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Claiming the Indirect Credit for Foreign Taxes of a PFIC

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It is difficult to overstate the extent to which the passive foreign investment company ("PFIC") rules operate at odds with the rest of the Code. Recently I had occasion to explore a simple issue that well illustrates just how puzzling the PFIC rules can be.[1]

The PFIC rules, enacted in 1986, were aimed at eliminating the deferral of tax that could be achieved through ownership by U.S. persons of interests in offshore mutual funds. But the statutory definition of PFIC sweeps in far more than offshore mutual funds. The definition can pick up foreign operating companies and joint ventures that do not have sufficient U.S. ownership to be classified as controlled foreign corporations ("CFCs").[2] Many such foreign corporations may be located in high-tax jurisdictions.

The fact pattern explored here is simple: A U.S. corporation owns 10% or more of the stock of a foreign operating corporation that is a PFIC, and that PFIC pays tax in its home jurisdiction at significant rates. Section 902 allows an indirect credit against U.S. tax on the receipt by a 10%-or-greater U.S. corporate shareholder of a dividend from the foreign corporation, i.e., a distribution that is deemed to be out of the earnings and profits ("E&P") of the foreign corporation.[3] The U.S. corporate shareholder did not make a timely Qualified Electing Fund (QEF) election with respect to its PFIC shares, because it did not realize in time that the foreign corporation was a PFIC. It sells its PFIC stock at a gain, and seeks to claim a §902 credit for the foreign tax paid on the PFIC's foreign income.

The U.S. shareholder of the PFIC here in question is subject to the §1291 regime. Under that regime, a U.S. shareholder is subject to a unique tax on "excess distributions." An excess distribution includes both regular distributions in excess of 125% of a base amount and, important to this commentary, all gains from the disposition of PFIC shares.[4] The calculation of the tax on excess distributions, intended to discourage investment in PFICs, is arbitrary and draconian. The amount of an excess distribution is first allocated on a per diem basis to all of the days of the U.S. shareholder's holding period for the PFIC shares. Amounts allocated to days in the current year and days in any period before the foreign corporation was a PFIC are taxed at the highest prevailing ordinary income tax rate. Amounts allocated to days in prior years in which the foreign corporation was a PFIC

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[1] I am indebted to Bruce Zavon of Zavon & Associates PC for contacting me with this issue.

[2] Since 1997, §1297(d) has provided that a foreign corporation that is a CFC as to a particular U.S. shareholder is not treated as a PFIC in that shareholder's hands. For simplicity, this commentary assumes away the issues that can arise where a U.S. shareholder of a foreign corporation is subject to both the PFIC and CFC regimes by reason of holding stock before 1997.

[3] Section 960 allows the indirect credit against §951(a) inclusions, but that rule is not relevant here because the PFIC is, by definition, not a CFC. As noted below, similar rules apply under §1248.

[4] §1291(b), §1291(a)(2).

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form the basis for a "deferred tax amount" that incorporates a tax and an interest charge.

Nothing in the operation of §1291 turns on the existence of E&P. This was likely because Congress did not believe that a U.S. shareholder of a PFIC would have access to E&P information, or that the PFIC would bother to keep E&P accounts. The law is unclear how even regular PFIC distributions (that is, those that are not excess distributions) are taxed; presumably the normal rules apply here and a distribution is a dividend only to the extent of the PFIC's E&P. Given that the shareholder will not usually know the PFIC's E&P, in practice most regular PFIC distributions are probably reported as dividends. Where there is an excess distribution, the PFIC could have zero or negative E&P, yet the U.S. shareholder could be subject to tax under §1291. Due to the decoupling of the PFIC rules from the normal corporate tax rules that key into E&P, in some cases the tax under §1291 can exceed not only the shareholder's economic income, but even its gross amount realized.[5]

The indirect tax credit rules, in contrast, are all about E&P. Under §902, if a U.S. corporation receives a dividend from a foreign corporation in which it owns at least 10% of the voting stock, it is deemed to have paid foreign tax in the proportion that the amount of such dividend bears to the foreign corporation's E&P. Under §1248, a similar rule applies when a U.S. corporation sells stock of a foreign corporation, but only if the foreign corporation was a CFC within the five-year period preceding the sale. In that case, the selling U.S. shareholder's gain is treated as a dividend to the extent of the CFC's undistributed E&P. The selling shareholder can claim an indirect foreign tax credit in respect of the amount thus recharacterized as a dividend.

Despite the fact that the PFIC and indirect foreign tax credit regimes do not mesh, §1291(g) provides an indirect foreign tax credit where there are distributions in respect of PFIC stock. The credit can be taken against the tax on ordinary income allocable to the current year and to any year prior to the time the foreign corporation was a PFIC. In addition, if an excess distribution is allocated to a prior year in which the foreign corporation was a PFIC, allocated foreign taxes will reduce the deferred tax amount.

Proposed regulations attempt to flesh out these calculations.[6] The regulations finesse the lack of any E&P concept in §1291 by requiring the taxpayer to determine the amount of creditable taxes "as if" §1291 did not apply, providing a formula that reconstructs a PFIC distribution without regard to the normal rules of §1291.[7] They generally ignore E&P.[8] The resulting deemed-paid foreign taxes are credited against the ordinary tax amount, and reduce the deferred tax amount.

Section 1291(g) refers to the term "distribution with respect to stock." The regulations do not define the term "distribution." In normal tax parlance, a distribution would include only a §301 distribution and not gain on the sale of stock. It is unclear whether the term "distribution" as used in §1291(g) may include gain on a sale of PFIC stock treated under §1291 as an *excess* distribution. The proposed regulations contain one set of rules for regular distributions and another set of rules for gains treated as excess distributions, suggesting that gains are not treated as distributions for other purposes.[9] However, the foreign tax credit proposed regulations refer generally to excess distributions without making the distinction between the two types of distributions.

Section 1291(g)(2)(C) applies the rules of §1291(g) to gain on a sale of stock that would be includible in income as a dividend under §1248. But as noted above, §1248 applies to treat a portion of a selling shareholder's gain as a dividend only if the foreign corporation was a CFC at some point in the five years prior to sale. Therefore, if a PFIC happens to be a CFC (which was possible prior to 1997), gain on the sale of PFIC stock treated as a dividend would bring with it indirect §902 credits.

Section 1291(g) does not say that gain on the sale of stock of a PFIC that is a 10/50 company (that is, a foreign corporation that is not a CFC but that can pay a dividend eligible for the §902 credit in the hands of a 10% U.S. corporate shareholder) cannot bring up §902 credits; the statute is simply silent on this score. The proposed regulations, however, turn the statutory language on its head, stating that gain from the disposition of stock of a PFIC is treated as a "distribution" *only to the extent* that the gain would be treated as a dividend under §1248. Under that rule, gain on the sale of stock of a PFIC that is a 10/50 company, which is treated as an excess distribution under the PFIC rules, would not bring up any §902 credits, even if the PFIC had undistributed E&P.

Section 1291(a)(2) provides that the PFIC rules apply to gain recognized upon a disposition of PFIC stock "in the same manner as if such gain were an excess distribution." While that is not the same thing as saying it is a "distribution," given that an actual dis-

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[5] *See* Blanchard, 6300 T.M., *PFICs*, Worksheet 7.

[6] Prop. Reg. §1.1291-5.

[7] Prop. Reg. §1.1291-5(c)(1)(i)(B), cross-referenced by Prop. Reg. §1.1291-5(d).

[8] Prop. Reg. §1.1291-5(c)(1)(v) (flush language), Prop. Reg. §1.1291-5(c)(3)(x). E&P is referred to only in the context of the §904 baskets; *see* Prop. Reg. §1.1291-5(c)(1)(i).

[9] *Cf.* Prop. Reg. §1.1291-2, §1.1291-3.

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tribution that happens to be an excess distribution brings up indirect credits, it can be argued that gain should as well.

In other contexts, the IRS has generally been reluctant to treat gains as distributions bringing up foreign tax credits, for fear that a seller and a buyer of stock would each claim foreign tax credits with respect to the same E&P. For this reason, the foreign tax credit rules of §959 and §960 go to some length to ensure that shareholder-level tax consequences are coordinated with corporate attributes. This probably also explains why a regular §951 inclusion is not treated as a dividend.[10]

Nevertheless, in the context of §1291, gain treated as an excess distribution should be treated as a distribution that entitles the seller to claim the indirect foreign tax credit. The reason that §1291 treats gains as excess distributions is that Congress intended to penalize deferral of U.S. tax through investment in offshore mutual funds. If a PFIC were to retain its cash and not make current distributions, its U.S. shareholders would not be subject to tax on a current basis. If a U.S. shareholder could sell its PFIC shares without being subject to the excess distribution regime, the rules could be easily avoided. Section 1291 therefore operates so as to deem gain on sale as if it were an excess distribution, running through the §1291 calculation in the same manner as if the gain had been distributed. Thus, the inclusion of gains as excess distributions was necessary to make the regime operate correctly. And because gains are treated as excess distributions, §1291(g) cannot operate correctly without treating such gains as ''distributions with respect to stock'' that can bring up indirect foreign tax credits.

There is no question that coordinating the foreign tax credit rules with the §1291 regime is messy. But the IRS has authority to make §1291(g) work, and the proposed regulations thereunder already try to coordinate the §902 regime, which is based on E&P, with the §1291 regime, which disregards E&P. As long as the IRS is writing coordination rules, it should write rules that effectuate the whole of the statutory scheme.

If the regulations can provide, as they do, that an actual distribution from a PFIC brings up indirect credits even though §1291 operates without regard to E&P, the regulations should similarly provide that a gain on sale treated as an excess distribution should bring up indirect credits. Congress's intent was to allow the indirect foreign tax credit to be claimed against amounts taxable under §1291, including gains treated as dividends by reason of §1248. That intent is frustrated by denying the foreign tax credit to gains that are taxable as excess distributions.

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[10] *See Rodriguez v. Commissioner*, 722 F.3d 306 (5th Cir. 2013).

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