time period for making a valid and timely QEF election in the case of an investment in a start-up corporation, to the third tax year of the corporation's existence. Section 1295(b)(2) currently allows for retroactive QEF elections under certain situations, but 2 percent or greater shareholders are not eligible for this relief under Treas. Reg. § 1.1295-3(e)(2)(i). Furthermore, section 9100 relief is also prohibited by Treas. Reg. § 1.1295-3. An expansion of the current time period to make a valid, timely QEF election will allow for US persons to have full knowledge of whether or not the start-up exception is met and encourage compliance with PFIC reporting rules and the associated election.

3. Expand Eligibility to Make a Retroactive QEF Election

Current Law and Explanation

A US person that fails to make a "pedigreed" QEF election, (a "pedigreed" QEF election is one that is made in the first year of the US person's holding period in a PFIC), is potentially subject to adverse tax consequences. Specifically, the complex provisions of the excess distribution regime of section 1291 will apply. In addition, the US person will be ineligible for long-term capital gains treatment on the subsequent disposition of the stock of the foreign corporation. The current income tax rate difference between ordinary income and long-term capital gains is as high as 20 percent, depending upon the income level of the US person.

For example, many US persons are unaware of the PFIC rules and have no knowledge of the advantages of making a QEF election. Many US persons hold indirect investments in PFICs due to holding minor investments in foreign investment partnerships that large US brokerage firms commonly sell to their clients. Often a taxpayer prepares his or her own return, which includes the first year of ownership of a PFIC, and then decides to seek the services of a competent tax advisor due to the increased complexity of their return. Since the PFIC regulations are highly complex and there are limited options available for addressing situations such as this, the taxpayer is placed in an uncomfortable position.

[4] Under section 1294(d), a QEF election is considered timely if it is made no later than the due date of the return (including extensions) in the year the taxpayer acquires the investment. If a timely QEF election is not made, a taxpayer can still file a QEF election in a subsequent year, but that may subject them to the negative consequences associated with an unpedigreed election unless they make a deemed sale election or a deemed dividend election.

As stated above, section 1295(b)(2) allows for retroactive QEF elections in certain narrow circumstances. In order for relief under section 1295(b)(2) to be granted, the US person essentially would need to have either a) anticipated the potential PFIC issue and filed a protective statement for the first tax year of the investment; or b) not anticipated the PFIC issue, and relied on a qualified tax professional and not prejudice the interests of the government; or c) own less than 2 percent of the corporation and relied on the corporation's representation that it was not a PFIC. In addition to section 1295(b)(2), a US person could apply for a private letter ruling (PLR). A US person wanting to request a PLR generally would need to retain an attorney or tax advisor to prepare the PLR and pay the associated fees which generally are prohibitively high.

<u>AICPA Recommendation</u>

The AICPA recommends the expansion of the conditions to make a retroactive pedigreed QEF election to include US persons who had not previously affirmatively selected a PFIC method. We believe that the potential abuse for permitting such a retroactive election is small if the US person were also required to file a qualified amended return for all affected prior year returns in order to include any unreported QEF income. Many investors are not made aware that they have invested in a PFIC, particularly in indirect situations, until after the time to make a pedigreed QEF election has passed.

4. Relax the Requirements for QEF Documentation

<u>Current Law and Explanation</u>

Under section 1295 and Treas. Reg. § 1.1295-1(f)(1)(iii), in order for a QEF election to remain valid during the holding period of the US shareholder, the US person must annually receive a PFIC Annual Information Statement. Treasury Reg. § 1.1295-1(g)(1)(ii)(c) specifies the required content of the annual statement. In order to comply with the requirements of section 1295, the PFIC must essentially keep a separate set of books and records that are determined under US income tax principles. Furthermore, if a corporation was not previously a PFIC but becomes one, the corporation would need to go back to its year of organization and re-construct the appropriate records. The maintenance of such US tax-compliant records by the PFIC is very costly, and many foreign corporations have no incentive to maintain these records under laws of their local jurisdictions. Therefore, it is not practical or many times possible for foreign corporations to adhere to these requirements.

<u>AICPA Recommendation</u>

We recommend relaxing the requirements of the PFIC Annual Information Statement to determine the annual QEF income inclusion by allowing the PFIC to provide to its shareholders, who are also US persons, financial statements prepared in accordance with Generally Accepted Accounting Principles (GAAP), International Financial Reporting

Standards (IFRS), or the auditing standards in effect in the foreign jurisdiction. We understand that this recommendation may in some cases shift the burden for determining US taxable income to the US PFIC shareholder. However, we believe that, as with all income tax filings, the burden of support ultimately rests with the taxpayer. This change is consistent with the existing self-reporting framework of the tax system.

5. Simplify the Computation of the Section 1291 Deferred Tax Amount

Current Law and Explanation

A US person, who owns an interest in a PFIC but has not made a pedigreed QEF election, is subject to the excess distribution regime of section 1291. Section 1291 requires calculating the deferred tax amount related to an excess distribution at the highest tax rate for each year to which the distribution was related and that the corporation was a PFIC. Some excess distributions can contain amounts related to multiple prior tax years.

AICPA Recommendation

We believe Treasury should recommend that Congress make a statutory change by allowing, on an elective basis, taxing the aggregate excess distribution at the highest ordinary income rate for the current tax year, rather than at the highest rate for each prior tax year related to the distribution. This proposed simplification is unlikely to result in a loss of tax revenue to Treasury since the highest ordinary income tax rate today of 39.6 percent is the highest it has been since the introduction of the PFIC rules with the TRA (at which time the highest marginal rate was 28 percent).

6. Provide a De Minimis Exception for the Application of the Section 1291 Interest Computation

Current Law and Explanation

Under section 1291, interest on the deferred tax amount must be computed for each excess distribution allocated to each tax year. For any given tax year, a US person could have dozens of excess distributions, many of which may be very minor. The computation of interest is required for each tax year that the excess distribution is related to, regardless of materiality. The compliance costs to compute the required interest expense on each deferred tax amount could easily exceed the interest and indeed the underlying tax.

AICPA Recommendation

We believe Treasury should recommend that Congress waive the requirement to compute the interest charge related to each deferred tax amount, when the aggregate excess distributions received by a US person during the tax year does not exceed US $1,000 (and index the initial threshold for inflation). Since 1993, the interest rate on underpayments of estimated tax has never exceeded 9 percent. We believe the maximum potential cost in almost all cases is unlikely to exceed the interest on the amount. We believe this recommendation is a reasonable trade off in order to remove the onerous requirement that US persons with minor amounts of excess distribution income compute an inconsequential interest charge on thes income. The exception would eliminate hundreds of dollars of annual compliance costs for many US persons who own small interests in PFICs.

7. Allow for Annual Aggregations of PFIC Stock Purchases for Purposes of Section 1291

<u>Current Law and Explanation</u>

The deferred tax amount determined under section 1291 is calculated by computing the tax on an excess distribution by the tax year the distribution originated. Some PFICs have dividend reinvestment programs that could result in multiple purchases of the stock in the same tax year by a US person, which creates significant complexity with respect to the determination of the excess distribution allocable to each particular tax year.

<u>AICPA Recommendation</u>

We believe Treasury should recommend that Congress allow for the annual aggregation of multiple purchases of the same PFIC stock provided the purchases do not exceed 10 percent of the US person's total ownership share. For purposes of allocating an excess distribution to a given tax year, the shares could be treated as being purchased on January 1, June 30, or December 31, provided these alternate dates were applied consistently throughout the holding period of the US person.

8. Provide for Automatic QEF Treatment for Money Market Funds

<u>Current Law and Explanation</u>

Generally, foreign money market funds are mutual funds. These entities are almost always PFICs. There are many foreign nationals who are resident in the US and are therefore US persons who own foreign money market funds. US citizens who reside abroad and own money market funds are also subject to US tax. Money market funds are very common investments since they offer flexibility, check writing capabilities, and easy redemption and re-investment options. Earnings on these investments are the equivalent of interest although it is frequently termed a dividend based on the corporate nature of the underlying investment.

Since these funds are almost always PFICs, in order to avoid the complexities and negative tax consequences of the section 1291 excess distribution regime, foreign money market fund holders should make QEF elections at the appropriate time. However, in practice, a QEF election is not something that all foreign nationals are aware of nor are their tax advisors, particularly when related to such basic investments as money market funds.

AICPA Recommendation

We recommend treating owners of foreign money market mutual funds as though they have automatically made QEF elections. Accordingly, the owners, subject to US tax, would not be required to formally elect to include all earnings in the current year as interest income. We believe this recommendation would greatly simplify the US tax reporting requirements for owners of the funds that may not have the services of a tax advisor with knowledge of the PFIC regime at their disposal.

9. Allow for Consolidated Form 8621 Filings

Current Law and Explanation

The current Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company*, only allows for the reporting of a single PFIC per form. The implication of the one-PFIC-per Form 8621 is the increase in volume of the number of pages in a US person's tax return if they have numerous PFIC investments. Many foreign investment partnerships contain dozens of investments that require Form 8621 filings, due to indirect ownership by US investors (foreign partnerships are not eligible to make QEF elections, etc.). As previously stated, there is no materiality level for QEF elections, the imposition of the excess distribution regime or mark-to-market elections. In addition, now that the section 1298(f) temporary regulations have been promulgated, the annual disclosure of all PFIC investments, with limited exceptions, is required.

We acknowledge that Temp. Reg. § 1.1298-1T(b)(2)(ii) eliminates the Form 8621 filing requirement in certain circumstances when a US person owns a PFIC indirectly through a domestic partnership that itself complies with section 1298(f). However, this exception provides no relief to US persons who own PFICs indirectly through foreign partnerships.

During 2012 at least two widely used commercial tax return preparation products did not allow for electronic filing of a Form 1040 containing more than five Forms 8621. Accordingly, the current one-PFIC-per-Form 8621 filing procedure works against the Service's goal of increasing the e-filing of tax returns.

AICPA Recommendation

We recommend re-designing Form 8621[5] to allow for the disclosure of more than one PFIC and their relevant elections. We believe a landscape/horizontal supporting schedule

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[5] This section refers to the December 2012 version of Form 8621.

which lists the pertinent information for each PFIC would accomplish that goal. When detailed computations related to section 1291 are required, separate supporting schedules which accommodate the calculations could satisfy the reporting requirements. Alternatively, when the disclosure of any excess distribution income and the associated interest charge is required and included in income, we also recommend allowing the reporting of an excess distribution on a separate schedule or even retaining the existing form for PFICs with substantive disclosures.

10. Eliminate the Form 8621 for De Minimis Amounts of Excess Distribution Income from Indirectly held PFICs

<u>Current Law and Explanation</u>

Many US persons hold indirect interests in PFICs via partnership investments. These indirect PFIC investments may generate very minor excess distribution income. In the extreme, even one dollar of section 1291 excess distribution income requires the filing of a Form 8621. We would like to emphasize that the section 1291 excess distribution regime and the associated compliance applies at the individual shareholder/unit-holder level and precludes the use of the de minimis reporting exceptions under Temp. Reg. § 1.1298-1T(c)(2).

<u>AICPA Recommendation</u>

We recommend that Treasury modify the temporary regulations to permit the de minimis exceptions under Temp. Reg. § 1.1298-1T(c)(2) to continue to apply in situations when the total excess distribution income for a tax year does not exceed $1,000 (indexed for inflation), in aggregate, for all PFICs indirectly held by a US person where there the PFIC investment is held indirectly through a domestic pass-through entity. This amount is the same threshold we have proposed for eliminating the interest computation on excess distribution income in our proposal above. We note that there is precedence for eliminating the filing of an international tax form when minor amounts are involved. Form 1116, *Foreign Tax Credit*, is not a required filing when the total foreign tax credits for a US person do not exceed $600 and the amounts are reported on a Form K-1 or Form 1099. Since a domestic partnership, trust or S corporation must file a Form K-1 for each owner or beneficiary, the section 1291 excess distribution income is already reported to the IRS.

We acknowledge that Temp. Reg. § 1.1298-1T(c)(2) provides some simplification by waiving the Form 8621 filing requirement when the shareholder owns a low aggregate value of PFICs. However, this exception to the Form 8621 filing requirement only applies when there is no section 1291 excess distribution income. Our proposal would further simplify PFIC compliance rules when only a minor amount of excess distribution income is earned by the indirect PFIC shareholder.

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We appreciate your consideration of our comments and recommendations, and we welcome further discussion. If you have any questions, please contact me at (304) 522-2553 or jporter@portercpa.com; Christine Ballard, Chair, International Tax Technical Resource Panel, at (408) 369-3738 or christine.ballard@mossadams.com; Andy Mattson, Chair, Passive Foreign Investment Company Task Force, at (408) 369-2566 or andy.mattson@mossadams.com; Kristin Esposito, AICPA Technical Manager, at (202) 434-9241 or kesposito@aicpa.org.

Sincerely,

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Chair, Tax Executive Committee

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