PFICs Are Here to Stay — and So Is FATCA

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In this article, Wood and Van Loo discuss passive foreign investment companies in light of the new 2012 offshore voluntary disclosure program (OVDP) and its appeals for taxpayers. In addition to the more well-known exemption from FBAR penalties, the OVDP provides an alternative mark-to-market tax regime for PFIC investments that is significantly more favorable than the statutory PFIC regime. The article reviews the genesis of the PFIC rules, compares the qualified electing fund election with the "reporting fund" regime in the United Kingdom, and offers suggestions for reform.

Everyone seems to hate the Foreign Account Tax Compliance Act. Foreign financial institutions hate it for imposing an unheralded degree of reporting and compliance obligations on them, seemingly without regard to the lack of U.S. business they may conduct. And 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 it do its work. That rubs many the wrong way.

For individuals and businesses, the challenge of FATCA is more subtle. U.S. persons living abroad may find themselves less desirable by virtue of their American connections and the FATCA compliance duties their American status brings to institutions with which they do business. 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 of their offshore assets to the U.S. government, FATCA seals the deal and seems to make it inevitable that they must do so.

Get With the Program

After the success of its two earlier offshore voluntary disclosure programs (OVDPs) in 2009 and 2011, the IRS announced a third one in January 2012. In the current OVDP, the offshore penalty rate increased from 25 to 27.5 percent, but the IRS did not establish any deadline or termination date.

Instead, the IRS has announced that it can change the terms of the program at any time by increasing penalties, limiting eligibility to participate, or ending it entirely. In June 2012 then-IRS Commissioner Douglas 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.[1] For taxpayers, the OVDP's primary selling point is the exemption from more draconian civil penalties and from criminal liability for failing to file foreign bank account reports.

Indeed, the civil penalty for willful failure to file an FBAR for tax years since October 22, 2004, can be up to the higher of $100,000 or 50 percent of the total balance of each foreign account per violation.[2] A willful violation is a "voluntary, intentional violation of a known legal duty."[3] Even non-willful violations (other than those attributable to reasonable cause) can lead to a penalty of as much as $10,000 per violation.[4] Violations can be counted

[1] *See* IR-2012-64.
[2] 31 U.S.C. section 5321(a)(5)(C).
[3] Internal Revenue Manual section 4.26.16.4.5.3.
[4] 31 U.S.C. section 5321(a)(5)(B). Violations attributable to reasonable cause may not be subject to any penalty.

separately for each year and each account. Therefore, a failure to report three accounts for three years could constitute as many as nine separate violations. And a taxpayer may be criminally liable for a fine of up to $250,000 and five years of imprisonment for each willful FBAR violation.[5]

Dark Clouds Gathering

The government recently scored a significant victory in its ability to impose FBAR penalties. 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.[6] This victory may make it easier for the IRS to impose ''willful'' penalties.

Moreover, in many cases it is 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 on the advice of a professional tax adviser who was aware of the foreign account. It is also important for there to be no effort to conceal income or assets in the account. A legitimate purpose for establishing the account helps, such as living abroad or spending a substantial amount of time in the country where the account is opened, as does no more than a de minimis tax deficiency.[7]

However, an FBAR that omits one or more foreign accounts tends to be a strong indicator of willfulness. Thus, selective or partial disclosure of foreign accounts can be a dangerous strategy. Reasonable cause is almost certainly unavailable if a taxpayer failed to reveal the account to his tax adviser or accountant, or if the taxpayer avoided a material tax liability because of his failure to report income from the account. Both of those circumstances are quite common.

Of course, these fact patterns are difficult for advisers, too. As with many multifactor tests, how to balance different factors is unclear. For instance, the Internal Revenue Manual explains that an omission of a foreign account on an FBAR may not lead to a willfulness penalty if the account was merely omitted because of an unintentional mistake.[8] It gives the example of an individual who omitted a foreign account that was already closed when the FBAR was submitted. Notably, all income was reported. However, what if the omitted foreign account had still been open when the FBAR was submitted? And what if the account generated a small amount of income that was not reported?

It appears that this might well be sufficient to rise to a willful violation. For that matter, it is unclear how to determine if the amount of income was de minimis or material, and whether there is an absolute or relative scale. Is $2,500 of omitted income de minimis for a taxpayer reporting $100,000 of income? Would it be different for a taxpayer with $700,000 of income?

To Opt Out or Not to Opt Out

The OVDP even has a mechanism for taxpayers who have second thoughts. If a taxpayer believes the mandatory 27.5 percent penalty is too severe, he can opt out and go through a regular audit.[9] This might happen, for example, because the OVDP penalty applies to *all* assets that were acquired with noncompliant funds, including art, patents, real estate, and other assets, even if those assets were not subject to any reporting requirements.[10] A taxpayer may balk at the size of the mandatory OVDP penalty and decide to opt out.

Why would a taxpayer participate in the OVDP only to opt out in the end? After all, as a condition of entering the OVDP, a taxpayer has to agree to extend the statute of limitations for FBARs and income tax returns. Moreover, the opt-out process is notorious for taking too long.[11] One reason may be that the taxpayer wants to avoid the risk of criminal liability or a willful FBAR civil penalty.

By entering the OVDP, the taxpayer has a chance to test the waters with the OVDP agent and get a sense of whether his situation might give rise to criminal liability or willful civil penalties. The uncertainty over which civil FBAR penalty would apply and the attendant risk of criminal liability that accompanies FBAR violations can provide strong incentives to participate in the OVDP. Yet the fear some taxpayers feel upon entering the OVDP can be replaced a year later with boldness because the taxpayer has come forward voluntarily, and with unhappiness at a 27.5 percent penalty that may have seemed entirely reasonable a year earlier.

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 tax calculations for the passive foreign investment company voluntary disclosure participant's investments. Determining the tax due on an ''excess

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[5] 31 U.S.C. section 5322(a).

[6] *See United States v. Williams*, No. 10-2230 (4th Cir. 2012).

[7] *See* FS-2011-13.

[8] *See* IRM section 4.26.16.4.5.3, Example 8.B.

[9] ''Offshore Voluntary Disclosure Program FAQs'' (OVDP FAQs) (June 26, 2012), FAQ 51.

[10] *Id*. at FAQs 35 and 36.

[11] *See* Nina Olson, ''National Taxpayer Advocate 2012 Annual Report to Congress'' (Dec. 31, 2012) (explaining that opt-out cases took an average of approximately 550 days to complete for the 2009 program).

distribution,'' including gain from the sale of PFIC stock,[12] requires a complex calculation.[13]

To streamline the process and help resolve cases faster, the OVDP includes an alternative mark-to-market (MTM) regime for reporting investments in PFICs.[14] This alternative regime includes a lower tax rate on PFIC gain. However, it certainly lacks the big-ticket appeal of the protection from FBAR penalties that the OVDP ensures. Even so, it can be helpful, as we shall see.

PFICs as Counterparts to CFCs

Congress originally passed the PFIC rules because of its concern that U.S. taxpayers were investing in offshore funds to defer tax on investment income and to convert ordinary investment income (such as dividends or interest) into capital gain. Before the PFIC rules, as long as the offshore fund was not a controlled foreign corporation, 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.

As long as an offshore fund was not owned more than 50 percent by U.S. shareholders, it would not be classified as a CFC.[15] U.S. shareholders were U.S. persons who owned at least 10 percent of the voting stock of the foreign corporation.[16] Thus, a foreign corporation would not be a CFC if, for example, it was owned by one U.S. shareholder who owned 50 percent of the voting stock, five other unrelated U.S. persons who each owned 9 percent of the voting stock, and a seventh unrelated U.S. person who owned the remaining 5 percent of the 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.[17] This can be worrisome. The IRS has successfully argued that some arrangements cause a foreign corporation to be treated as a CFC because U.S. shareholders exercised practical control over the foreign corporation.[18]

Also, U.S. shareholders will be treated as owning a majority of the voting power of a foreign corporation if they have specific tiebreaking powers.[19] In spite of those provisions, in the context of an offshore fund, which is typically organized to include many unrelated investors, it was generally easy to avoid the CFC regime. Congress responded to that perceived abuse by passing the PFIC rules under sections 1291 through 1297 in 1986.

The PFIC Solution

The PFIC rules were passed as an additional set of anti-deferral restrictions to complement the CFC rules. Under the PFIC rules, gain from PFICs is generally taxed at ordinary income tax rates.[20] PFIC dividends are not taxed at the lower rate that applies to qualified dividend income.[21] Moreover, under section 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.[22] 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 of the gain.[23]

By allocating gain ratably to each day of the holding period, the PFIC regime fails to take into account the law of compound returns. Therefore, it overallocates gain to earlier holding periods. So not only is gain taxed at ordinary rates, but there is also a punitive interest charge that overallocates 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 exceeds 125 percent of the average amount of distributions for the previous three years.[24]

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 section 1295. To make a QEF election, the PFIC must

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[12]*See* section 1291(a)(2).
[13]*See* section 1291(a)(1).
[14]*See* OVDP FAQs (June 26, 2012), FAQ 10.
[15]Section 957(a).
[16]Section 951(b).
[17]Reg. section 1.957-1(b)(1).
[18]*See, e.g.*, *Kraus v. Commissioner*, 490 F.2d 898 (2d Cir. 1974) (U.S. shareholders who owned common stock with 50 percent of the voting power were determined to control the foreign corporation when voting preferred stock with the 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).

[19]*See* reg. section 1.957-1(b)(1)(ii). *But see Framatome Connectors USA Inc. v. Commissioner*, Nos. 03-40119 and 03-40121 (2d Cir. 2004) (Japanese corporation was not a CFC even though a U.S. shareholder owned 50 percent of the voting stock, because the U.S. shareholder lacked sufficient tiebreaking powers).
[20]Section 1291(a)(2).
[21]Section 1(h)(11)(C)(iii).
[22]Section 1291(c)(2).
[23]Section 1291(c)(3).
[24]Section 1291(b)(2)(A).

agree to provide its shareholders with a PFIC annual information statement.[25]

That information statement must include a variety of detailed information, including: (1) the shareholders' pro rata share of the PFIC's ordinary earnings and net capital gain; (2) sufficient information for a shareholder to calculate his pro rata share of the PFIC's ordinary earnings and net capital gain; or (3) a statement that the PFIC has permitted the shareholder to examine its books and records to calculate his pro rata share of the PFIC's ordinary earnings and net capital gain for U.S. federal income tax purposes.[26]

On top of this burden to calculate its income according to U.S. federal income tax principles, a QEF must also generally provide its U.S. shareholders broad access to its books and records.[27] Despite these onerous requirements, which impose various burdens on a corporation that may have no connection to the United States other than some minority shareholders, a QEF election remains a compelling option for some PFICs. After all, gain from the sale of stock in a QEF qualifies as capital gain.[28]

If a QEF election is not available, an MTM election under section 1296 may be. An MTM election is available if the PFIC stock is marketable stock as defined under section 1296(e)(1). Under the MTM election, the U.S. taxpayer is taxed on the excess of the fair market value of the PFIC stock on the last day of the year over his adjusted basis in that stock.[29]

If the adjusted basis exceeds the FMV, the taxpayer may deduct the difference, but only to the extent of any prior "unreversed inclusions."[30] The MTM election has an advantage over the QEF election in that it does not require an information statement from the PFIC. However, in contrast to the QEF election, which allows shareholders to recognize capital gain both on a look-through basis and on the sale of QEF stock, *all* MTM gain is taxed at ordinary rates.

The QEF election has a further advantage in that it may offer an opportunity to defer tax. For example, assume that the value of a PFIC increases because of the appreciation in value of securities with a long-term holding period or an intangible asset (such as know-how or goodwill). As long as that asset is not sold or transferred in a taxable transaction, under the QEF election, no income should pass through to the shareholder. However, under the MTM election, the shareholder would generally have to recognize income each year as the value of the PFIC increased.

A shareholder of a PFIC must generally make a QEF election for a given tax year by filing Form 8621 with his tax return by the due date (including extension).[31] But what about taxpayers who already own PFICs? Many U.S. taxpayers have only recently become aware of the PFIC rules and may not have realized what punitive tax rules apply to their PFIC holdings.

One option is to create a pedigreed QEF by making a purging election.[32] However, under this election all unrealized gain is subject to tax under the punitive PFIC rules. Moreover, the election generally can be made only on an amended return filed within three years of the due date of the original return.[33] Thus, the purging election may generate an unacceptably high tax liability for holders of PFICs that have substantially appreciated in value.

A better option might be to make a retroactive election beyond the applicable three-year statute of limitations.[34] A retroactive election is generally available only for shareholders who believed at the time of acquiring their PFIC stock that the company was not a PFIC and filed the necessary protective election.[35] However, under some circumstances, a taxpayer may make a retroactive election even if he did not make the protective election.[36]

To satisfy the requirements for that special retroactive election, the taxpayer generally must: (1) show that he reasonably relied on a qualified tax professional who failed to advise him of the possibility of making a QEF election; (2) agree to pay all tax under the election, even for tax years closed by the statute of limitations; (3) request the election before the IRS raises the PFIC issue in an audit; and (4) obtain a ruling.[37] Although the requirements to make a retroactive QEF election are stringent, the IRS has granted many requests.[38]

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[25]Reg. section 1.1295-1(g)(1).

[26]Reg. section 1.1295-1(g)(1)(ii).

[27]Reg. section 1.1295-1(g)(1)(iv) (explaining that a QEF must provide either (1) a statement that the PFIC will permit the shareholder to examine its books and records to establish that the PFIC's income is calculated according to U.S. federal income tax principles, or (2) a description of an alternative documentation arrangement approved by the commissioner in a private letter ruling).

[28]*See* section 1291(d)(1).

[29]Section 1296(a)(1).

[30]Section 1296(a)(2).

[31]Reg. section 1.1295-1(e)(1).

[32]Section 1291(d)(2)(A).

[33]*See* reg. section 1.1291-10(c).

[34]*See* reg. section 1.1295-3(a).

[35]*See* reg. section 1.1295-3(b).

[36]Reg. section 1.1295-3(f)(1).

[37]*Id.*

[38]*See, e.g.*, LTR 201314026.

Defining a PFIC

The definition of a PFIC has significant complexities beyond the calculations required to determine the interest charges on gain and excess distributions. In general, under section 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 calculate its gross income for U.S. federal income tax purposes and to then classify the 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 challenging to implement the PFIC test. Complicating matters further is the fact that the definition of passive income and assets can be too broad.

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. Income and assets are generally classified as passive or active by cross-referencing the subpart F rules for CFCs under section 1297(b)(1). However, there is a special exception for banking income derived in the active conduct of a banking business and for insurance income derived in the active conduct of an insurance business under section 1297(b)(2).

Active Banking Notice

The IRS issued a notice to provide guidance on what constitutes an active banking business.[39] 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 banking business are so clouded that it is not certain that major global banks such as Citigroup, RBS, JPMorgan Chase, and BNP Paribas are squarely within the active bank category.[40]

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 check-the-box elections to treat all 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 who 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 in the OVDP

The OVDP includes a special MTM regime for PFICs[41] that 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 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 disclosure period. In lieu of the interest charge on PFIC gain, an additional tax at a rate of 7 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 OVDP 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.[42] The tax rate of 20 percent is far below the top individual marginal tax rate of 35 percent from 2003 to 2012.

The difference in tax rates between the special MTM regime and PFICs outside the program is significant. It is easy to imagine a scenario in which

[39] *See* Notice 89-81, 1989-2 C.B. 399.

[40] NYSBA, "Report Commenting on Select Issues With Respect to the Passive Foreign Investment Company Rules" (Mar. 8, 2010).

[41] OVDP FAQs (June 26, 2012), FAQ 10.

[42] *Id*.

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 $38,000 in total tax ($35,000 in tax plus $3,000 in interest charges). That individual also had an undisclosed foreign account of which the 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.[43] 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 of limitations 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 were 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 apply *only* 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 voluntary disclosure period under the OVDP.''[44] And 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. For most practitioners, 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 probably have no difficulty determining which of their portfolio investments are classified as PFICs. Ernst & Young LLP offers a product called the PFIC Analyzer, which allows portfolio managers to determine which securities in their portfolios constitute PFICs. Until the PFIC Analyzer is sold at Wal-Mart, its cost may put it outside the range of the ordinary investor.

The IRS provided OVDP participants 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. But by offering a lower rate in its alternative MTM regime, the IRS seems to have recognized that the statutory regime can lead to unduly harsh results.

Perhaps the easiest reform (one that would achieve the anti-deferral goal while providing relief to ordinary investors) would be to make the 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. Moreover, the IRS apparently has broad authority to modify the QEF rules without having to go to Congress.[45] Unfortunately, many ordinary investors find it is virtually impossible to make a QEF election except in the relatively rare circumstance when the company agrees to provide the necessary information.

The British 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.[46] Those rules appear to have been far more successful than the PFIC rules in preventing U.K. shareholders from inappropriately deferring income, while avoiding harsh, punitive tax rules for these investments.

Under U.K. tax law, the reporting funds regime applies broadly to offshore funds, defined generally as mutual funds that are resident or based in a country outside the United Kingdom.[47] Offshore funds are generally classified either as reporting or as non-reporting funds. In a fashion reminiscent of the QEF rules, investors in a reporting fund are

[43]*Id*. at FAQ 53.
[44]*Id*. at FAQ 10 (emphasis added).

[45]*See* section 1295(a)(2).
[46]*See* Offshore Funds Manual, *available at* http://www.hmrc.gov.uk/offshorefunds/offshore-funds-manual.pdf.
[47]*See* Offshore Funds Manual, OFM 02250, for a discussion of the definition of offshore funds.

taxed on the income of that offshore fund, regardless of whether that income is distributed.[48]

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. However, in contrast to the QEF regime, the reporting fund regime appears to be much more widely available for U.K. investors.

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, those who own less than 5 percent) to make a QEF election on the basis of the PFIC's financial statements.[49] Unfortunately, however, rather than becoming simpler, the QEF rules have recently become even *more* complex with the proposed regulations for the new Medicare tax on net investment income (NII) under section 1411.

In general, amounts that flow through to a U.S. taxpayer under a QEF election are not treated as a dividend or as capital gain for federal income tax purposes. Instead, they are separate items of income that may be passive income for some purposes but do not generally qualify as dividends or investment income.[50] Because of this feature of inclusions of income from a QEF, the IRS has concluded in proposed regulations that those inclusions are not subject to the new tax on NII until distributed.[51] This may make offshore investment funds that are treated as PFICs more attractive to U.S. investors, particularly if this structure enhances the ability of a U.S. investor to deduct management fees.[52]

It's worth mentioning that this arbitrage opportunity would also apparently introduce significant compliance complexity. Absent an election to treat those QEF inclusions as subject to the NII tax, QEF shareholders would generally be required to maintain a separate calculation of their basis in QEF stock for purposes of the NII tax.[53]

Some taxpayers may even have invested in PFICs as part of a strategy to conceal their foreign assets and foreign income. However, this is clearly not the only reason — and probably not even a significant reason — for U.S. taxpayers to make PFIC investments. The array of investment options available today is unprecedented. The tax rules should not be obstacles to those investments.

Conclusion

Clearly, PFICs are not going away. The expansion of investment opportunities outside the United States, the global mobility of U.S. citizens, and the ties of new citizens and U.S. residents to their countries of birth are all factors at play. Indeed, in spite of tax considerations, U.S. taxpayers will 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 too 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. But whatever happens, from Main Street to Wall Street, more and more taxpayers and their advisers will be dealing with these rules.

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[48]*See* Offshore Funds Manual, OFM 15550, for a description of the tax treatment of investors in reporting funds.

[49]*See* NYSBA, *supra* note 40 (recommending that the QEF election be available on the basis of a PFIC's financial statement).

[50]*See* LTR 201226004 (ruling that although PFIC inclusions did not qualify as dividend income, they qualified as qualifying income for purposes of the real estate investment trust rules under section 856(c)(5)(J)).

[51]*See* prop. reg. section 1.1411-10(c).

[52]*See* Peter J. Elias, ''Effect of the New Medicare Tax on U.S. Investors in Hedge Funds,'' *Tax Notes*, Feb. 25, 2013, p. 965.

[53]*See* prop. reg. section 1.1411-10(d).