March 8, 2019

LG “Chip” Harter
Deputy Assistant Secretary
Office of the International Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW, Room 3058
Washington, DC 20220

Submitted via email to: ITC@treasury.gov

Re: Personal Holding Company guidance

Dear Mr. Harter,

In 2010, the American College of Trust and Estate Counsel (“ACTEC”) submitted a memorandum setting forth proposals for guidance with respect to the coordination of the foreign corporation anti-deferral rules and subchapter J. As recent news reports indicate that this is a topic of current interest to the Treasury, we are taking the liberty of forwarding a copy of those 2010 comments to you.

ACTEC is a professional organization of approximately 2,500 lawyers from throughout the United States. Fellows of ACTEC are elected to membership by their peers on the basis of professional reputation and ability in the fields of trusts and estates and on the basis of having made substantial contributions to those fields through lecturing, writing, teaching, and bar activities. Fellows of ACTEC have extensive experience in providing advice to taxpayers on matters of federal taxes, with a focus on estate, gift and GST tax planning, fiduciary income tax planning, and compliance. ACTEC offers technical comments about the law and its effective administration, but does not take positions on matters of policy or political objectives.

If you or your staff would like to discuss the comments, please contact Ellen Harrison, at (301) 404-4736 or eharrison@mwe.com, Donald Kozusko, incoming Chair of the ACTEC Washington Affairs Committee, at (202) 457-7211 or dkozusko@kozlaw.com or Deborah McKinnon, ACTEC Executive Director, at (202) 684-8460 or domckinnon@actec.org.

Respectfully submitted,

Charles D. Fox IV, President

Attachments
American College of Trust and Estate Counsel ("ACTEC") Proposals for Guidance With Respect to the Coordination of the Foreign Corporation Anti-Deferral Rules and Subchapter J

The Internal Revenue Code of 1986, as amended (the "Code") contains rules to protect the right of the U.S. to tax U.S. citizens and residents on their worldwide income, including income that has been accumulated offshore. These rules prevent U.S. taxpayers from using foreign trusts and foreign corporations to avoid payment of U.S. tax. However, the rules overlap and create problems and inconsistencies when both foreign trusts and foreign corporations are involved.

This memorandum addresses certain aspects of the rules currently applicable to controlled foreign corporations ("CFCs") and passive foreign investment companies ("PFICs") that in some instances permit U.S. beneficiaries of trusts that hold interests in such entities to avoid or postpone taxation on income generated by such corporations and in other instances subject such beneficiaries to inappropriate income taxation on such income. It contains ACTEC's proposals for a regulatory approach to the coordination of the foreign corporate anti-deferral rules with the rules of Subchapter J that would ensure that the U.S. beneficiaries of foreign trusts that hold investments in foreign corporations are taxed in a manner that is more consistent with the objectives of the anti-deferral rules.1

Foreign trust tax rules

A foreign trust is subject to U.S. tax only on U.S. source income. However, U.S. persons who are the beneficiaries of foreign trusts are taxed on all of their worldwide income from the trust, either currently or at some future date when the accumulated income is finally distributed to them.

Various rules prevent or inhibit the use of foreign trusts to avoid U.S. income tax, or even to postpone tax. In particular, section 6792 treats as grantor trusts, owned by the grantor, foreign trusts created by U.S. persons if they have U.S. beneficiaries. This memorandum will deal only with the U.S. income taxation of foreign trusts that are not taxed as grantor trusts. Due to the broad application of section 679, in most cases such trusts will have been created either by non-U.S. grantors or by U.S. grantors who are deceased.

* The primary authors of this memorandum are Henry Christensen III, Ellen K. Harrison, Donald D. Kozusko and Edward C. Northwood. Anne O'Brien, Carlyn S. McCaffrey, and Ronald D. Aucutt provided helpful comments.


2 References in this memorandum to “section” or “sections” refer to sections of the Code.
Under the rules of Subchapter J of the Code, U.S. taxpayers have long been subject to tax on the worldwide income of foreign trusts when the income is distributed to them, even though the income is not taxed to the trust itself. Three principles apply to accomplish this end. First, under section 641(b) all trusts, whether domestic or foreign, are taxed in a manner similar to the manner in which individuals are taxed. Since 1997, section 641(b) has included a sentence making clear that a foreign trust will be treated as a nonresident alien individual not present in the U.S. at any time. Second, because the trust is treated as a nonresident alien individual not present in the U.S. at any time, foreign source income and U.S. source capital gains (with some exceptions) will not be taxed to a foreign trust, but will still be part of the income of the trust, computed under sections 641 and 643, and will be taxed to U.S. beneficiaries when distributed to them from the foreign trust. Because of the modification to the distributable net income (“DNI”) rules under section 643(a)(6) for foreign trusts, all income collected from any source by the trust, including foreign source income, will be included in the trust’s DNI and therefore will be carried out to U.S. beneficiaries as part of any distribution to the beneficiary, even though the same income would not have been taxed by the U.S. to the trust itself.

Third, and most importantly for this discussion, sections 665 et seq. of the Code impose a tax (the accumulation distribution tax) on distributions to U.S. beneficiaries from foreign nongrantor trusts that are deemed to come out of undistributed net income (“UNI”). UNI is the trust’s DNI for prior years minus income deemed distributed to beneficiaries in prior years. While foreign source income that is accumulated in a foreign nongrantor trust is not taxed currently by the U.S., either to the trust or the beneficiaries, the benefit of deferral is taken away by the accumulation distribution tax. First, the accumulation distribution is taxed as ordinary income regardless of the character of the accumulated income (unless the accumulated income was tax exempt income); most importantly, capital gains that become UNI will be taxable as ordinary income when distributed to U.S. beneficiaries. Second, a U.S. beneficiary who receives UNI is taxed at a rate equal to the average marginal tax rate of the beneficiary for the prior five years, the UNI is allocated to the taxable years in which it was deemed to have been accumulated in the foreign trust and an interest charge is applied on the tax allocated to each such year, to appropriately charge the taxpayer and recompense the Treasury for any deferral in collecting a tax. The interest charge eliminates the benefit of deferring the time for payment of tax on foreign source income accumulated in a foreign nongrantor trust.

However, the operation of the accumulation distribution tax may be undermined by the use of foreign holding companies. If a foreign nongrantor trust invests through or in a foreign holding

3  Code §665(a) reduces UNI by the amount of income taxes imposed on the trust but a distribution of UNI carries out taxes attributable to that income and the beneficiary is allowed to credit the accumulation distribution tax by the amount of income tax imposed on the trust that is allocated to such beneficiary. Code §§666(c) and 667(d).
4  Code §667(a).
5  Code §§667(b) and 668.
6  References in this memorandum to “foreign holding companies” refer to corporations organized under the laws of a nation other than the U.S. or a political subdivision of the U.S. As discussed below in more detail, such companies may be either controlled foreign corporations or passive foreign investment companies.
company, the trust will not have any taxable income until either the holding company makes a
distribution to the trust or the trust sells the shares of the holding company. If the holding company
makes distributions to the foreign trust which the trust in turn distributes currently to the U.S.
beneficiaries, then, in our view, it would be appropriate to tax the income accumulated in the
holding company in prior years, as PFIC income to the U.S. beneficiaries. But while we believe it
appropriate to tax the distribution as PFIC income, unless Treasury adopts a clarifying regulation, at
present the distribution from the holding company cannot be taxed as UNI because it constitutes
current income, not UNI. If the holding company liquidates into, or makes a distribution to the
foreign trust and the trust makes no current distribution to its U.S. beneficiaries, it is not clear
whether any of the U.S. beneficiaries would be subject to current tax on the event.

We propose that this potential loophole be closed by adopting a rule that the DNI of a foreign
nongrantor trust be calculated by treating income that was accumulated in the foreign holding
company owned by the trust as income of the trust when it is distributed by the foreign holding
company, and then taxing it through to the U.S. beneficiaries when distributed to them under the
rules of Subchapter J. This rule would be consistent with Congressional intent and Treasury's
statement in 1992, that the PFIC rules should be harmonized with Subchapter J rules, and that the
Subchapter J approach of delaying tax until a U.S. person receives an actual distribution should
prevail.

One way to reconcile the rules of Subchapter J with the PFIC tax regime would be to calculate
the DNI of the trust by applying the same rules that apply to U.S. taxpayers who own shares of
PFICs, which are discussed below. These rules currently do not apply to a foreign nongrantor trust
because it is not a U.S. taxpayer. If those rules applied, broadly speaking, the income of the PFIC
would enter into the computation of DNI of the trust for the year the income accrued to the holding
company in the same fashion as if the foreign trust were a U.S. taxpayer, and be added to the trust's
DNI for each year that the trust owned shares of the PFIC, and thus would be part of the trust's UNI.
Under such a rule, when the trust received a distribution from the holding company and made a
distribution to a U.S. beneficiary in the same year, a portion of that income would be treated as UNI
and the accumulation distribution tax would apply to that portion.

Another way to reconcile the rules of Subchapter J with the PFIC tax regime would be to tack the
holding period of income accumulated in PFICs owned by foreign trusts to the period in which
the UNI is held by the trust itself. Both alternatives are discussed below.

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7 Code §665(b) provides that if the amounts distributed do not exceed the income of the trust for such year, there shall
be no accumulation distribution. Code §643(b) defines “income” as fiduciary accounting income.
8 Congress intended, when a U.S. shareholder directly owned shares in a passive foreign investment company, that the
PFIC rules would track the Subchapter J accumulation distribution rules, and postpone tax until a U.S. person received an
actual distribution, General Explanation of the Tax Reform of 1986 prepared by the Staff of the Joint Committee on Taxation,
May 4, 1987 (the “Blue Book”), at p. 1032. The preamble to the PFIC regulations proposed by Treasury in 1992 states:
“Pursuant to section 1291, a U.S. person that is a shareholder of a section 1291 fund pays tax and an interest charge on receipt
of certain distributions and upon disposition of stock of the section 1291 fund.” 1992-1 CB 1124, at 1125.
9 Preamble to proposed Treasury regulations, 1992-1 C.B. 1124, at 1127.
We suggest that these rules apply in lieu of rules that have been proposed to date to treat U.S. beneficiaries of foreign nongrantor trusts as the indirect owners of the shares of PFICs owned by the trust in proportion to their beneficial interests in the trust. These indirect ownership rules, discussed below, are not workable when the beneficiary does not control the trust assets, when different beneficiaries are entitled to income and principal and when the interests of the trust beneficiaries are not fixed, clear and vested, which is the typical case. As a result, these rules have not been effective. Treasury’s current indirect ownership rules create problems with both fairness and administrability, including the following:

1. Beneficiaries of foreign trusts usually do not control the distribution of income from a foreign holding company or from the trust and may not even know what investments the trust owns.

2. Certain elections available to U.S. shareholders of PFICs may not be available to a U.S. beneficiary (at least as a practical matter).

3. The exclusion from income allowed to the U.S. shareholder of a PFIC that was previously taxed to such shareholder will not work properly if income is imputed to a U.S. beneficiary and that income is actually received by another person (or retained in the trust).

4. The application of the accumulation distribution tax and the corporate anti-avoidance taxes, discussed below, to the same amounts needs to be coordinated.

These problems can all be avoided by adopting any of the rules we recommend. We do not necessarily favor any one of our recommendations herein over the others, or over any alternative proposal that Treasury may develop. But a workable, fair set of rules must be developed.

If the use of PFICs to undermine the accumulation distribution tax can be curtailed by any of the methods we propose, there would be no need to tax currently changes in ownership of shares of PFICs owned by foreign nongrantor trusts to their U.S. beneficiaries in order to prevent “free” deferral of U.S. tax. Deferral is not “free” and it is not abusive when an appropriate interest charge is imposed in consideration of the deferral of tax payments.\(^\text{10}\) The accumulation distribution tax regime should be expanded and the imputation of current tax to indirect ownership of shares of investment companies owned by foreign nongrantor trusts should be limited, we think appropriately, to the rare cases when a U.S. beneficiary of a foreign nongrantor trust actually or in effect controls trust investments. Of course, U.S. grantors of foreign grantor trusts would continue to be subject to the corporate anti-avoidance rules.

Although we acknowledge that Treasury’s present approach to the indirect ownership rules, if it were effective, would be likely to expose the income of PFICs to U.S. tax sooner than the rules we propose, we think the present indirect ownership rules are not effective. Any of the rules we propose would likely result in a workable solution by imposing an interest charge on tax attributable to the distribution of income accumulated in PFICs owned by foreign nongrantor trusts.

\(^\text{10}\) See, e.g. Code §1294 allowing a shareholder of a PFIC who has made a QEF election to defer payment of tax.
Moreover, there is little logic to allowing deferral of tax on income accruing directly to a foreign trust under the trust rules, or of allowing deferral of tax on income accruing to a PFIC whose shares are held directly by a U.S. shareholder, until there is a distribution to or a disposition by the U.S. beneficiary/shareholder, and denying such deferral to beneficiaries of foreign trusts that invest in PFICs. There are good nontax reasons for investing through PFICs and the different tax treatment merely traps U.S. beneficiaries who are served by ill advised trustees. In many cases the indirect ownership rules can be avoided by making a check-the-box election for the company to be treated as a flow-through entity. However, a foreign trustee may not be aware of the problem and potential solution.

We are not suggesting abandonment of the indirect ownership rules where a foreign trust owns an interest in a foreign holding company. Our recommendations go to establishing sound taxing rules, not to abandoning indirect ownership rules. Thus, the provisions of section 958(a)(2) and section 1298(a)(3) should be enforced in accordance with their terms, although we believe that a proper application of the “facts and circumstances” test of Treasury regulation § 1.958-1(c)(2) would defer, or make only tentative, an attribution of an interest in a foreign holding company to a U.S. person whose interest in the foreign trust is not clear and vested. What we are suggesting, however, is that the taxing rules of section 951(a) and section 1298(b)(5) be conformed to the principles of Subchapter J.

The corporate anti-avoidance rules

There are two sets of corporate anti-avoidance rules – one for CFCs and one for PFICs.

CFC rules

A foreign corporation is a CFC if “U.S. shareholders” own more than 50% of the total combined voting power or more than 50% of the total value of the stock of the company. For this purpose, a “U.S. shareholder” is a person who owns 10% or more of the total combined voting power of the corporation. If a corporation is a CFC, then each “U.S. shareholder” is required to include in income his or her share of the “subpart F income” of the CFC. A U.S. taxpayer who does not own at least 10% of the voting stock is not a “U.S. shareholder” for purposes of this rule and therefore is not taxed on subpart F income that is not actually distributed to him or her. Subpart F income includes most passive type income. To prevent taxing the same income twice, section 959 provides that a shareholder is not taxed on receipt of a distribution of previously taxed income, and his or her basis in the shares is increased by the income that is taxed to him or her (and reduced by distributions of such previously taxed income) so that any gain realized on the disposition of shares is reduced by undistributed previously taxed income. Upon a disposition of shares, any gain that represents accumulated earnings and profits is taxed as ordinary income.

11 Code §957(a).
12 Code §951(b).
13 Code §951(a).
For purposes of determining whether a corporation is a CFC and whether a person is a U.S. shareholder, a U.S. person is treated as owning stock owned directly, indirectly or constructively. However, for purposes of imposing tax on a U.S. shareholder, only shares owned directly or indirectly (not constructively) are counted.

Taxing owners of voting shares when U.S. owners who each own at least 10% of the shares collectively own more than 50% of the voting stock makes sense because such persons, acting collectively, can compel the corporation to distribute funds to them to cover the tax attributable to their shares of CFC income. In addition, they can dispose of their shares. In most cases, it does not make sense to treat a U.S. beneficiary of a foreign nongrantor trust as an indirect U.S. shareholder for purposes of the CFC rules because he or she does not have any power to compel the payment of dividends or to force a sale of the stock held by the trust. If such beneficiary directly owned nonvoting shares, he or she would not be treated as a U.S. shareholder for purposes of the CFC rules, and it is inconsistent to treat a trust beneficiary who lacks voting rights less favorably. In fact, the person who owns nonvoting shares should be treated less favorably than a beneficiary of a foreign trust since the person who owns nonvoting shares has the option to sell or dispose of such shares. By contrast, the beneficiary has no recourse to avoid being taxed on income he or she has not received and may never receive.

It is important to recognize that a U.S. person cannot create a foreign trust to defer tax on his or her own, or his or her family’s beneficial interest in income earned by a foreign investment company owned by the foreign trust. Section 679 would apply to make the trust a grantor trust. Thus, the concern is limited to trusts created by non-U.S. grantors or U.S. grantors who are no longer living. The beneficiaries of such trusts generally have no control over distributions. This is why sections 665-668 tax the U.S. beneficiary only when he or she receives a distribution from the trust and impose an appropriate interest charge.

A U.S. beneficiary of a foreign nongrantor trust is deemed to own shares of a company owned by a foreign trust in proportion to his or her beneficial interest in the trust. Section 958(a)(2) provides that “stock owned, directly or indirectly, by or for a ... foreign trust or foreign estate ... shall be treated as being owned proportionately by its ... beneficiaries. Stock considered to be owned by a person by reason of the application of the preceding sentence shall, for purposes of applying such sentence, be treated as actually owned by such person.” Treasury regulation §1.958-1(b) provides that for purposes of the indirect ownership rules of section 958(a), stock owned by a foreign trust or foreign estate shall be considered as owned proportionately by its grantors or other persons treated as owners under sections 671 through 679 of any portion of the trust that includes the stock, or by the beneficiaries in the case of foreign nongrantor trusts. Treasury regulation §1.958-1(c)(2) provides that

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14 Code §957(a) provides that for purposes of determining whether a corporation is a CFC, stock is treated as owned by applying both the indirect and constructive ownership rules of Code §958.

15 Code §951(a) provides that income is attributed to a person who owns the shares or is treated as owning the shares indirectly by virtue of Code §958(a). The statute excludes ownership through §958(b)’s constructive ownership rules.

16 Code §958
The determination of a person’s proportionate interest in a foreign trust or foreign estate will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person’s proportionate interest in a foreign corporation, the purpose for which the rules of section 958(a) are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person’s proportionate interest in a foreign corporation will generally be determined with reference to such person’s interest in the income of such corporation.

If the issue is whether the income accruing to the corporation should be taxed to a beneficiary, only the interests of income beneficiaries and not remainder beneficiaries should be considered. The regulation further provides that “If the rules of section 958(a) are being applied to determine the amount of voting power owned for purposes of section 951(b) or 957, a person’s proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person.” This portion of the regulation should be construed to mean that a beneficiary who lacks voting power over the shares held by a foreign trust will not be considered to indirectly own the shares for purposes of determining whether he or she is a U.S. shareholder.

For purposes of the constructive ownership rules of section 958(b), Treasury regulation §1.958-2(c)(1)(ii) provides that stock owned by a trust shall be considered to be owned by the persons treated as the owners under sections 671-679 in the case of grantor trusts or, for nongrantor trusts, in proportion to the beneficiaries’ actuarial interests in such trust. However, a person who has been attributed constructive ownership who does not have indirect ownership is not a “U.S. shareholder” liable to tax under section 951(a).

Example (3) of Treasury regulation §1.958-1(d) illustrates indirect ownership through a foreign trust. Example (3) is as follows:

Foreign trust Z was created for the benefit of U.S. persons D, E, and F. Under the terms of the trust instrument, the trust income is required to be divided into three equal shares. Each beneficiary’s share of the income may either be accumulated for him or distributed to him in the discretion of the trustee. In 1970, the trust is to terminate and there is to be paid over to each beneficiary the accumulated income applicable to his share and one-third of the corpus. The corpus of trust Z is composed of 90 percent of the one class of stock in foreign corporation S. By the application of this section, each of D, E and F is considered to own 30 percent (1/3 of 90 percent) of the stock in S Corporation.

We think that this example should be narrowly applied. It involved a short-term fixed interest trust with vested remainders; the regulation was adopted in 1966 and by the terms of the example the trust was to terminate in 1970 and all of the assets were required to be distributed to
the named income beneficiaries. In such a case, we believe that the trustee would be violating a fiduciary duty to the beneficiaries by failing to distribute amounts at least sufficient to cover the beneficiary’s tax attributable to trust income. If such a fiduciary duty exists, in practical effect the beneficiaries have sufficient indirect control over distributions to justify their being taxed currently on the subpart F income of the investment company under a theory akin to constructive receipt principles. Only in such narrow circumstances is it reasonable and consistent with the assumption underlying the CFC rules that U.S. shareholders effectively control the CFC to tax beneficiaries on a share of CFC income. In addition, because the beneficiaries’ interests in the example were vested, there is no risk that the beneficiaries (or their estates if they died prior to the termination of the trust) would not actually receive the income on which they paid tax. Therefore, the CFC rules excluding previously taxed income from tax when distributed (discussed below) would work appropriately.

Nevertheless, even if D, E and F lack voting rights, as they almost surely do, we believe the right result is reached by the example, as long as the interests are vested.

Section 959 provides a mechanism for avoiding double tax when a shareholder receives previously taxed income from a CFC. Section 959 provides that earnings and profits of a foreign corporation attributable to amounts that are or have been included in the gross income of a U.S. shareholder under section 951(a) shall not, when such amounts are distributed through a chain of ownership described in section 958(a), be included in the gross income of such shareholder or any other U.S. person who acquires from any person any portion of the interest of such U.S. shareholder in such foreign corporation. Section 959 would apply fairly to the facts of Example 3 in Treasury regulation § 1.958-1(d) when the income was later distributed to D, E or F or their estates. But how is that mechanism to apply when a beneficiary of a trust receives a distribution of income previously taxed to another person?

For example, suppose that a foreign trust is established for the life income benefit of H and on his death the trust terminates and its assets are distributed outright in equal shares to A, B and C. Assume further that the CFC’s net income over several years includes substantial “foreign personal holding company income” defined in section 954(c) that is not distributed by the CFC and would be properly allocable to principal of the foreign trust were it to be distributed to the foreign trust by the CFC. Taxing that income to H when it is never going to inure to the benefit of H is unreasonable and unfair. That unfairness is not eliminated by allowing A, B and C (or any ultimate

17 The example does not expressly state that the beneficiaries’ interests in the trust are vested, but we believe that to be the fair reading of the facts.
discretionary beneficiaries who receive the trust principal) to exclude from income amounts previously taxed to H when they receive the money, particularly if there is no reason to believe that H would want to benefit A, B or C.

In some cases the application of the section 959 exclusion would be very complicated. For example, assume in the above example that upon H’s death, the assets were to be retained in a wholly discretionary trust for the benefit of A, B and C and their descendants. Suppose that the trust made no distributions for five years and then made a distribution to A. Would the DNI/UNI of the foreign trust be calculated by excluding from trust income the income previously taxed to H? If not, then upon a distribution to A, the previously taxed income would be taxed again. If the income is excluded in the calculation of DNI/UNI, then how is the excluded amount apportioned among A, B and C?

Section 961 and Treasury regulation §1.961-1 provide that a U.S. shareholder’s basis in his or her shares is increased by the amount the shareholder is required to include in income under section 951(a) and reduced by the amount of distributions of previously taxed income that is excluded from income under section 959. If a U.S. shareholder indirectly owns shares through a trust or estate, Treasury regulation §1.961-1(b)(1) provides that the basis of his or her beneficial interest in the foreign estate or trust is adjusted. According to this regulation, if income is taxable to beneficiaries under section 951(a) but not distributed, the trust may not increase its basis in the shares of the CFC. The adjustment of the basis of a beneficiary’s beneficial interest in the foreign trust is ineffective to avoid double tax. Basis in a trust or estate generally is meaningless in the rules governing the taxation of trusts and estates. Basis does not affect the determination of a beneficiary’s share of income derived from the trust or estate. Rather, a beneficiary is taxed on his or her share of trust or estate income, and a beneficiary’s basis in his or her beneficial interest would not enter into the calculation of trust or estate income.

Our recommendation is that foreign trusts owning shares in corporations that would be classified as CFCs be treated as owning shares in PFICs, and not CFCs, except in the rare and limited circumstance that (1) the U.S. beneficiaries serve as trustees or co-trustees, (2) the U.S. beneficiaries have the right to remove and replace the trustee of the foreign trust with trustees subservient to them, or (3) the interests of the U.S. beneficiaries, in all classes of income, are so fixed, clear and vested that the trustee of the foreign trust would have a fiduciary duty to distribute the income of the foreign investment company currently to the U.S. beneficiaries, and not accumulate it in the corporation.

PFIC rules

A foreign corporation is a PFIC if 75% or more of the gross income of such corporation is passive income or the average percentage of assets held by such corporation which produce passive income or which are held for the production of passive income is at least 50 percent.18 The PFIC rules were adopted in the Tax Reform Act of 1986 because Congress recognized that while income

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18 Code §1297(a)
accumulated in foreign trusts was being taxed to the U.S. beneficiaries with an appropriate interest charge, income being accumulated in foreign corporations was not being appropriately taxed to the less than 10% U.S. shareholders. Instead, they could effectively dispose of their shares at capital gains tax rates after years of accumulating income in the foreign investment company.\(^{19}\)

As originally passed in the House bill, the new provisions would have subjected less than 10% shareholders to current tax on accumulated passive income in foreign investment companies. The Senate, noting with approval the operation of the foreign trust rules, which delayed imposition of tax until a beneficiary actually received a distribution, but then imposed tax with an appropriate interest charge to compensate the Treasury for the delay in payment of taxes, amended the House bill to apply to foreign investment companies a regime similar to the Subchapter J regime. With modifications, the Senate approach became law.

A U.S. shareholder of a PFIC is not taxed currently on PFIC income unless certain elections are made. Instead, a regime similar to the accumulation distribution tax applies when a U.S. shareholder receives (or is deemed to receive) an “excess distribution.” An excess distribution is (i) a distribution that exceeds 125% of the average distributions received in the prior three years; and (ii) gain realized on a disposition (or gain deemed realized on a disposition) of PFIC shares. Certain nontaxable transfers are treated as generating an excess distribution equal to the excess of fair market value of the shares over basis.\(^{20}\)

The PFIC rules apply regardless of the percentage of ownership of shares held by U.S. persons. Because control of the PFIC is not important to the application of the PFIC rules, the fact that a beneficiary of a trust does not control the trust investments is not important to the application of the PFIC rules to trust beneficiaries. However, a corporation may be both a CFC and PFIC. In that case, the CFC rules take precedence.\(^{21}\)

When a U.S. person receives or is treated as receiving an excess distribution, the excess distribution is allocated equally to all prior years in the person’s holding period, tax is calculated for each such year and an interest charge is imposed on the tax allocated to each prior year for the number of years between the tax due date for each such year and the date the tax is paid.\(^{22}\)

A U.S. person may avoid the excess distribution tax regime by making certain elections. One election is the “qualified electing fund” or “QEF” election. Under this election, which is only available if the PFIC agrees to provide the necessary tax information to shareholders, the U.S. shareholder includes in his or her income his or her share of PFIC income as it accrues. If this election is made, the character of the income to the shareholder is the same as the character of the income realized by the PFIC. Capital gain income, for example, retains its character. The


\(^{20}\) Code §1291.

\(^{21}\) Code §§951(c) and 1297(d).

\(^{22}\) Code §1291.
distribution of previously taxed income is not taxed again and a U.S. shareholder’s basis in the PFIC shares is adjusted for the income taken into account under the QEF election.\textsuperscript{23} In addition, a U.S. shareholder may elect to defer the payment of tax on income imputed under a QEF election, but interest accrues on the deferred tax.\textsuperscript{24}

A second election is the mark-to-market election, which is available only for publicly traded securities. Under the mark-to-market election, the U.S. shareholder includes in his or her income annual appreciation in the market value of securities and is entitled to a loss if the value declines, to the extent of appreciation previously included in income. As under the QEF election, the basis of the PFIC shares is adjusted for the appreciation or depreciation taken into account under the mark-to-market elections.\textsuperscript{25}

Shares of an investment company held by a nonresident alien are not treated as PFIC shares. Only a U.S. person is treated as a PFIC shareholder.\textsuperscript{26} Thus, a U.S. person’s holding period of PFIC shares does not include the holding period of the shares when they were previously owned by a nonresident alien because the shares were not PFIC shares in the hands of the nonresident alien owner. Similarly, a corporation is not treated as a PFIC with respect to a shareholder for those days included in the shareholder’s holding period before the shareholder became a U.S. person.\textsuperscript{27} While this rule is correct as a matter of tax policy for shares that are owned by a nonresident alien individual, this rule should not apply to shares owned by a foreign trust, even though a foreign trust is taxed like a nonresident alien individual, because application of this rule to a foreign trust would undermine the application of the accumulation distribution tax rules, as discussed below.

A U.S. person is treated as indirectly owning shares of a PFIC held by a foreign nongrantor trust of which he or she is a beneficiary in proportion to his or her beneficial interest.\textsuperscript{28} The definition of indirect ownership is identical to the definition used for a CFC. Proposed Treasury regulation §1.1298-1(b)(8) defines an indirect shareholder as a person who is treated as owning the stock of a corporation that is owned by another person (the actual owner) under this paragraph. In applying this paragraph, the proposed regulation provides that the determination of a person’s indirect ownership is made on the basis of all the facts and circumstances in each case; the substance rather than the form of ownership controls, taking into account the purposes of section 1291. Paragraph (8) cross references Treasury regulation §1.958-1(c)(2). Proposed Treasury regulation §1.1291-1(b)(8)(iii)(C) provides that the beneficiaries of an estate or trust that owns stock of a corporation will be deemed to own “a proportionate amount” of such stock.

\begin{itemize}
  \item \textsuperscript{23} Code §1293.
  \item \textsuperscript{24} Code §1294.
  \item \textsuperscript{25} Code §1296.
  \item \textsuperscript{26} Treasury regulation §1.1291-9(j)(1), which defines a PFIC, provides “A corporation will not be treated as a PFIC with respect to a shareholder for those days included in the shareholder’s holding period when the shareholder, or a person whose holding period of the stock is included in the shareholder’s holding period, was not a U.S. person within the meaning of section 7701(a)(30).”
  \item \textsuperscript{27} Proposed Treasury regulation §1.1291-1(b)(1)(i).
  \item \textsuperscript{28} Code §1298(a)(3).
\end{itemize}
Unlike the CFC rules, the proposed regulations do not limit indirect ownership rules to shares held by foreign entities. The application of the indirect ownership rules to shares held by domestic entities seems to be unintended because other PFIC regulations recognize the domestic pass through entity as the shareholder, e.g. for purposes of making a QEF or mark-to-market election. It serves no apparent purpose to impute ownership from a domestic trust to a U.S. beneficiary, since the PFIC tax regime would apply to the U.S. trust itself. In addition, section 1298(a)(1) (B) implies that this should not be the case. Section 1298(a)(1) (B) provides that “except to the extent provided in regulations, [attribution of ownership] shall not apply to treat stock owned (or treated as owned under this subsection) by a United States person as owned by any other person.” Because a domestic trust is a U.S. person, ownership of corporate shares held by a domestic trust should not be attributed to any other person, including a beneficiary of such trust. The PFIC regulations should be changed to prevent the application of the indirect ownership rules to PFIC shares held by domestic entities.

When a person is treated as indirectly owning shares owned by an entity, including a trust, a transaction that results in a reduction of his or her indirect ownership of PFIC shares may be treated as a disposition of those shares. Section 1298(b)(5) provides:

(A) IN GENERAL. – Under regulations, in any case in which a United States person is treated as owning stock in a passive foreign investment company by reason of subsection (a) [providing that beneficiaries are treated as owning proportionately shares owned by a trust] –

(i) any disposition by the United States person or the person owning such stock which results in the United States person being treated as no longer owning such stock or

(ii) any distribution of property in respect of such stock to the person holding such stock,

shall be treated as a disposition by, or distribution to, the United States person which respect to the stock in the passive foreign investment company.

Although there are no regulations implementing section 1298(b)(5), Treasury regulation §1.1291-3(e) does define an “indirect disposition” as any transfer that results in an indirect shareholder’s interest being reduced. For example, a U.S. beneficiary of a foreign nongrantor trust would be treated as making an indirect disposition of shares of a PFIC that he or she is treated as indirectly owning if the trust disposes of the PFIC shares either by sale, liquidation or distribution.

29 Treasury regulation §1.1295-1(d)(2)(iii). Treasury regulation §1.1296-1(e)(1) provides that for purposes of the mark-to-market election, only shares owned by a foreign trust or foreign estate are deemed to be indirectly owned by beneficiaries.
to another beneficiary.\textsuperscript{30} Such deemed disposition could be treated as generating an excess distribution. If so, what is the U.S. beneficiary's basis in the PFIC shares and what is his or her holding period? Would shifting beneficial interests cause multiple excess distributions to be generated? In thinking about these problems, it must be recognized that the U.S. beneficiary would not necessarily have received distributions to cover any tax imposed by these rules.

Similarly, under section 1298(b)(5), if implemented by regulations, a distribution from the PFIC to the foreign trust could be treated as a distribution to the indirect shareholder/beneficiary. If the distribution is an excess distribution, the PFIC tax regime could be made to apply to the beneficiary.

The issue of whether the excess distribution amounts are properly allocable to the trust's income or principal accounts should affect the determination of which beneficiary is appropriately treated as owning the income and therefore appropriately taxed on such income. For example, if income is payable to A in the trustee's discretion and principal is payable to B, taking into consideration all relevant facts, if anyone is to be imputed income from the trust, dividends should be imputed to A and capital gains or liquidating distributions to B. But under the PFIC regime, only either A or B is treated as indirectly owning the shares. There is no mechanism for allocating fiduciary income to A and principal receipts to B.

The elections available to U.S. shareholders of PFICs mitigate the harsh tax treatment of excess distributions. However, these elections are not, at least as a practical matter, available to U.S. beneficiaries who are treated as indirectly owning the shares held by a foreign trust. Although the QEF and mark-to-market elections may be made by a U.S. beneficiary of a foreign trust who is treated as the indirect shareholder,\textsuperscript{31} in most cases the beneficiary does not have a fixed right to any share of the trust and would not want to elect to be taxed on amounts he or she does not, in any common meaning of the term, own. Moreover, when such an election could be made, for example when the trust had a single beneficiary or fixed shares, the rules for dealing with previously taxed income would need to be clarified or modified to make sure that the same income is not taxed more than once.

For example, assume that a beneficiary makes a mark-to-market election. Treasury regulation §1.1296-1(d)(2) provides that the basis of shares in the hands of a foreign partnership or foreign trust is adjusted for amounts taken into income by a partner or beneficiary who has made a mark-to-market election, but only for purposes of determining the subsequent income tax treatment of the U.S. person who is treated as owning such stock. The regulation provides:

\begin{quote}
If a foreign partnership or foreign trust is treated as an owner of shares, the basis of such shares in the hands of its owner is determined as provided in paragraphs (a)(2) and (c) of this section. Such basis is determined for purposes of determining the income tax consequences to the owner of the tax consequences from the sale or exchange of such shares. For this purpose, the basis of the shares in the hands of the owner shall be increased or decreased by an amount equal to the amount of income from the disposition of the shares which would be reported to the owner if he or she were directly exercising the right to dispose of the shares.
\end{quote}

\textsuperscript{30} In PLR 200733024, a technical advice memorandum involving disposition of shares in a PFIC by a foreign discretionary trust, the IRS asserted that U.S. beneficiaries should be treated as receiving an excess distribution when the trust disposed of PFIC shares the beneficiaries were treated as indirectly owning even though regulations had not been issued under that statute. The beneficiaries were treated as owning the shares indirectly in proportion to an actuarial allocation of the interests in the trust among the beneficiaries, even though they had no current right to the income and no distributions had ever been made to them. The matter described in the TAM has been settled on other terms.

\textsuperscript{31} Treasury regulation §§1.1295-1(d)(2)(iii)(B) and 1.1296-1(h).
Such increase or decrease in the adjusted basis of the section 1296 stock shall constitute an adjustment to the basis of partnership property only with respect to the partner making the section 1296 election. Corresponding adjustments shall be made to the adjusted basis of the United States person’s interest in the foreign entity and in any intermediary entity described in paragraph (e) of this section through which the United States person holds the PFIC stock.

Although paragraph (e) pertains to trusts as well as partnerships, the regulations fail to address how the adjustment to basis will function in the case of a trust. The regulation quoted above does not work appropriately for a trust since there is no mechanism under the trust rules to adjust the taxable amount received by a beneficiary for the adjustment to basis of the shares owned by the trust.

In the case of a QEF election, the regulations provide no guidance at all as to how income that is taxed to a U.S. beneficiary of a foreign trust is to be accounted for when actually distributed to avoid double taxing the income attributable to the corporation.

**Coordination of accumulation distribution and PFIC rules**

The preamble to the proposed PFIC regulations notes the need to coordinate the accumulation distribution and PFIC tax regimes:

> [T]he regulations do not provide explicit rules for determining the tax consequences to a trust or estate (or a beneficiary thereof) that directly or indirectly owns stock of a section 1291 fund. Until such rules are issued, the shareholder must apply the PFIC rules and Subchapter J in a reasonable manner that triggers or preserves the interest charge.32

We believe that adjustments to the accumulation distribution rules are necessary to achieve the result of preserving the interest charge on untaxed income.

A beneficiary of a trust who receives a distribution that represents the current year's income is taxable on his or her share of the trust’s DNI.33 DNI is taxable income from all sources, including (in the case of a foreign trust) capital gains and foreign source income. The character of the income received by the beneficiary in the same year it accrues to the trust is the same as the character of the income to the trust.34 If a foreign trust’s receipt of a distribution from a foreign holding company would be treated as an excess distribution if the shares were held by a U.S. taxpayer, it

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32  Preamble to proposed regulations issued 4/1/92, 1992-1 C.B. 1124, 1127.
33  Code §662(a).
34  Code §662(b).
would be consistent with the trust income tax rules to tax a beneficiary who receives that excess
distribution in the same year as subject to the PFIC tax regime.

However, there is no authority clearly applying the above rule. Moreover, an argument
could be made that because the holding company shares are not PFIC shares in the hands of a
foreign trust, the character of the income to the trust (which flows through to the beneficiary) is not
PFIC income. Shares held by a foreign person are not PFIC shares. As noted below, one of our
alternative recommendations is the adoption of a regulation under section 643(a)(6) stating that
income distributed from a PFIC through a foreign trust to a U.S. beneficiary in the current year as
part of DNI will be treated and taxed to the beneficiary as PFIC income.

In addition, if a foreign nongrantor trust receives an excess distribution in a year (or what
would be an excess distribution if made to a U.S. shareholder) and does not make a distribution to a
U.S. beneficiary in the same year, the PFIC tax regime cannot apply to the U.S. beneficiary (unless a
beneficiary is treated as indirectly owning the PFIC shares). That is because the excess distribution
accumulated in the trust would become UNI. The character of income that becomes UNI is not
preserved and is taxed as ordinary income to the beneficiary when distributed, subject to an
interest charge. However, the interest charge would be based only on the number of years the
income was accumulated in the trust and would exclude the number of years the income was
accumulated in the holding company. The tax result of not treating a U.S. beneficiary as the
indirect owner of PFIC shares will be satisfactory only if the trust accumulation distribution rules
are changed to increase the interest charge to cover the period that the income was accumulated in
the holding company.

Proposed solutions

We recommend that Treasury adopt one or more regulations that will integrate the rules for
taxation of PFICs with the taxation of accumulation distributions from foreign trusts, under
the structure of Subchapter J. We believe that the situations in which foreign trusts should
be deemed to own CFCs is extremely limited, as discussed above. Alternative solutions for
the taxation of PFICs owned by foreign trusts follow. We believe these solutions can be
effected by regulations.

We further recommend that all PFIC events that occur at the trust level—that is, a
disposition by a foreign trust of an interest in a PFIC or an excess distribution by the PFIC to
the foreign trust—should not be taxed to the U.S. beneficiary at the time of the PFIC event,
but instead should be taxed only at such time as the U.S. beneficiary actually receives a
distribution. Consistent with both the Subchapter J and PFIC rules, the U.S. beneficiary
should pay an appropriate tax with appropriate interest charges, reflecting the total period
that the income has been accumulated offshore, when he or she receives the distribution.

35 Code §667(a).
36 Code §668(a)(3) and (4).
1. One way to accomplish the integration of the Subchapter J and PFIC rules is to modify the accumulation distribution rules of Subchapter J so as to treat the excess distribution received by the trust as if the trust were a U.S. taxpayer for the limited purpose of allocating the excess distribution to prior taxable years of the trust and to calculate the UNI of the trust for such prior years. This allocation of excess distributions to UNI would apply to distributions made in the year of the trust’s receipt of the excess distribution and in future years but would not require any change in the tax treatment of distributions that had been made to beneficiaries in prior years.

Precise integration for the taxation of the income accumulated in the PFIC to the income accumulated in the foreign trust would be achieved by requiring the PFIC to give to the trustee of the foreign trust (and, ultimately, the U.S. beneficiary) detailed financial information similar to that for a QEF election, and to require the trustee of the foreign trust, upon receiving the excess distribution, to analyze the PFIC’s income and to allocate the excess distribution to the appropriate prior years of the trust in computing UNI, as if the PFIC had never existed and the income had been earned and accumulated directly in the trust. If the PFIC did not provide sufficient information to the trustee, the trustee of the foreign trust would be permitted to allocate the excess distribution among prior years on the basis of the annual changes in the net fair market value of the PFIC. Either of these two integration methods would, we believe, operate fairly.

If the information necessary to achieve such an integration is not available, then the trustee would have to allocate the excess distribution without regard to the PFIC’s actual history of earnings and appreciation. For example, under this method, if a trust owned shares in a PFIC for ten years and received an excess distribution in the tenth year, the excess distribution would be allocated equally to all prior years and treated as UNI. This produces the same result as treating the foreign trust as a U.S. taxpayer subject to the PFIC tax rules for the sole purpose of calculating DNI and UNI.

A distribution to a beneficiary in the year that the trust receives an excess distribution or any subsequent year that exceeds the DNI and accounting income of the trust for the year of distribution would be an accumulation distribution. Regardless of the method of integration that is used, to protect the application of the accumulation distribution tax in this context, the excess distribution that is allocated to prior years would have to be excluded in computing accounting income of the trust in the year it is received. If the excess distribution were treated as DNI and/or accounting income, the distribution in the year of receipt would not be an accumulation distribution because a distribution that does not exceed the greater of DNI or accounting income is not an accumulation distribution. If the portion of the excess distribution that is allocated to prior years is excluded from the computation of DNI and accounting income, the distribution of the excess distribution would be treated as a distribution of UNI taxable under the accumulation distribution rules. An interest charge would be applied to the tax allocated to each of the prior years in the trust’s holding period of the corporation’s shares.

We also suggest that the PFIC rules be modified to allow a foreign trust to make a QEF or mark-to-market election even though it is not a U.S. taxpayer. If this election were made, the elections would not accelerate the due date for payment of U.S. tax. Rather, the elections would be used solely for purposes of calculating the DNI of the trust and calculating the interest charge due
on an accumulation distribution. The election would cause income to accrue to the trust as such income was earned by the holding company rather than equally over the holding period of the shares, as is the case under the PFIC tax rules. The mark-to-market election would cause income to accrue to the trust as the investment appreciated.

2. An alternative way to compute a fair amount of tax and interest would be to adopt a "tacking" of the period that income is accumulated in the PFIC to the period the income is accumulated in the foreign trust, but not integrate the PFIC income into UNI unless it is in fact accumulated in the trust after being distributed by the PFIC. Two steps would be needed to adopt this alternative method.

   a. First, Treasury could adopt a regulation under section 643(a)(6) stating that any distributions received from a passive foreign investment company that are distributed through to U.S. beneficiaries in the current year as part of DNI shall retain their character as PFIC income and shall be taxed to the U.S. beneficiary as such.

   We believe that this may be the result under current law, but recommend adoption of a regulation to remove all doubt. We believe that Treasury has the authority to adopt such a regulation under the provisions of section 643(a)(7). We suggest that Treasury adopt a regulation under section 643 stating that PFIC income will be treated as such when received by a foreign trust (even though it is a foreign person), will constitute part of DNI and will retain its character as PFIC income if distributed currently to U.S. beneficiaries as part of DNI. This is consistent with the treatment in Subchapter J of foreign trusts as modified conduits. The trust itself is taxed as a nonresident alien individual. But every class of income collected by the trust passes through to U.S. beneficiaries with its character maintained, if it is distributed in the current year.

   b. In addition, Treasury could adopt a regulation under section 1298(b)(5) that called for tacking the period that income is accumulated in a PFIC to the period that the income is accumulated in the foreign trust, if the PFIC distribution is not distributed currently to the U.S. beneficiaries by the foreign trust.

   By this method, Treasury would ensure that an appropriate interest charge was imposed upon the U.S. taxpayer for the full period that the income was accumulated, either in the PFIC or in the trust. If the trustee had full information from the PFIC on the income that had been accumulated in the PFIC, the trustee could provide all of that information to the beneficiary receiving a distribution as part of the trustee’s beneficiary statement. If not, the trustee (and the beneficiary) would compute the accumulation distribution tax for the "tacked" period of accumulation in the PFIC by allocating the income equally to the years during which the foreign trust had owned shares in the PFIC, using any of the allocation methods described in the first alternative, so that when the trust later made an accumulation distribution, interest would be charged for the full period that tax was deferred. The resulting tax and interest charge may not be the same in all cases as under the first alternative, but in either case the U.S. beneficiary will not have received a benefit from accumulation of income offshore that is not fairly taxed.
We believe that any of the methods proposed here would achieve a fair result, and do not urge the adoption of one of them over another.

If either of the integration or tacking rules is adopted as proposed above, a regulation under section 1298(b)(5) should be adopted to limit the circumstances in which a beneficiary of a foreign trust is deemed to be taxable under that section to cases (admittedly rare) where a beneficiary voluntarily transfers his or her beneficial interest in a foreign trust that owned PFIC shares. If the U.S. beneficiary voluntarily transfers his or her interest in the foreign trust, he or she presumably will have received consideration for the interest transferred, and have funds to pay the PFIC tax. A regulation might postpone the tax in the case of a donative transfer, but again tack holding periods.

**Conclusion**

The goal of the PFIC and CFC rules is to prevent U.S. taxpayers from escaping an appropriate tax and interest charge when tax is deferred through the use of foreign corporations. The same result should occur if the interest is held directly or through a foreign trust. The accumulation distribution tax rules under Subchapter J can be modified to accomplish this result. The accumulation distribution rules are equitable because they impose tax on a beneficiary only at the time he or she receives a distribution from the trust. For the same reason, such rules are more administrable. If beneficiaries are treated and taxed as indirect shareholders, complex rules will be necessary to avoid a beneficiary paying tax on income that may ultimately be distributed to someone else and avoid imposing tax on previously taxed income. In addition, the unfairness of imposing tax on income that a beneficiary has no right to receive creates an incentive for taxpayers to try to evade their tax responsibilities.

Our proposals are consistent with the legislative history of the PFIC rules. The 1986 Blue Book explained that:

The Act provides authority to the Secretary to prescribe regulations that are necessary to carry out the purposes of the Act’s provisions and to prevent circumvention of the interest charge. **Another instance when regulations may be necessary to carry out the purposes of the Act’s provisions is when the ownership attribution rules attributed stock ownership in a PFIC to a U.S. person through an intervening entity and the U.S. person disposes of his interests in the intervening entity. In these cases, the intervening entity may not be a PFIC, so that the U.S. person could technically avoid the imposition of any interest charge. Similarly, if necessary to avoid circumvention of the Act’s interest charge, it may be necessary under regulations to treat distributions received by an intervening entity as being received by the U.S. person.**

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37 Blue Book, at 1032.
In the case of a trust, a beneficiary generally is not able to transfer his or her beneficial interest and thereby escape the PFIC tax regime. In those rare cases when a beneficiary can (and does) sell his or her beneficial interest in a foreign trust, it may be appropriate to impose the PFIC tax regime to preserve the interest charge. However, the PFIC tax regime should not be imposed on a U.S. beneficiary whose beneficial interest (and therefore indirect ownership) is reduced involuntarily, either by the exercise of fiduciary discretion or pursuant to the terms of the trust instrument.

In conclusion, we submit that our proposals are administrable, are fair, meet the goal of Congress when it adopted the PFIC rules of delaying tax to U.S. beneficiaries until they receive a distribution, and integrate the operation of the PFIC Rules with Subchapter J. We would welcome an opportunity to discuss this memorandum with Treasury staff.