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FATCA and PFICs Are a Match Made in Heaven

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FATCA is the law that everyone seems to hate. Foreign financial institutions hate it for imposing an unheralded degree of reporting and compliance obligations on them, seemingly without regard to whether they conduct business in the United States. Foreign governments hate it for multiple reasons.

Some hate it for threatening to curtail the access of their local financial institutions to U.S. financial markets. Others hate it because it is yet another demonstration of the efforts of the U.S. government, particularly the IRS, to try to make everyone else around the world help them do their work. That rubs many the wrong way.

For individuals and businesses alike, the challenge of FATCA is more subtle. U.S. persons living abroad may find themselves less desirable by virtue of their American connections. Their American status will bring FATCA compliance to institutions. For that reason, some financial institutions will turn them away.

Other U.S. persons find that if they haven't yet started worldwide tax reporting and full disclosure to the U.S. government of their offshore assets, FATCA seals the deal and seems to make it inevitable that they must do so. After the success of its two earlier offshore voluntary disclosure programs in 2009 and 2011, the IRS announced a third Offshore Voluntary Disclosure Program (OVDP) in January 2012. In the current OVDP, the offshore penalty rate increased from 25 percent to 27.5 percent but the IRS did not establish any deadline or termination date for the program.

Instead, the IRS has announced that it can change the terms of the program at any time: increasing penalties, limiting eligibility to participate, or ending it entirely. In June 2012, IRS Commissioner Doug Shulman announced that the IRS had collected more than $5 billion in back taxes, interest, and penalties from 33,000 voluntary disclosures made under the first two programs. [*See* "IRS Says Offshore Effort Tops $5 Billion," IR-2012-64 (June 26, 2012).] For taxpayers, the primary selling

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point of the OVDP is the exemption from civil penalties and criminal liability for failing to file reports of Foreign Bank and Financial Accounts (Form TD F 90-22.1).

The civil penalty for willful failure to file an FBAR can be up to the higher of $100,000 or 50 percent of the total balance of each foreign account per violation. Even nonwillful violations (other than those due to reasonable cause) can lead to a penalty of as much as $10,000 per violation. Violations can be counted separately for each year and each account.

Therefore, a failure to report three accounts for three years could constitute nine separate violations. And a taxpayer may be criminally liable for a fine of up to $250,000 and five years of imprisonment for a willful FBAR violation.

Dark Clouds Gathering

The government recently scored a significant victory in its ability to impose FBAR penalties when the Fourth Circuit overturned a district court and held that a taxpayer "willfully" violated the FBAR rules when he deliberately turned a blind eye to his reporting requirement. [*See J.B. Williams*, CA-4, 2012-2 USTC ¶50,475 (2012).] This victory may make it easier for the IRS to impose "willful" FBAR penalties. Moreover, in many cases it is very difficult for taxpayers to satisfy the "reasonable cause" standard for FBAR penalties to be excused.

According to the IRS, factors that support reasonable cause include reliance upon the advice of a professional tax advisor who was aware of the foreign account. It is also important for there to be no efforts to conceal income or assets in the account. A legitimate purpose for establishing the account helps, as does no more than a *de minimis* tax deficiency. [*See* IRS Fact Sheet FS-2011-13 (Dec. 2011).]

Thus, if a taxpayer failed to reveal the account to his or her tax adviser or accountant, or if the taxpayer avoided a material tax liability due to failure to report income from the account, reasonable cause is almost certainly not available. Both of these circumstances are quite common. As such, the attendant risk of criminal liability and high civil penalties that accompany FBAR violations can provide strong incentives to participate in the OVDP.

Although the FBAR rules command the headlines, the OVDP also includes another significant enticement for taxpayers. The IRS found itself spending inordinate amounts of time dealing with the highly complex tax calculations for the passive foreign investment company (PFIC) investments of voluntary disclosure participants. In an effort to streamline the process and help resolve cases more expeditiously, the OVDP includes an alternative mark-to-market (MTM) regime for reporting investments in PFICs. [*See* Offshore Voluntary Disclosure Program FAQs (June 26, 2012), FAQ 10.]

This alternative regime includes a lower rate of tax on PFIC gain, yet it certainly does not possess the big-ticket appeal of the protection from FBAR penalties the OVDP ensures. Even so, it can be helpful, as we shall see.

Counterparts to Controlled Foreign Corporations

Congress originally passed the PFIC rules because of its concern that U.S. taxpayers were

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investing in offshore funds to defer tax on investment income and to convert ordinary investment income into capital gain. Before the PFIC rules, as long as the offshore fund was not a "controlled foreign corporation" (CDC), U.S. shareholders would not be taxed on the earnings of the offshore fund until they were distributed. Moreover, gain on the sale of stock in the offshore fund would be treated as capital gain, even if the offshore fund's earnings consisted of ordinary income.

An offshore fund is classified as a CDC if it is more than 50 percent owned by "U.S. shareholders." U.S. shareholders are U.S. persons who owned at least 10 percent of the voting stock of the foreign corporation. Thus, a foreign corporation would not be a CFC if it were owned by one U.S. shareholder who owned 50 percent of the voting stock, five other unrelated U.S. persons who each owned nine percent of the voting stock, and a seventh unrelated U.S. person who owned the remaining five percent of voting stock.

However, whether U.S. shareholders own the necessary voting power for a foreign corporation to be classified as a CFC is based on all the facts and circumstances. [Reg. §1.957-1(b)(1).] This can be worrisome. [*See, e.g., H.P. Kraus,* CA-2, 74-1 USTC ¶9168, 490 F2d 898 (1974) (U.S. shareholders who owned common stock with 50 percent of voting power were determined to control a foreign corporation when voting preferred stock with remaining 50 percent of voting power was merely a device to avoid CFC status, and when voting preferred shareholders were relatives, friends or business associates of the U.S. shareholders).]

Moreover, U.S. shareholders aretreated as owning a majority of the voting power of a foreign corporation if they have certain tie-breaking powers. [Reg. §1.957-1(b)(1). *But see Framatome Connecters USA, Inc.,* CA-2, 2004-2 USTC ¶50,364, 108 FedAppx 683 (2004) (Japanese corporation was not a CFC even though U.S. shareholder owned 50 percent of voting stock because U.S. shareholder lacked sufficient tie-breaking powers).] In the context of an offshore fund, which is typically organized to include a significant number of unrelated investors, it was generally not difficult to avoid the CFC regime. Congress responded to this perceived abuse by passing the PFIC rules under Internal Revenue Code Sections ("Code Secs.") 1291–1297 in 1986.

The PFIC Solution

The PFIC rules were passed as an additional set of anti-deferral rules to complement the CFC rules. Under these rules, gain from PFICs is generally taxed at ordinary income rates. [Code Sec. 1291(a)(2).] PFIC dividends do not qualify for the lower rate for qualified dividend income. [Code Sec. 1(h)(11)(C)(iii).] Moreover, under Code Sec. 1291, there is a punitive interest charge on PFIC gain and "excess distributions."

Under these rules, gain from the sale of a PFIC is allocated ratably to each day of the shareholder's holding period for the stock. Gain allocated to previous years is taxed at the highest tax rate in effect for that year. [Code Sec. 1291(c)(2).] Interest is charged on the corresponding tax liability from the time the return was due in the year of the allocation to the time the return was due in the year gain was recognized. [Code Sec. 1291(c)(3).]

By allocating gain ratably to each day of the holding period, the PFIC regime fails to take into account the law of compound returns. Instead, it over-allocates gain to earlier holding periods. Thus, under the statutory PFIC rules, not only is gain taxed at ordinary rates, but there is also a punitive interest charge that over-allocates gain to earlier periods.

This interest charge applies not only to *gain* from the sale of PFICs, but also to "excess distributions." Excess distributions are defined as the amount of total distributions during a year that exceed 125 percent of the average amount of distributions for the previous three years. [Code Sec. 1291(b)(2)(A).]

QEF Elections

To avoid the punitive interest charge, PFIC shareholders can make a "qualified electing fund" (QEF) election to treat the PFIC as a passthrough under Code Sec. 1295. Alternatively, they can make an MTM election under Code Sec. 1296. To make a QEF election, the PFIC must agree to provide its shareholders with a PFIC Annual Information Statement. [Reg. §1.1295-1(g).]

That information statement must include sufficient information for the PFIC's shareholders to calculate their *pro rata* share of the PFIC's ordinary earnings and net capital gain or loss for U.S. federal income tax purposes. Although the QEF rules impose an onerous burden on the PFIC to provide the annual statement, a QEF election carries a significant benefit. After all, gain from the sale of stock in a QEF qualifies as capital gain. [*See* Code Sec. 1291(d)(1).] However, in many cases, the QEF election is not available because the PFIC will not agree to provide a PFIC Annual Information Statement.

Even if a QEF election is not available, an MTM election may be. An MTM election is available if the PFIC stock is "marketable stock" as defined under Code Sec. 1296(e). Under an MTM election, the U.S. taxpayer is taxed on the excess of the fair market value (FMV) of the PFIC stock on the last day of the year over his or her adjusted basis in such stock. [Code Sec. 1296(a)(1).]

If the adjusted basis exceeds FMV, the taxpayer may deduct the difference, but only to the extent of any prior "unreversed inclusions." [Code Sec. 1296(a)(2).] In contrast to a QEF election, an MTM election does not require an information statement from the PFIC. However, its sole advantage is to avoid the punitive interest charge. That is, unlike gain under a QEF election, MTM gain is taxed at ordinary rates.

Applying U.S. Tax Principles to Foreign Corporations

In addition to the complex calculations required to determine the interest charge on gain and excess distributions, the definition of a PFIC has significant complexities. In general, under Code Sec. 1297(a), any foreign corporation is a PFIC if 75 percent or more of its gross income is passive income or if 50 percent or more of its assets are passive assets. To determine if a foreign corporation is a PFIC, it is first necessary to determine its gross income for U.S. federal income tax purposes and then to classify income into ordinary and passive baskets based on the PFIC rules.

Of course, most foreign corporations have no need to determine their gross income for U.S. federal income tax purposes. As a practical matter, this can make it very challenging to implement the PFIC test. Complicating matters further is the fact that the definition of "passive" income and assets can be overbroad.

Active Banking

Income and assets are generally classified as passive or active by cross-referencing the "Subpart F" rules for CFCs under Code Sec. 1297(b)(1). However, there is a special exception for banking income derived in the active conduct of a banking business and insurance income derived in the active conduct of an insurance business under Code Sec. 1297(b)(2). Thus, some of the most difficult issues for testing PFIC status arise in the context of banks, insurance companies, real estate companies and other financial institutions.

The IRS issued a Notice to provide guidance on what constitutes an active banking business. [*See* Notice 89-81, 1989-2 CB 399.] However, more than 26 years after the statute was passed, the IRS still has not issued final regulations. Indeed, as a recent report from the New York State Bar Association explained, the rules on qualifying as an active bank business are so clouded that it is not certain that major global banks such as Citigroup, RBS, JP Morgan and BNP Paribas are squarely within the active bank category. [NYSBA, Report Commenting on Select Issues with Respect to the Passive Foreign Investment Company Rules (Mar. 8, 2010), Report 1207.]

Real Estate Too

In many real estate companies, the management group is housed in a separate subsidiary distinct from the subsidiaries that own the real estate assets. This can create difficulties in the PFIC test, because the PFIC test is normally applied at the subsidiary level. Thus, if a subsidiary earns rental or lease income, it may be classified as passive income, even if a sister subsidiary is actively managing the property.

Foreign real estate corporations sensitive to the tax needs of U.S. investors are sometimes willing to address this issue by making a "check-the-box" election to treat all of their subsidiaries as disregarded entities. By electing to treat all subsidiaries as disregarded entities of the parent, the PFIC test is effectively applied on a consolidated basis. However, making a check-the-box election on Form 8832 for each separate subsidiary is not always a practical solution, particularly when the real estate company has tens or even hundreds of subsidiaries.

Moreover, many foreign real estate companies are reluctant to take on an ongoing and conceivably momentous U.S. tax compliance responsibility. Indeed, the company's only connection to the United States may be the minority U.S. shareholders that purchase shares of the company on the open market. For such a corporation, a "check-the-box" election might otherwise have no effect because it has no U.S.-source income or U.S. assets.

The PFIC rules are so formalistic that a check-the-box election that otherwise has no impact on a foreign corporation may nevertheless make the difference in escaping classification as a PFIC.

Special MTM Rules

The OVDP includes a special MTM regime for PFICs. It is based on the statutory MTM rules. For example, the amount of MTM gain or loss for a PFIC is calculated as the difference between the FMV of the PFIC investment on the last day of the year and the taxpayer's basis.

To elect the MTM regime, the taxpayer first determines his or her basis in each PFIC investment for the first year of the disclosure period based on the best available evidence. The taxpayer then computes net MTM gain for the first year of his or her disclosure period. In lieu of the interest charge on PFIC gain, an additional tax at a rate of seven percent of the tax computed for MTM gains in the first year of the disclosure period is added to the tax for that year.

The main benefit of the special MTM regime for PFIC investments is the special rate. OVDP participants are taxed at a rate of 20 percent for MTM gains and net gains from PFIC dispositions for *all* PFIC investments during the disclosure period. [*See* FAQ 10.] The tax rate of 20 precent is far below the top individual marginal tax rate of 35 percent from 2003 to 2012.

The difference in tax rate between the special MTM regime and the rate for PFICs outside the program is significant. It is not difficult to imagine a scenario in which a taxpayer with substantial gain from PFIC dispositions, and a relatively modest balance in an undisclosed foreign account, would pay *less* tax under the OVDP than outside it.

For example, suppose an individual recognized and reported $100,000 in PFIC gain in 2010. Assume that the individual paid total tax of $38,000 ($35,000 in tax plus $3,000 in interest charges). That individual also had an undisclosed foreign account whose highest aggregate balance was $70,000.

Because the highest aggregate balance of the undisclosed account was less than $75,000, the taxpayer qualifies for a reduced penalty rate of 12.5 percent, resulting in penalties of $8,750. [*See* FAQ 53.] However, the lower rate for PFIC gain would decrease the individual's tax liability on his PFIC gain in 2010 from $38,000 to $20,000. Because the statute has not yet expired on amending his 2010 tax return, the taxpayer should receive a tax refund of $18,000 plus interest that would more than offset his penalty of $8,750.

In allowing a beneficial rate for PFIC investments, the IRS apparently assumed that, in contrast to this example, PFIC assets would generally be included among the undisclosed foreign assets. If the PFIC stock is included in the undisclosed assets, a taxpayer would generally pay a higher rate under the OVDP. After all, the offshore penalty applies to the entire gross value of the account balance, not merely to gain.

However, the MTM rules apparently do not *only* apply when the PFIC assets are included among the undisclosed offshore assets. Indeed, the special MTM rate applies to "gains from *all* PFIC dispositions" during the disclosure period. [*See* FAQ 10 (emphasis added).] The IRS appears to be applying the special MTM rules broadly.

For example, in one case, an IRS agent conceded that the special rate applies to gain from PFICs with a short-term holding period. Therefore, if the special rate applies to short-term PFIC stock, it also appears to be available for gain from PFICs held in duly reported accounts.

Needed Reform

The PFIC rules include both a highly punitive tax regime and a complex test for determining PFIC status. Moreover, the test for determining PFIC status appears to be overly inclusive, particularly in the context of banks, insurance companies and real estate companies. Foreign corporations in these sectors sometimes have difficulty concluding that they are not PFICs, despite having hundreds or even thousands of employees engaged in complex businesses.

Of course, those with deep pockets such as hedge funds will have no difficulty in determining which of their portfolio investments are classified as PFICs. For example, Ernst & Young offers a product called the "PFIC Analyzer," which allows portfolio managers to determine which securities in their portfolio constitute PFICs. Yet the cost of the PFIC Analyzer may put it outside the range of the ordinary investor.

The IRS provided participants in the OVDP with a significant concession for their PFIC investments. The IRS explained its alternative approach as based on the difficulty and complexity of the statutory PFIC calculations. That is a fair point. Yet in offering a lower rate in their alternative MTM regime, the IRS seems to have recognized that the statutory regime can lead to unduly harsh results.

Perhaps the easiest reform that would achieve the anti-deferral goal while providing relief to ordinary investors would be to make a QEF election more widely available. After all, U.S. investors who agree to be taxed on a look-through basis no longer have the benefit of deferral. Unfortunately, many ordinary investors find it is virtually impossible to make a QEF election except in the relatively rare circumstances in which the company agrees to provide the necessary information.

U.K. Experience

The IRS may be able to learn something from the United Kingdom and its offshore fund tax regime. In 2009, the United Kingdom introduced a new "Reporting Funds" regime. These rules appear to have been far more successful in preventing U.K. shareholders from inappropriately deferring income, while avoiding harsh, punitive tax rules for these investments.

Under U.K. tax law, offshore funds are generally classified either as Reporting Funds or as Non–Reporting Funds. Similar to the QEF rules, investors in a Reporting Fund are taxed on the income of that offshore fund, regardless of whether that income is distributed. Moreover, like the QEF rules, gain on the sale of Reporting Funds qualifies as capital gain, while gain on the sale of Non–Reporting Funds is taxed at ordinary rates.

It appears that the main difference between the Reporting Fund regime and the QEF rules is that the Reporting Fund regime is much more widely available for U.K. investors. By comparison, the QEF election remains rare. Of course, it might not be difficult for the IRS to make the QEF election more widely available.

One approach might be to allow small shareholders (for example, less than five percent) to make a QEF election on the basis of the PFIC's financial statements. [*See* NYSBA, Report Commenting on Select Issues with Respect to the Passive Foreign Investment Company Rules (Mar. 8, 2010), Report 1207 (recommending that the QEF election be available on the basis of a PFIC's financial statement).] Taxpayers have sometimes invested in PFICs as part of a strategy to conceal their foreign assets and foreign income. However, this is clearly not the only reason for U.S. taxpayers to make PFIC investments. The array of investment options available today is unprecedented, and the tax rules should not be obstacles to investment.

Conclusion

PFICs are going away. The expansion of investment opportunities outside of the United States, the global mobility of U.S. citizens, and the ties of new citizens to their countries of birth are all factors at play. Indeed, in spite of tax considerations, U.S. taxpayers will surely continue to own substantial offshore assets. PFICs are sure to be included among them.

The IRS should consider ways to make it easier for these U.S. taxpayers to comply with the PFIC rules without suffering punitive results. Indeed, even the IRS has seemed to recognize that the statutory PFIC rules are overly harsh and complex. A few relatively simple changes to the PFIC rules could provide relief. For example, the IRS could expand the availability of the QEF regime, which would make it possible for ordinary investors to own offshore funds without suffering punitive tax consequences.