MSBA

March 4, 2014

The Honorable Mark J. Mazur
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Maryland State Bar Association Taxation Section Comments to Temporary Regulations on PFICs and Related Recommendations

Dear Assistant Secretary Mazur and Commissioner Koskinen:

On behalf of the Maryland State Bar Association Taxation Section, I am pleased to submit these comments to the Temporary Regulations issued under Sections 1291 and 1298 of the Internal Revenue Code ("Code") that provide guidance on annual filing requirements for shareholders in a passive foreign investment company ("PFIC") among other matters. TD 9650. In particular, this new guidance modifies the reporting requirements for PFICs relating to Form 8621 (*Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*) resulting from changes in the statute. Specifically, Section 521 of the Hiring Incentives to Restore Employment Act of 2010 (Public Law 111-147, 124 Stat. 71) ("HIRE Act") added new paragraph (f) to Code Section 1298 effective March 18, 2010. Section 1298(f) requires a United States person that is a shareholder of a PFIC to file an annual report containing such information as the Secretary may require. Prior to this change in the statute, reporting on Form 8621 was generally not required unless a taxable distribution or disposition occurred or if an election to mark-to-market or treat a PFIC interest as a Qualified Electing Fund ("QEF") was being made.

The special anti-deferral tax regime and reporting requirements for PFICs are truly foreign to many less sophisticated but well meaning US taxpayers. These compliance issues come up quite often when a US citizen or resident decides to diversify investments globally and invest in foreign type mutual funds such as collective investment arrangements authorized under the Undertaking for Collective Investment in Transferrable Securities (UCITS) Directive by the European Union. Many unsophisticated US taxpayers including persons recently emigrated to the US have such holdings without realizing the potential onerous tax regime and compliance burden such holdings pose. The rules pertaining to such required tax calculations and filing requirements can be quite daunting.

The penalties and other consequences attendant to a failure to file such forms when required can be quite severe, even where there is little or no unpaid tax. At the same time, we are keenly aware of the Government's interest in gathering information needed to adequately enforce the tax laws which must be balanced with the compliance burden. With this in mind, we offer the following comments/recommendations which can be summarized as follows:

1. We recommend that the monetary thresholds in Regulation Section 1.1298-IT(c)(2) excepting small PFIC owners from annual reporting be increased/modified.
2. We recommend that some relief be provided where a foreign entity with historically active business experiences a downturn or contraction so that it may avoid meeting the asset definition to be classified as a PFIC under Section 1297(a).
3. We recommend that for taxpayers with relatively small PFIC holdings where a taxable event occurs, that there be a simplified method to calculate the tax and interest charge if market-to-market or QEF elections have not been made.

A more detailed description and analysis of our comments/ recommendations is attached in Appendix A.

We also commend the Government for not requiring reporting for suspended years prior to the effective date of publication of the regulations as was originally contemplated by Notice 2011-55, 2011-29 C.B. 612, as per Regulation Section 1.1298-IT(b)(3).

These comments represent the views of the Maryland State Bar Association Section of Taxation. They have not been approved by the Board of Governors of the Maryland State Bar Association, and should not be construed as representing the policy of the Maryland State Bar Association.

Principal responsibility for the preparation of these Comments was exercised by Glen Frost, Mark Schweighofer and Eli Noff. Significant contributions to the drafting were made by Kaitlyn Loughner.

Although many of the members of the Taxation Section who participated in preparing these Comments have clients who may be affected by the legal issues addressed by the, no such member (or firm or organization to which any such member belongs) has been engaged by a client to make a submission with respect to, or otherwise influence the development or outcome of, the specific subject matter of these Comments.

We are pleased to discuss any questions you may have. Please feel free to contact the undersigned at (301) 951-9368 or via e-mail at pmarcotte@paleyrothman.com.

Very truly yours,

Paul G. Marcotte, Jr.
Chair

Enclosure: Detailed Explanation/Analysis of Comments/Recommendations

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SECTION OF TAXATION
MARYLAND STATE BAR ASSOCIATION

Appendix "A"
Detailed Explanation/Analysis of Comments/Recommendations

I. Introduction

The proposals contained in this report are made in response to the Internal Revenue Service's request for comments relating to the newly issued temporary regulations surrounding the taxation of a Passive Foreign Investment Company (PFIC).[1]

II. Summary

The PFIC tax regime was enacted through the Tax Reform Act of 1986. The purpose of the PFIC rules was to create a disincentive for foreign investment. Specifically to prevent interest free tax deferral on passive income, or changing the character of ordinary income to a capital gain through the use of investments in foreign corporations. The rules have removed the deferral advantage enjoyed through foreign investment and have created a tax regime which makes foreign investment costly and prohibitive. Two distinct applications of the PFIC rules are discussed in these comments. First, are the PFIC rules application to foreign mutual funds and its implications with regard to investors in those funds. Second discussed, is the wide net that the PFIC rules cast over foreign companies and the harsh implications that ensue.

III. PFIC Definition

According to § 1297(a), a foreign corporation is defined as a PFIC if (i) 75 percent or more of the gross income of such corporation for the taxable year is passive income (the "income test"), or (ii) the average percentage of assets held by such corporation during the taxable year which produce passive income or which are held for the production of passive income, is at least 50 percent (the "asset test").

IV. Three PFIC Tax Provisions

There are three separate PFIC tax regimes – the Excess Distribution regime[2], the Qualified Electing Fund ("QEF") regime,[3] and the Mark-to-Market ("MTM") regime.[4]

1. Excess Distribution Regime

This regime applies an interest charge on "excess distributions." The Code defines excess distributions as any distribution in respect of stock received during any

[1] Section references hereinafter are to the Internal Revenue Code of 1986 ("Code") as currently in effect.
[2] § 1291
[3] § 1293-1295
[4] § 1296

taxable year to the extent such distribution does not exceed its ratable portion of the *total* excess distribution (if any) for such taxable year. "*Total* excess distributions" is defined as the excess, if any, of the amount of the distributions in respect of the stock received by the taxpayer during the taxable year, over 125 percent of the average amount received in respect of such stock by the taxpayer during the 3 preceding taxable years (or, if shorter, the portion of the taxpayer's holding period before the taxable year).[5] This 3 year look-back is referred to as the "base period average." Only excess distributions included in gross income during the 3 preceding taxable years may be considered as part of the base period average.

In general, the current year distribution from the PFIC will be considered an excess distribution to the extent it exceeds 125 percent of the base period average. The distribution which does not exceed 125 percent of the base period average is not considered an excess distribution, but rather it is treated as a distribution under § 301. All gains on dispositions of PFICs are considered excess distributions by default.

The excess distribution spreads the recognition of the tax over multiple years. A portion of the excess distribution is included as ordinary income on line 21 of IRS form 1040 during the year of distribution. The remaining excess distribution is carried back over the holding period of the PFIC and taxed at the highest ordinary income tax rate for each of the carry-back years. The aggregate tax resulting from this treatment is reported on line 44 of IRS form 1040, along with the individual's tax resulting from the other-than-PFIC income. Additionally, the excess distribution regime applies an interest charge for the ratable portion of the income carried back to each year of the PFIC holding period. The aggregate interest charge is reported as a footnote on page 1 of IRS Form 1040. This interest charge, along with the tax rate applied to the ratable distribution, can lead to situations where the interest charge and tax exceed the value of the portfolio altogether.

2. Qualified Electing Fund Regime

The QEF regime offers an alternative to the excess distribution rules and is elective for the U.S shareholder. Once elected, the shareholder may not revoke the election without permission from the IRS. Under this method, the PFIC shareholder includes in income their pro-rata share of the PFICs earnings and profits. The character of the income, ordinary or capital gains, depends on the underlying character of the PFIC income. A QEF election must be made within the first year of the shareholder's holding period of the PFIC and within the first year in which the corporation is classified as a PFIC in order to be considered a "pedigreed QEF."

The implications and benefits of becoming a pedigreed QEF will be discussed more thoroughly in the comment relating to the wide net the PFIC regime casts on foreign companies. Briefly, the "once a PFIC, always a PFIC" rule does not apply to pedigreed shareholders electing QEF treatment. Additionally, shareholders who do not make the election within the first year must continue to use the excess distribution

[5] § 1291

regime. This is called an "unpedigreed QEF." The difficulty with this election is that it requires that the PFIC supply the investor with annual financial information, which is difficult to obtain for a mutual fund shareholder. The election requires that the corporation supply the shareholder with a statement of the U.S. shareholder's pro-rata share of earnings and profits, as well as a statement that the PFIC will permit the shareholder to access the company's books and records to ensure that the income was determined using U.S. tax principles. Needless to say, in the mutual fund context, compliance costs are significant and foreign mutual funds are reluctant to provide such information to a shareholder.

3. Mark-to-Market Regime

This election applies to "marketable stock" held in a PFIC.[6] In general, under this election, the taxpayer includes in income the value of the PFIC over the adjusted basis, at the end of each year.[7] The income is characterized as ordinary.[8] In the event the adjusted basis exceeds the value of the stock at year end, a deduction is allowed up to the previously included gains reported, also known as "unreversed inclusions." The deduction is an ordinary loss for tax purposes.

One disadvantage of this is that the excess distribution regime must still be applied in the first year that the Mark-to-Market regime is elected, if the PFIC is an unpedigreed PFIC at the time of election.

V. First Proposal: PFIC Application to Mutual Funds

Outside of high wealth investors who use foreign corporations and other structures to defer U.S. tax obligations, the PFIC rules create a harsh reporting requirement for owners of foreign mutual funds held outside of a U.S. brokerage account. The rationale for this lies within the tax disparity between investment in domestic and foreign mutual funds. U.S. mutual funds are required to pass through income resulting from dividends or sales of securities held in the portfolios to their shareholders. Foreign mutual fund investors were not reporting their proportional income from the portfolio for the year, thereby deferring tax on the income for many years. This deferral led to extreme disparities, such as foreign investors, who enjoyed gains on the reinvested tax deferred income, interest free.

As previously mentioned, the PFIC rules encompass foreign mutual funds and similar investments. This raises many issues for persons who are relatively new U.S. taxpayers who have moved to the U.S. from a foreign country. Often times these immigrants have foreign accounts, including mutual funds, which were opened before they ever contemplated moving to this country. Upon becoming a U.S. person, these individuals are subject to the complex PFIC rules, and often remain oblivious of that fact, until they discover the PFIC rules, if ever.

[6] See § 1296(e) for definition of "marketable stock".
[7] § 1296(a)
[8] § 1296(c)

We propose creating a threshold amount for the complex PFIC rules to apply with respect to foreign mutual funds and similar foreign investment fund accounts.[9] Single taxpayers with an aggregate foreign mutual fund account value under $25,000, and married taxpayers with an aggregate foreign mutual fund value under $50,000, should not have to apply the complex, time consuming, costly, and harsh PFIC rules. Alternatively, we propose creating a dollar threshold for distributions from foreign mutual funds, under which PFIC rules would not apply. Any distribution from a foreign mutual fund under $1,000 annually ($2,000 for married filing jointly) should not be subject to the PFIC tax regime. In either proposal, these taxpayers should be allowed to report the income from these foreign funds on their tax returns in the same manner as shareholders of U.S. based mutual funds. The PFIC Form 8621 is complex and the excess distribution default computations, if no election is made, are very intricate. The Treasury Department itself estimates that the amount of time it takes to complete one PFIC Form 8621 is approximately 22 hours. Taxpayers with multiple mutual funds face tens of hours of form preparation, and potentially astronomical compliance costs, if they utilize a paid preparer, many of which do not prepare PFIC forms or calculations at all.

Although these taxpayers have the option to elect use of the Mark-to-Market method (assuming they even know their accounts are PFICs), the default § 1291 method must still be applied within the first year of the Mark-to-Market election if the fund is an unpedigreed QEF. Taxpayers who are unaware of this complex regime certainly have not made a QEF election, leaving them to contend with the excess distribution regime under § 1291. Additionally, as discussed above, QEF elections require data which the investment firms are reluctant to provide due to the burdens of compliance.

The Temporary Regulations provide an exception for the § 1298(f) reporting requirements. Briefly, § 1298(f) now requires annual informational reporting for PFICs, even if there are no distributions. The regulatory exception provided in the Temporary Regulations provide generally that any shareholder with an aggregate value of directly owned PFICs under $25,000 is not required to file an IRS Form 8621 if there were no excess distributions in that year.

On its face, this exception seems to be similar to the proposal offered herein. However, the current exception does not provide relief to those who need it most. The typical taxpayers we describe are often unaware of their foreign mutual funds PFIC status and have either not been reporting the income from that account on their U.S. tax return, or have been reporting it incorrectly, without applying the complex PFIC rules.

As indicated earlier, the base period average through which an excess distribution, if any, is figured, may only take into account prior distributions, which have been reported correctly using the PFIC regime. Any prior year distributions, which have not been reported, may not be used to determine the base period average. Thus, the result is that a taxpayer who owns a foreign mutual fund, and was unaware of the PFIC rules, will always have an excess distribution if the mutual fund distributes *any* money during the

[9] This proposal may be outside of the authority of the Treasury Department to regulate, and may be more of a Congressional proposal since the PFIC regime is prescribed by statute.

year since he may not take into account any prior year distributions. This is a noteworthy result since the current Form 8621 reporting exception only applies to taxpayers whose PFICs did *not* make an excess distribution. Under current rules, the regulatory exception does not provide relief to the many U.S. persons who own foreign mutual funds abroad for reasons other than tax deferral. Any distribution made by the foreign mutual fund will be considered an excess distribution and will trigger the § 1291 excess distribution default calculation regime.

Additionally, with the new FATCA laws being implemented, the ability for U.S. persons to shelter money in foreign mutual funds will be hindered. From a policy standpoint, the PFIC rules intended to remove the incentive of foreign mutual fund investment. The new FATCA regime will further reduce the ability of U.S. persons to invest their money tax free abroad. It will also have the effect of reducing the need for the application of the PFIC regime to foreign mutual funds and similar investments.

VI. Second Proposal: The PFIC Regime Implication on Active Businesses.

Our second comment surrounds the overly broad PFIC status application to active businesses. The result of the current Treasury interpretations of the PFIC statutes is that PFIC classification is given to active businesses based on the above described "income test" or "asset test." Currently, pursuant to IRS Notice 88-22, cash and other liquid assets are considered passive assets for the purposes of the income test, and the asset test, even if the cash is working capital. Additionally, the Notice states that non-passive assets are limited to "depreciable property used in a trade or business."

The Treasury's interpretation of passive assets results in PFIC classification for many foreign businesses that do not have significant assets, such as service based companies, even though they are active businesses. Additionally, companies may also gain PFIC status through application of the income test. For example, an active foreign company may have poor operating income during the current year. However, if that corporation's passive income is greater than 75 percent of the corporation's total income for the year, then the business will be classified as a PFIC and will be subject to the complex PFIC regime.

The implications of a company being classified as a PFIC during any year due to the income test or asset test are not to be taken lightly. Pursuant to the special rule commonly known as "once a PFIC, always a PFIC", a corporation treated as a PFIC during one year with respect to a shareholder, will be treated as a PFIC indefinitely with respect to that shareholder. The shareholder may avoid this PFIC classification through the use of the § 1298(b)(2) start-up exception, or through the use of purging elections. The start-up exception provides that a corporation shall not be treated as a passive foreign investment company for the first taxable year such corporation has gross income if: (A) no predecessor of such corporation was a passive foreign investment company, (B) it is established to the satisfaction of the Secretary that such corporation will not be a passive foreign investment company for either of the first two taxable years following the start-up year, and (C) such corporation is not a passive foreign investment company for either of the first two taxable years following the start-up year.[10] This exception is very limited since most companies, which may be classified as PFICs in future years of operations, never contemplated that treatment since they are unaware of the PFIC regime during the company's early years.

A corporation that becomes classified as a PFIC may also make one of various purging elections to remove itself from PFIC status. The primary purging methods are known as the deemed dividend and deemed distribution methods. However, the compliance and potential legal fees associated with these elections are not cheap and come with a steep price tag.

As previously discussed, a QEF election in the first year would be a way to avoid any later PFIC regime application to the foreign corporation through the "once a PFIC always a PFIC" rule since this rule does not apply to a pedigreed QEF.[11] However, as mentioned earlier, QEF elections are difficult since they require data which companies are reluctant to surrender. Furthermore, active businesses do not contemplate ever being classified as a PFIC, either because they are unaware of the PFIC regime, or because they are an active business, and would therefore be unlikely to make a QEF election.

In order to avoid classification of active businesses as PFICs, we request that the Treasury consider the following proposals. First, with regard to QEF elections, the Treasury may consider classifying QEF elections, made outside of year 1, as pedigreed QEFs. Additionally, the Treasury should consider liberalizing the circumstances under which retroactive QEF elections may be made. These proposals would protect businesses abroad from being trapped by the "once a PFIC, always a PFIC" rule. Finally, the Treasury should consider departing from its interpretation in Notice 88-22 and redefine cash and liquid assets required, as working capital for the business in question, as non-passive. This would reduce the amount of PFIC classification for active foreign businesses.

VII. Third Proposal: Simplified PFIC Calculation for "Small" PFIC Holdings.

Given that the rules governing the taxation of a PFIC are a tangled maze of complexity beyond the capacity of most taxpayers (and many advisors), our final proposal contemplates relief in the form of a simplified calculation methodology for smaller PFIC investments. Modeled in part after the modified mark-to-market regime found in FAQ # 10 of the Offshore Voluntary Disclosure Program ("OVDP") and its predecessors, our proposal permits taxpayers with relatively small PFIC investments to elect out of the statutory rules, even if the PFIC is not "marketable" within the meaning of § 1296, provided that sufficient information is provided to track the annual change in value (the "Small PFIC Election"). For the purposes of our proposal, the Small PFIC Election applies only if a taxpayer's PFIC investments: (i) have an aggregate fair market value of Fifty Thousand Dollars ($50,000) or less; and (ii) have Ten Thousand Dollars ($10,000) or less of aggregate appreciation in each tax year prior to the year the election

[10] § 1298(b)(2)
[11] § 1298(b)(1)

is made. Permitting this simplified calculation methodology promotes two longstanding and important goals: (i) increasing voluntary compliance and (ii) minimizing revenue loss.

In our experience, many taxpayers simply do not realize they hold shares in a PFIC. In addition to foreign mutual funds discussed hereinabove, many of our clients own "managed" overseas bank accounts. Often, these accounts were opened for several years before the taxpayer immigrated to the United States. In other instances, the accounts are inherited. Almost universally, the account managers invest at least some portion of the taxpayer's funds in one or more investments that are properly classified as a PFIC. Even if the taxpayer properly identifies the investment as a PFIC, many bank statements fail to provide sufficient detail to allow the either a QEF or Mark-to-Market election.

The result is that taxpayers are left grappling with the byzantine rules under the excess distribution regime of § 1291. As noted above, taxpayers incur substantial costs, both in terms of time and professional fees, in properly reporting and paying tax on their PFIC investment. While there is a place for complexity, particularly in cases involving larger PFIC investments where deferral can result in significant revenue loss absent stern rules to the contrary, this complexity is unnecessary and counterproductive for smaller PFICs. In our experience, the statutory PFIC rules often result in the taxpayer incurring professional fees in excess of the PFIC inclusion, if any. This discourages voluntary compliance and, as a result, many PFICs go unreported resulting in lost revenue.

Our proposal adopts much of the framework set out in the OVDP[12]. Once made, the Small PFIC Election would apply to all small PFICs held by the taxpayer and would be irrevocable absent consent of the Secretary. PFIC gains, including gains on disposition, would be taxed a flat rate of 25%. This hybrid rate is a compromise of the more favorable tax rates if a QEF election is made and the ordinary income rates that apply following a statutory Mark-to-Market election. Losses would be limited to unreversed inclusions. If the investment qualified as a PFIC in any year preceding the Small PFIC Election, any unrecognized appreciation would be reported in the first year of the election. Once a taxpayer's aggregate PFIC investments exceeds the $50,000 threshold, or the annual increase in value in any single year exceeds $10,000[13], the Taxpayer would be required to report the PFIC in accordance with the statutory rules, including making a QEF or Mark-to-Market election at the time the PFIC graduates out of small PFIC status and otherwise qualifies to make such election.

This proposal simplifies the reporting and tax calculation requirements in several respects. First, it allows taxpayers holding relatively small investments to avoid dealing

[12] The authors recognize that the OVDP remains an option for taxpayers with unreported foreign income and undisclosed foreign financial assets. However, we believe this program is far too burdensome and time consuming for taxpayers whose issues relate solely to a failure to properly report their PFIC investments.
[13] Our proposal contemplates that the amount included in income in the first year of the Small PFIC Election may exceed $10,000, provided that the annual appreciation in tax years prior to such election did not exceed $10,000 in any single year.

with the complexities attendant to the excess distribution regime by providing an alternative to those unable to make a QEF election, either because they realize too late that their investment is a PFIC or because their investment does not supply the necessary information. Along the same lines, because this approach does not involve the detailed calculation and reporting requirements prescribed by the statutory PFIC methods, this approach saves taxpayers considerable time and expense and fosters increased compliance.

Further, because we are limiting the application the Small PFIC Election to relatively small PFIC investments, we believe the resulting revenue loss, if any, would be minimal. First, the 25% flat tax rate on Small PFIC represents a compromise on the appropriate tax rate applicable to PFIC investments. In many instances, taxpayers may pay more in tax under a Small PFIC Election than would otherwise be due if they were eligible to make a QEF election (though professional fees may be substantially less). Second, a simplified calculation methodology assists the IRS in its compliance initiatives. For instance, the Small PFIC Election will expedite the Service's review in an examination. Additionally, as taxpayers will be more likely to report their PFICs under a simplified methodology, the Small PFIC Election affords the Service another tool to track taxpayers PFICs as they increase in value.

VIII. Conclusion

The PFIC regime is complex and has widespread implications, which are burdensome to taxpayers from an economical and compliance perspective. The U.S. Department of Treasury should consider modifying the PFIC regime to take into consideration the real life implications of this regime on U.S. persons who hold small interests in foreign mutual funds, as well as active businesses that become entangled in this regime during an economic downturn or otherwise poor operating year from an income perspective. The PFIC rules in their current state are far reaching, overly broad, and unduly burdensome to the average taxpayers who find themselves classified as PFIC shareholders.