

Indirect Ownership of CFC and PFIC Shares by U.S. Beneficiaries of Foreign Trusts

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A recent TAM has highlighted the issues that may arise in international estate planning from the interaction of the CFC and PFIC rules with the Subchapter J rules that govern taxation of trusts and beneficiaries. The facts in the TAM are not particularly unusual, which means that the onerous result imposed by the IRS may cause considerable concern for planners.

Here's a scenario familiar to American lawyers who work in international estate planning: A wholly discretionary trust established in an offshore jurisdiction owns 100% of the shares of a foreign corporation that functions as a holding company for a variety of investments. Can a U.S. citizen or resident beneficiary of the trust be taxed on the investment income of the holding company without regard to whether the trust makes distributions to the beneficiary?

A cursory review of the indirect and constructive ownership rules under the U.S. controlled foreign corporation (CFC) and passive foreign investment company (PFIC) rules suggests that the answer is yes. A close examination of these rules, however, demonstrates that the answer should often be no.

Concerned about Americans' tax-advantaged investing overseas, Congress enacted the CFC rules as part of the Revenue Act of 1962. Congress followed up the CFC rules with the PFIC rules in TRA '86. The purpose of the two sets of rules is to prevent American taxpayers from deferring federal income tax through the deliberate use of foreign corporations. To ensure compliance with these rules, Congress adopted indirect ownership rules—and, for the CFC rules, constructive ownership rules—that deem U.S. taxpayers to own shares in foreign corporations held by related persons and organizations. Congress already had provided for indirect and constructive ownership rules in the Code in other situations, so the use of those rules in the CFC and PFIC regimes did not generate much attention at the time.

Among the CFC indirect and constructive ownership rules are rules that attribute ownership of shares of a foreign corporation owned by a foreign trust to the trust's U.S. beneficiaries. The CFC indirect ownership rules and constructive ownership rules appear to allow the U.S. to

tax U.S. beneficiaries of a foreign discretionary trust on the Subpart F income of a CFC in which the trust owns shares even if the trust does not make any distributions to the beneficiaries. Similarly, the PFIC indirect ownership rules appear to permit the U.S. to tax U.S. beneficiaries of foreign trusts that own PFICs when the trust receives an excess distribution from a PFIC or sells its PFIC shares. In fact, the IRS recently did so in TAM 200733024.

The CFC indirect and constructive ownership rules and PFIC indirect ownership rules, however, are internally inconsistent, and the Service's application of those rules does not reflect congressional intent. The discussion below demonstrates that U.S. beneficiaries of foreign trusts should not be treated as the indirect or constructive owners of shares of a foreign corporation owned by a discretionary trust for CFC and PFIC purposes except in limited circumstances.

CFCs

A foreign corporation will be a CFC if on any day during its tax year one or more U.S. shareholders directly, indirectly, or constructively own more than 50% of the total combined voting power of all classes of the foreign corporation's voting stock or more than 50% of the total value of the foreign corporation's stock.¹ For purposes of the CFC rules, a U.S. shareholder is a "United States person" who "owns ... or is considered as owning" 10% or more of the total combined voting power of all classes of stock entitled to vote.² To apply these rules, the IRS must determine that:

- One or more U.S. taxpayers own 10% or more of the total combined voting power of all classes of stock entitled to vote,³ and
- The 10% U.S. shareholders collectively own more than 50% of the total combined voting power of the corporation's outstanding stock or more than 50% of the total value of the stock of the corporation.⁴

¹ Section 957(a); Reg. 1.957-1(a). Congress added the "majority of value" test as part of TRA '86.

² Section 951(b). For purposes of this rule, a "United States person" is a U.S. citizen or resident within the meaning of Section 7701(a)(30), subject to special rules for residents of Puerto Rico, Guam, American Samoa, and the Northern Mariana Islands. See Section 957(c).

³ Section 951(b).

⁴ Section 957(a).

If both conditions are met, the corporation will be a CFC. If either condition is not satisfied, the corporation is not a CFC.

If the corporation is a CFC, the next step is to determine the extent to which any of the CFC's U.S. shareholders are subject to U.S. income tax on the CFC's income. Each 10% U.S. shareholder of a CFC is subject to U.S. income tax on the shareholder's proportionate share of the CFC's "Subpart F income," which broadly speaking is income from the CFC's nonoperating or passive assets.⁵ For this purpose, the shareholder's "proportionate share" is based on both the shareholder's voting shares and the shareholder's nonvoting shares. A U.S. shareholder who owns less than 10% of the voting power of a CFC, however, is not subject to tax on her pro rata share of the CFC's Subpart F income even if she owns more than 10% of the value of the CFC's shares due to her ownership of nonvoting shares.

If the corporation is a CFC, the next step is to determine the extent to which any of the CFC's U.S. shareholders are subject to U.S. income tax on the CFC's income.

CFC Indirect Ownership Rules and Foreign Trusts

A foreign corporation will not be a CFC unless there is at least one U.S. taxpayer who is a 10% shareholder.⁶ For purposes of determining whether a U.S. taxpayer is a 10% shareholder in a foreign corporation, the IRS considers shares owned directly, indirectly, and constructively.

The direct ownership rules in Section 958(a)(1) are fairly straightforward. If a U.S. taxpayer owns shares of a foreign corporation, the IRS will count those shares towards the 10% ownership test. Thus, for example, if a domestic nongrantor trust owns more than 10% of the shares of a foreign corporation, the trust will be a "U.S. shareholder" under Section 951(b).

In addition to the direct ownership rules, Congress provided in Section 958(a)(2) that U.S. taxpayers who have interests in certain foreign entities that own shares in a foreign corporation will be deemed to indirectly own the foreign entity's shares in the foreign corporation for purposes of determining whether the foreign corporation is a CFC: "For purposes of subparagraph (B) of paragraph (1), stock owned, directly or indirectly, by or for a foreign corporation, foreign partnership, or foreign trust or

⁵ See generally Section 952(a).

⁶ See Section 951(a).

foreign estate (within the meaning of section 7701(a)(31)) shall be considered as being owned proportionately by its shareholders, partners, or 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."

Reg. 1.958-1(c)(2) provides that the determination of a U.S. taxpayer's "proportionate interest" in a foreign entity, including a foreign trust, depends on the facts and circumstances of the situation: "The determination of a person's proportionate interest in a foreign corporation, foreign partnership, 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) and this section are being applied will be taken into account."

Congress did not provide any rules for determining when a U.S. beneficiary of a foreign trust would be deemed to indirectly own the trust's shares of a foreign corporation under Section 958(2)(a)(2). The Regulations under Section 958(a)(2) have one example of how to apply this facts and circumstances test in the context of a foreign trust and its beneficiaries:

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 be either accumulated or distributed, 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% 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% (one-third of 90%) of the stock in S corporation.⁷

This example is confusing because it does not specify whether it relates to the determination of whether U.S. beneficiaries (1) indirectly own 10% of the voting power of the corporation, (2) indirectly own more than 50% of the voting power of the corporation, (3) indirectly own more than 50% of the value of the stock, or (4) are subject to tax on the corporation's Subpart F income as a result of their indirect share ownership. All of these questions are relevant to the application of the CFC rules.

Of these four questions, the threshold one in determining whether a foreign corporation that is wholly owned by a foreign trust with U.S. beneficiaries is a CFC is whether any of those U.S. beneficiaries indirectly control "10 percent or more of the total combined voting power of all

⁷ See Reg. 1.958-1(d), Example 3.

classes of stock entitled to vote."⁸ Without at least one such beneficiary, such a foreign corporation cannot be a CFC. Example (3), however, concludes that a foreign trust's income beneficiaries indirectly own the trust's shares under Section 958(a)(2) without considering whether those beneficiaries have any influence or control over voting of the trust's shares.⁹ In Reg. 1.958-1(d), Example 3, the IRS simply identified to whom the current economic benefits of the trust flowed—the income beneficiaries—and from that concluded that those beneficiaries indirectly owned the trust's shares.

The only other IRS statement on how to apply the facts and circumstances test of Section 958(a)(2) in the CFC context to trusts is FSA 199952014.¹⁰ In that FSA, the IRS National Office addressed the application of the indirect ownership rules to a trust that provided all net income was to be paid to one of two beneficiaries during the primary beneficiary's lifetime. The principal issue was whether the actuarial values of the trust beneficiaries' interests were appropriate "facts and circumstances" that could be used to determine whether the trust's income beneficiaries were indirect shareholders.

The IRS National Office concluded that the actuarial values of the trust beneficiaries' interests were not relevant facts and circumstances for purposes of applying the CFC indirect ownership rules. The National Office acknowledged that several other indirect ownership rules in the tax law relied on actuarial values to determine trust beneficiaries' indirect ownership of trust assets, but thought that the use of actuarial values for purposes of Section 958(a)(2) was inappropriate:

"Although certain other provisions of the Code contain language identical to that in section 958(a)(2), and have been construed by the Service or the courts, the relevance of those provisions to determinations required to be made under section 958(a)(2) is at best questionable, as the purpose for which indirect ownership is being ascertained differs in each case. For that reason, we believe that even though the Service has construed statutory language identical to that in section 958(a)(2) regarding the indirect ownership of stock through a trust, those analyses are unhelpful in the present inquiry.... Similarly, judicial constructions of the same or similar language, used in different provisions of the Code for various, non-subpart F

⁸ Section 951(b).

⁹ The IRS used a similar analysis in FSA 199952014, discussed in considerable detail in the text, below. The Service's conclusion in the FSA that the trust's income beneficiaries should be deemed to indirectly own a foreign trust's shares in a foreign corporation suffers from the same infirmity as Reg. 1.958-1(d), Example 3: a failure to analyze whether the U.S. beneficiaries had any control over the voting of the shares.

¹⁰ The IRS effectively applied the principles of Section 958(a)(2) to a foreign trust for PFIC purposes in TAM 200733024, discussed in detail in the text, below.

purposes, also are unhelpful.... This is especially so because for purposes of section 958, section 958(b) and Treas. Reg. §1.958-2(c)(1)(ii) expressly determine constructive ownership with reference to actuarial interests (as do regulations under section 318), thereby suggesting that section 958(a)(2) and Treas. Reg. §1.958-1(c)(2) need not mandate application of the same rule."

The National Office advised the field that under the facts and circumstances of the trusts in question, the IRS should treat the income beneficiaries as the owners of the trust's stock under Section 958(a)(2):

"[F]or purposes of section 958(a)(2) and Treas. Reg. §1.958-1(c)(2), where a foreign non-grantor trust provides ... that all its net income should be distributed to a single named individual, the trust's income beneficiaries should be treated as proportionately owning stock owned, or considered as owned, by the trust. Under these circumstances and for this purpose, remainder beneficiaries, whether vested or contingent, should not be taken into account."

Congress did not provide rules for determining when a U.S. beneficiary of a foreign trust would be deemed to indirectly own a trust's shares of a foreign corporation.

Example 3 in Reg. 1.958-1(d) and FSA 199952014 focus on who receives the current benefit of a trust's investments in their analysis of whether the trust's U.S. beneficiaries should be deemed to indirectly own the trust's shares in a foreign corporation. The fact of who receives the economic benefit from a trust's shares of a foreign corporation is relevant for purposes of determining whether the U.S. beneficiaries should be deemed to indirectly own more than 50% of the value of the foreign corporation's shares.¹¹

But that issue is academic unless there is at least one 10% U.S. shareholder. If the trust owns 100% of the shares of the corporation, the U.S. beneficiaries must have some ability to control the voting of the shares in order for those beneficiaries to be 10% shareholders and, therefore, for the corporation to be a CFC. Neither Example 3 nor FSA 199952014, however, address whether the income beneficiaries had any influence or control over the trust's shares in the corporation in question. To this extent, Example 3 and FSA 199952014 do not fully address all the issues relevant to determining whether a foreign corporation that is wholly owned by a foreign discretionary trust is a CFC.

¹¹ See Section 957(a)(2).

The requirement that a foreign corporation have at least one U.S. shareholder who controls 10% or more of the vote reflects Congress's intention to apply the CFC regime only to U.S. taxpayers who could influence the management of a foreign corporation: "Not all U.S. persons who are shareholders in such a controlled foreign corporation, however, are to have attributed to them the specified types of foreign income of a controlled foreign corporation. This is to be done only in the case of those having on any day during the year a stock ownership of 10 percent or more of the combined voting power of all classes of stock, or of the total value of shares of all classes of stock. This *de minimis* rule prevents the attribution of the undistributed income back to the shareholders where their interest is small and their influence on the corporation's policy is presumably negligible."¹²

The FSA concluded that the actuarial values of the trust beneficiaries' interests were not relevant circumstances for purposes of applying the indirect ownership rules.

The Service's treatment of owners of nonvoting shares in the indirect ownership rules shows that the IRS appreciates the importance of control. In determining the extent to which U.S. taxpayers directly or indirectly own shares of a foreign corporation through a second corporation, Reg. 1.958-1(c)(2) provides that the facts and circumstances test should be applied with reference to who can vote the shares in the first corporation: "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."

Three special rules in Reg. 1.957-1(b)(1) determine when a foreign corporation will be deemed to be controlled by U.S. shareholders when those shareholders can exercise some control over the corporation's directors even though the shareholders do not have plenary voting control:

- If the U.S. shareholders can elect, appoint, or replace a majority of persons who with respect to the foreign corporation exercise the powers ordinarily exercised by the board of directors of a domestic corporation,
- If U.S. shareholders can elect exactly one-half of a board of directors but a person elected or appointed by the U.S. shareholders can break a deadlock of the board or assume the powers of the board while the board is deadlocked, or

¹² H. Rep't No. 1447, 87th Cong., 2d Sess. (1962), 1962-3 CB 463.

- If someone other than the board of directors can exercise the powers of the board and the U.S. shareholders can elect, appoint, or replace that person.

Reg. 1.957-1(b)(2) also provides that "[a]ny arrangement to shift formal voting power away from United States shareholders of a foreign corporation will not be given effect if in reality voting power is retained."¹³ For example, the Regulation notes that IRS will take into account the fact that the voting power of a class of stock owned by non-U.S. persons is "substantially greater than its proportionate share of corporate earnings."

The Service's application of the facts and circumstances test with respect to the indirect ownership of shares in a foreign corporation through ownership of nonvoting shares in a foreign corporation under Section 958(a)(2) is consistent with the congressional purpose of preventing deliberate deferral of investment income through a foreign corporation effectively controlled by U.S. persons.¹⁴ By contrast, Example 3 and FSA 199952014 may not be faithful to the congressional purpose of subjecting to tax only those U.S. taxpayers who have some influence over control of the corporation in which a foreign trust owns shares.

In particular, Example 3 appears to provide that trust beneficiaries should be deemed to indirectly own the trust's shares simply because they are trust beneficiaries without regard to whether they can influence the voting of the shares. The nonvoting stock rules, on the other hand, will deem nonvoting shareholders to indirectly own shares of a foreign corporation owned by another foreign corporation only if the nonvoting shareholders in fact have some influence over the management of the "holding" corporation under the facts and circumstances of the situation.

The indirect ownership rules for trust beneficiaries should be similar to the indirect ownership rules for owners of nonvoting shares in intermediate corporations. When a foreign trust owns 100% of the shares of a foreign corporation, unless the U.S. beneficiaries of the trust have considerable influence over the trustee or actual control over the voting of the trust's shares, those beneficiaries should not be deemed to indirectly own the voting power of the trust's shares.

¹³ See, e.g., TAM 199914034. See also Letter Rulings, "CFC Status Avoided Where U.S. Shareholder's 50% Interest Was Subject to Agreement With Other Shareholders," 90 JTAX 375 (June 1999).

¹⁴ See H. Rep't No. 1447, supra note 12, at 1962-3 CB 461 (referring to President Kennedy's complaints that "enterprises organized abroad by American firms have arranged their corporate structures ... in order to reduce sharply or eliminate completely their tax liabilities both at home and abroad"). See also id. at 462 (House Ways and Means Committee convinced that "many have taken advantage of the multiplicity of foreign tax systems to avoid taxation by the United States on what could ordinarily be expected to be U.S. source income").

When should the law deem trust beneficiaries to indirectly own trust-owned shares for purposes of determining voting control? Under general trust law principles, trust beneficiaries are not the legal owners of corporate shares owned by the trust and, therefore, do not automatically have the right to vote the shares. The indirect ownership rules of Section 958(a)(2), when applied to trusts, should observe the distinction between legal ownership and equitable ownership in the trust relationship. Thus, in applying the facts and circumstances test of Section 958(a)(2) to a foreign trust and its beneficiaries to determine whether those beneficiaries control the voting power of the trust's shares, the IRS should focus first on the extent to which the U.S. beneficiaries can control or influence the voting of the shares.¹⁵ Factors the IRS could consider include:

- Is the beneficiary acting as trustee or in another capacity in which she has the ability to vote the shares?
- If the beneficiary can vote the shares, is she acting in a fiduciary capacity when she votes the shares or does the trust instrument limit her discretion in voting the shares?
- If the beneficiary cannot vote the shares, can she control the identity of the fiduciary that votes the shares in such a way as to justify the IRS treating the beneficiary as if she could vote the shares?

If a U.S. taxpayer owned nonvoting shares of a foreign corporation that owned shares in another foreign corporation, the IRS would not treat the taxpayer as owning voting power in the second corporation under Section 958(a)(2) unless the facts justified such a conclusion.¹⁶ The Service should consider examining similar facts and circumstances when considering whether a trust beneficiary should be deemed to indirectly possess the power to vote a trust's shares. Such an approach would be consistent with the congressional purpose of applying the CFC tax regime only where U.S. taxpayers have more than a negligible level of influence on a foreign corporation's distribution policy.¹⁷

IRS focused on who had the current benefit of a trust's investments in analyzing if U.S. beneficiaries should be deemed to indirectly own the foreign corporation.

Other parts of federal tax law recognize the division between equitable and legal title inherent in the trust relationship. If a beneficiary also is a trustee or other fiduci-

¹⁵ See Reg. 1.958-1(c)(2).

¹⁶ See generally Reg. 1.957-1(b).

¹⁷ See H. Rep't 1447, *supra* note 12, at 1962-3 CB 463.

ary with the power to vote the stock, it may make sense to treat him or her as an indirect owner of the stock for CFC purposes. Under the grantor trust rules, for example, if a trust beneficiary can withdraw trust property and vest that property in himself, Section 678 treats the beneficiary as the owner of all the trust's items of income, gain, or loss for income tax purposes. The CFC rules recognize the effect of the grantor trust rules in the indirect ownership rules.¹⁸ Similarly, under estate tax law a trust beneficiary who is not acting as a trustee will be deemed to have the powers of the trustee only if she has a broad power to remove and replace a trustee.¹⁹

PFICs

Like the CFC rules, the PFIC rules seek to penalize the deferral of U.S. income tax through the use of a foreign corporation, but the PFIC rules differ from the CFC rules because control of the corporation is irrelevant. A PFIC is a foreign corporation that meets one of the two tests in Section 1297(a):

- 75% or more of the gross income of the corporation is "passive" income.
- The average percentage of assets held by the corporation during a tax year that produce passive income or are held for the production of passive income is at least 50%.

Subject to certain limited exceptions, "passive income" is foreign personal holding company income within the meaning of Section 954(c).²⁰ In determining whether a foreign corporation is a PFIC, if a foreign corporation owns at least 25% of the stock of another corporation, then the first corporation will be deemed to own a pro rata share of the assets of the other corporation and directly receive a pro rata share of the other corporation's income.²¹ This rule effectively permits the use of a holding company to own a foreign operating business without that holding company being classified as a PFIC.

The PFIC regime generally does not apply to a U.S. taxpayer who is a 10% shareholder of a CFC.²² Because such a shareholder is currently taxable on her share of the CFC's Subpart F income, it is unnecessary to subject her to the PFIC tax regime; the CFC rules accomplish Congress's anti-deferral objectives.

Distributions. A special tax regime applies when a U.S. shareholder receives a distribution from a PFIC. Unlike the normal rules of U.S. federal corporate income taxation, a PFIC's E&P often is not relevant to the taxation of a PFIC distribution. Rather, the taxation of a PFIC distri-

¹⁸ Reg. 1.958-1(b).

¹⁹ See Rev. Rul. 95-58, 1995-2 CB 191.

²⁰ See generally Section 1297(b).

²¹ See Section 1297(c).

²² See Section 1297(e).

bution depends on the relative size of the distribution as compared to the PFIC's distributions in prior years, including the years before the corporation became a PFIC.

Distributions from a PFIC fall into two categories, "excess" distributions and "nonexcess" distributions. An excess distribution is the portion of a distribution from a PFIC that exceeds 125% of the average distributions made to the shareholder with respect to the shareholder's shares within the three preceding years included in the shareholder's holding period or, if the shareholder's holding period is less than three years, the shareholder's actual holding period.²³ A nonexcess distribution is the part of a distribution that is not an excess distribution.

The portion of a PFIC distribution that is a nonexcess distribution is taxed to the shareholder based on the general rules of U.S. corporate income taxation, which will result in dividend treatment to the extent of current or accumulated E&P.²⁴ A nonexcess distribution from a PFIC will not qualify for the 15% rate on "qualified dividend income" because a PFIC by definition is not a "qualified foreign corporation."²⁵

The portion of a PFIC distribution that is an excess distribution is subject to special treatment. The taxpayer must first allocate the distribution pro rata to each day in the shareholder's holding period for the shares.²⁶ Whether the PFIC had E&P in those years is irrelevant. The portion of the excess distribution allocated to the current year and the pre-PFIC years is included in the taxpayer's income for the year of receipt as ordinary income.²⁷ Those amounts of the excess distribution are not qualified dividends for federal income tax purposes.²⁸

The portion of the excess distribution allocated to other years in the taxpayer's holding period (the "PFIC years") is not included in the shareholder's income. Rather, this portion is subject to a special "deferred tax" under Section 1291(c) that the taxpayer must add to her tax that otherwise is due. To compute the deferred tax, the shareholder must first multiply the distribution allocated to each PFIC year by the top marginal tax rate in effect for that year. The shareholder then aggregates all the "unpaid" tax amounts for the PFIC years. The shareholder must then compute interest on those increased tax amounts as if she had not paid the tax for the PFIC years when due using the applicable federal underpayment rate.

The taxpayer includes the deferred tax and interest as separate line items on her individual income tax return.²⁹

²³ Section 1291(b)(2)(A).

²⁴ Prop. Reg. 1.1291-2(e)(1).

²⁵ Section 1(h)(11)(C)(iii).

²⁶ Section 1291(a)(1)(A).

²⁷ Sections 1291(a)(1)(B)(i) and (ii).

²⁸ See note 25, *supra*.

²⁹ See Section 1291(a)(1)(C).

The effect of the deferred tax and the interest charge is similar to the throwback rule that applies to accumulation distributions from foreign nongrantor trusts.

Section 1291(a)(2) treats the sale of PFIC shares as an excess distribution to the extent the proceeds of sale exceed the seller's basis in the PFIC shares. The effect of these rules is to treat the gain as ordinary income realized ratably over the seller's holding period with deferred tax and interest on the amounts allocated to prior years.

QEF election. Instead of subjecting herself to the excess distribution regime, a U.S. shareholder of a PFIC may make a "qualified electing fund" (QEF) election for her shares. If this election is made, the shareholder must include a pro rata share of the PFIC's ordinary income and net capital gain in her gross income for a tax year.³⁰ Thus, instead of waiting until the PFIC makes a distribution, the shareholder elects to be taxed currently on the PFIC's E&P. If a shareholder makes this election, however, she must have access to the PFIC's books and records so that she can determine how to compute her allocable share of the PFIC's income and gains.

The congressional purpose was to subject to tax only those U.S. taxpayers who have some influence over control of the corporation in which a foreign trust owns shares.

Mark-to-market. If a U.S. taxpayer acquires shares in a PFIC that are "marketable," she may make a mark-to-market election for the shares.³¹ A PFIC's shares are marketable when the shares are regularly traded (as defined in Reg. 1.1296-2(b)) on at least one of the following:

- A national securities exchange that is registered with the Securities and Exchange Commission.
- The national market system established under section 11A of the Securities and Exchange Act of 1934.
- A foreign securities exchange that is regulated or supervised by a governmental authority of the country in which the market is located and has the characteristics described in Reg. 1.1296-2(c)(1)(ii).³²

Under the mark-to-market regime, the shareholder annually includes in her gross income the excess of FMV of the PFIC shares over her adjusted basis in the shares. The shareholder may adjust her basis in the shares for the amount of income subject to inclusion under the mark-to-market regime.

³⁰ See generally Section 1293(a).

³¹ See generally Section 1296.

³² Instructions to IRS Form 8621 (Rev. December 2004), page 2.

PFIC Indirect Ownership Rules and Foreign Trusts

As it did with the CFC rules, Congress provided for indirect ownership of PFIC shares by U.S. beneficiaries of foreign trusts. Section 1298(a)(3) provides that "[s]tock [in a PFIC] owned, directly or indirectly, by or for a partnership, estate, or trust shall be considered as being owned proportionately by its partners or beneficiaries."

In 1992, Proposed Regulations were issued under what was then Section 1297(a)(3). Those Proposed Regulations, which have yet to be finalized, generally provide that a trust beneficiary will be deemed to own a proportionate amount of the stock owned by the trust.³³ Indirect ownership depends on the facts and circumstances in each case, with the substance rather than the form of ownership controlling, taking the purposes of the PFIC rules into account.³⁴

When should the law deem trust beneficiaries to indirectly own trust-owned shares for purposes of determining voting control?

The Proposed Regulations do not address how to apply the proportionate ownership rule to trusts and estates and their beneficiaries. The Preamble to the Proposed Regulations solicited comments as to "whether different attribution rules, such as the indirect ownership rules in §25.2701-6 (relating to special valuation rules for purposes of estate and gift taxes), should be adopted for purposes of determining whether a beneficiary of a trust or estate is an indirect shareholder of a PFIC."³⁵ At least one law firm submitted comments on the attribution rules in the Proposed Regulations. Treasury and the IRS have not taken any action to finalize these now-15-year-old proposals.

In TAM 200733024, however, the IRS recently indicated that it would use a "facts and circumstances" test in applying Section 1298(a)(3) to trusts and their beneficiaries: "Section 1298(a)(3) states that '[s]tock owned, directly or indirectly, by or for a partnership, estate, or trust shall be considered as being owned proportionately by its partners or beneficiaries.' No temporary or final regulations have been promulgated under section 1298(a)(3). However, unlike section 1298(b)(5), section 1298(a)(3) contains no language contemplating the promulgation of regulations and there is therefore no ambiguity with regard to its applicability.

³³ Prop. Reg. 1.1291-1(b)(8)(iii)(C).

³⁴ Prop. Reg. 1.1291-1(b)(8)(i). Unlike the CFC rules, the PFIC rules do not rely on the constructive ownership principles of Section 318(a) to attribute ownership of PFIC shares of stock from one person to another.

³⁵ 1992-1 CB 1125.

"Regulations have been issued under subpart F, another anti-deferral regime, that provide a method of allocating subpart F income to the beneficiaries of a trust that holds an interest in a controlled foreign corporation...."

"In the absence of temporary or final regulations under section 1298(a)(3), the Service proposes to determine the beneficiaries' proportionate share of the stock of [the foreign corporation] by applying a facts and circumstances analysis, following the method imposed under the subpart F regulations."

The TAM involved the application of the indirect ownership rules to a foreign discretionary trust that liquidated a PFIC, and is discussed in detail below. The Service's reliance on the CFC indirect ownership rules is not surprising, given that the PFIC rules and the CFC rules have a similar purpose—to discourage U.S. taxpayers from deferring U.S. income tax on passive investments by using foreign corporations to hold those investments. The Service's application of the CFC indirect rules to the facts in TAM 200733024, however, raises several questions, particularly in the context of dispositions of PFIC interests by foreign trusts.

The application of the PFIC indirect ownership rules to foreign trusts that distribute income and principal to U.S. beneficiaries would at first glance seem to be unnecessary because the normal principles of Subchapter J would appear to carry out an excess distribution to the beneficiaries if that excess distribution was a dividend paid by the PFIC (as opposed to a sale). An analysis of the PFIC rules, however, shows that the indirect ownership rules are an important way to preserve the penalty tax and interest charge in a year when a foreign trust receives a dividend from a PFIC and in the same year makes a distribution to a U.S. beneficiary.

If a foreign nongrantor trust receives an excess distribution from what would be a PFIC, under U.S. rules that distribution will have excess and nonexcess portions. The nonexcess portion will be included in the trust's DNI for that year.³⁶ The portion of the excess distribution allocated to the current year and pre-PFIC years also will be allocated to DNI.³⁷ If the trust makes a distribution to a U.S. beneficiary in the year of receipt of the PFIC distribution, that beneficiary will pick up some or all of the portion of the PFIC distribution included in DNI in her income in accordance with the character rule.³⁸ If the trust does not make any distributions during the year, the portions of the distribution included in DNI will become undistributed net income (UNI).³⁹ In this way, a later distribution of the income would be subject to a penalty

³⁶ See Section 643(a)(6)(A).

³⁷ *Id.*

³⁸ See Section 662(b).

³⁹ See Section 665(a).

tax and interest through the throwback rule rather than through the PFIC rules.

The treatment of the portion of the excess distribution to a foreign complex trust that is allocated to prior years under the PFIC rule is unclear. Because the portion of the excess distribution allocated to prior years is not included in the trust's notional U.S. taxable income, the excess portion is not included in the trust's DNI.⁴⁰ The allocation of the excess portion to prior years cannot convert that income to UNI for those prior years because the excess portion is not DNI.⁴¹

This issue will arise when a foreign complex trust makes a distribution to a U.S. beneficiary that exceeds the portion of the PFIC dividend that was included in DNI. The distribution from the PFIC to the foreign trust should be fiduciary accounting income. The distribution of that accounting income to the beneficiary will not in and of itself be an accumulation distribution that draws out UNI from the trust.⁴² Thus, even if the IRS took the position that the excess distribution allocated to prior years was UNI, the distribution of accounting income to a U.S. beneficiary would not pull that UNI out of the trust.

Taking this position, however, would effectively defeat the deferred tax and the interest charge that are central to the PFIC regime by allowing the avoidance of U.S. income tax on the noncurrent portion of an excess distribution. In this situation, the foreign trust could distribute the full amount of the PFIC dividend, part of which was excess distribution, to a U.S. beneficiary but the U.S. beneficiary would pay tax only on the current portion of the excess distribution because only that portion would be included in DNI. The U.S. beneficiary would receive the balance of the excess distribution without any tax consequences because that portion of the distribution would not constitute current DNI of the trust and would not attract UNI because the distribution would not have exceeded the trust's accounting income. If the trust retained the excess distribution, the noncurrent portion of the excess distribution would not be UNI because the noncurrent portion was not DNI.

Although the IRS might not be able to collect the deferred income tax and interest by applying the general principles of Subchapter J, it may be able to do so under the indirect ownership rules of Section 1298(a)(3). To the extent the Service applies the CFC facts and circumstances approach suggested in TAM 200733024 when a foreign trust receives a PFIC dividend that was an excess distribution, the IRS should focus on the trust's distributions in the year in which the trust receives the dividend

and treat those beneficiaries as indirect owners of the PFIC shares, at least for that year.⁴³

The PFIC rules also penalize the deferral of U.S. income tax through the use of a foreign corporation, but here control of the corporation is irrelevant.

Such an approach should dovetail with the general Subchapter J rules. Under those rules, the current portion and pre-PFIC portion of an excess distribution would be included in DNI and carried out to the income beneficiaries.⁴⁴ The portion of the excess distribution allocated to previous years, however, will not be included in DNI for the reasons discussed above. That portion will be accounting income, so to the extent that accounting income is distributed to U.S. beneficiaries, those beneficiaries should receive some of that portion of the excess distribution under the character rule of Section 661(b). Thus, it makes sense to treat those beneficiaries as indirectly picking up a pro rata share of the noncurrent portion of the excess distribution. This result would be consistent with the general principles of Subchapter J because the beneficiaries did in fact receive the PFIC dividend, and therefore enjoyed the benefit of the deferral of U.S. income tax made possible by the trust's investment in the PFIC.

The utility of the CFC indirect ownership rules to the PFIC indirect ownership rules, however, breaks down when a foreign trust sells or otherwise disposes of PFIC shares. The PFIC rules generally treat a disposition of PFIC shares as an excess distribution to the extent the taxpayer realizes a gain on the disposition.⁴⁵ If a U.S. person indirectly owns PFIC shares, Section 1298(b)(5) provides that "under regulations" the U.S. person will be deemed to have disposed of the shares. Putting aside the fact that there are no Regulations applying Section 1298(b)(5) to trust beneficiaries, an attempt to apply the principles of the CFC indirect ownership rules in the case of a trust's disposition of PFIC shares does not work well.

The indirect ownership facts and circumstances test of Reg. 1.958-1(c)(2) focuses on who receives the income from a foreign trust to determine indirect ownership.⁴⁶ If a foreign trust disposes of PFIC shares and makes a distribution that would otherwise carry out the gain, then the analogy to the CFC indirect ownership rules works; the

⁴⁰ See Section 643(a)(1).

⁴¹ See Section 665(a), defining UNI by reference to DNI.

⁴² See Section 665(b).

⁴³ See generally FSA 199952014, rejecting the use of actuarial values to determine a trust beneficiary's proportionate ownership of shares owned by a trust for CFC purposes.

⁴⁴ See Section 661(b).

⁴⁵ Section 1291(a)(2).

⁴⁶ See generally Reg. 1.958-1(c)(2).

beneficiaries effectively received the benefit of the deferral when they received a cash distribution from the trust.

If, however, the trustee does not distribute the gain realized on the disposition of the PFIC shares, the application of the PFIC indirect ownership rules using the facts and circumstances described in Reg. 1.958-1(c)(2) becomes much more difficult. The receipt from the disposition of the PFIC shares will be trust accounting principal. With a discretionary trust, treating the trust's beneficiaries as owning the PFIC shares for purposes of imposing the excess distribution tax on the disposition seems unfair because those beneficiaries would have no legal right to receive the principal. Putting aside that inconvenience, how would such a beneficiary determine her deemed holding period for purposes of computing the deferred tax and interest charge? Using the trust's holding period might be a way to do this, but that does not take account of the fact that the trust may have never made distributions to the beneficiary in previous years, the fact that the beneficiary may not have been born during the trust's holding period, or the fact that the beneficiary may have been added as a beneficiary during the trust's holding period.⁴⁷

TAM 200733024 illustrates the difficulties of applying the indirect ownership rules based on the CFC facts and circumstances test when a trust disposes of PFIC shares but does not distribute the proceeds of sale to the trust beneficiaries. A foreign trust, referred to in the TAM as "Fund B," liquidated a PFIC, which meant that the trust had a notional excess distribution for purposes of the PFIC rules. Fund B's beneficiaries were the five children of one of the children of the settlor; none of the children were U.S. citizens or residents. Only two of the children, Child H and Child I, themselves had children during the years involved in the TAM, and only Child I's children were U.S. citizens or residents.

Although Fund B benefited five grandchildren and their families, the TAM indicates that the trustees had made distributions during the years in question only to the children of Child H and Child I; apparently the trustees did not make any distributions to the three other trust beneficiaries. According to the IRS, the trustees "historically" had made distributions in equal amounts between the children of Child H and the children of Child I.

Although the facts of the TAM are not entirely clear, it appears that two of the beneficiaries of Fund B who had not previously received distributions but who were likely to have children (apparently the fifth beneficiary was not

likely to have children) renounced their interests and their potential children's interests in Fund B. Child I and Child H also apparently renounced their interests in Fund B, leaving only the children of Child I and the children of Child H as the beneficiaries of Fund B. Following this series of renunciations, the trustees of Fund B liquidated the PFIC and in the same year distributed the accrued income of Fund B and a portion of the principal of Fund B to a separate non-U.S. trust established for the benefit of children of Child H, none of whom were U.S. citizens or residents. The total amount distributed to this trust was about 50% of Fund B's total assets (accrued income and principal). In the following year, the trustees distributed the balance of the property of Fund B to a U.S. domestic trust administered for the benefit of the children of Child I, all of whom were U.S. citizens or residents. The trustees of this new trust did not make any distributions to the children of Child I, so no individual U.S. citizen or resident received a distribution of income or principal of Fund B following the PFIC liquidation.

Among other things, the taxpayers argued that the distribution to the non-U.S. trust for the children of Child H, who were not U.S. citizens or residents, in the year of the PFIC disposition event carried out the DNI of Fund B along with the notional excess distribution to the non-U.S. trust, leaving only principal in Fund B. The taxpayers took the position that the distribution in that year to the non-U.S. trust "cleansed" Fund B of the notional excess distribution, leaving only principal to be distributed to the U.S. trust for the benefit of the children of Child I in the succeeding year. According to the taxpayers, no excess distribution remained in Fund B in the succeeding year because of the distribution to the trust for the benefit of the children of Child H in the preceding year. Because of the timing of the distributions, the taxpayers argued that the non-U.S. trust ended up with the excess distribution and the U.S. trust ended up with principal.⁴⁸

The taxpayers pointed out to the IRS that this result was consistent with the general rules of Subchapter J and its DNI principles: "Taxpayers argue that their adopted method of applying the trust distributable net income ('DNI') rules to preserve the PFIC excess distribution at the trust level and carry it out upon a subsequent distribution from the trust to the foreign beneficiaries is one such reasonable manner. Under Taxpayers' DNI method, the entire amount of the excess distribution resulting from the gain on the liquidating distribution from [the foreign corporation] would have been carried out to the beneficiaries

⁴⁷ By contrast, if a U.S. taxpayer indirectly owned PFIC shares through a foreign partnership or foreign corporation, her holding period would be relatively easy to determine; it would be the taxpayer's holding period for the shares of the foreign corporation or the partnership.

⁴⁸ The TAM indicates that there was a disagreement between the taxpayers and the IRS as to whether Fund B was a grantor trust. This disagreement was very fact-specific, and a discussion of the issues is beyond the scope of this article's focus on indirect ownership rules. If the trust had been a grantor trust as to a nonresident alien, the PFIC issues should not have arisen.

of Trust 5, along with all of the DNI of Fund B, ... when Fund B advanced half of its assets to Trust 5. Since Trust 5 has no U.S. beneficiaries, the excess distribution would result in the imposition of no PFIC tax. The distribution of the other half of the assets from Fund B to Trust 4 in the following year ... would correspondingly result in no PFIC tax as there would be no excess distribution amount remaining in that year.

The PFIC Proposed regulations do not address how to apply the proportionate ownership rule to trusts and estates and their beneficiaries.

"Taxpayers point specifically to the reference to subchapter J in the preamble to the proposed section 1291 regulations. Taxpayers argue that, since DNI is an integral part of the taxation of trusts and beneficiaries under subchapter J and since the utilization of the DNI rules results in the preservation of tax at the trust level in the form of DNI, their method is a reasonable manner of applying section 1298(b)(5)."

The IRS, however, thought that the taxpayers' approach was unreasonable because it did not preserve the excess distribution tax scheme and the interest charge: "It is the Service's position that Taxpayers' DNI approach is unreasonable because it fails to actually preserve any of the PFIC interest charge. To the contrary, it facilitates the avoidance of the interest charge altogether by allowing the entire excess distribution amount to be carried out to foreign beneficiaries who are not subject to the PFIC regime. The purpose of section 1298(a)(3) and (b)(5) is to insure that the PFIC tax is not circumvented by the imposition of a foreign pass-through entity such as a partnership or trust in an ownership chain between a U.S. person and a PFIC. Taxpayers' method of applying section 1298(b)(5) would make a trust with both U.S. and foreign beneficiaries an effective vehicle for circumvention of the PFIC regime because the PFIC tax and interest charge could be carried out to the foreign beneficiaries by manipulating the timing of distributions from the trust, as Taxpayers have done here. Taxpayers' method represents neither a reasonable nor a good faith attempt to implement the statute in light of its language and purpose."

Probably realizing the strength of the taxpayers' Subchapter J argument, the IRS decided to take a back-door approach by deeming the children of Child I to have indirectly owned 50% of the assets of Fund B at the time of the PFIC liquidation, thereby allowing the government to tax those children of Child I on one-half of the deemed excess distribution under Section 1298(b)(5). The IRS pointed out that in the years preceding the PFIC liquidation,

Practice Notes

Tax advisors and their clients should keep in mind that the Service's position in TAM 200733024 is nothing more than an articulation of its likely position in litigation. Taxpayers should not concede the application of the PFIC indirect ownership rules in the manner the IRS suggests.

tion, the trustees of Fund B had historically made distributions to the children of Child H and Child I in equal amounts and that certain documents described the settlor's intention that the benefits of Fund B be split between those two branches of the family on a 50-50 basis.

The Service's reliance on the CFC indirect ownership rules in the TAM is not surprising, given that the PFIC rules and the CFC rules have a similar purpose.

In its analysis of the distributions from Fund B, the IRS did not mention the fact that for most of the years in question there were actually three other beneficiaries of Fund B; the Service focused only on the distributions the trustees made to the children of Child H and the children of Child I. According to the IRS, these facts and circumstances meant that the children of Child H and the children of Child I should each be deemed to own 50% of the trust-owned PFIC under the indirect ownership rules of Section 1298(a)(3).⁴⁹

From an academic perspective, the Service's reliance on the facts and circumstances approach used in the CFC indirect rules in applying the PFIC indirect ownership rules is sensible because both sets of rules have the same purpose—to penalize tax deferral through the use of foreign corporations. In TAM 200733024, however, the IRS did not apply the CFC-based facts and circumstances test in a reasonable manner. The CFC indirect ownership rules follow trust distributions to identify proportions in which the beneficiaries of a foreign trust should be deemed to indirectly own the trust's shares.⁵⁰ To the extent the Service wants to rely on the facts and circumstances test used in the CFC indirect ownership rules for PFIC purposes, it should similarly focus on who receives

⁴⁹ Although the IRS acknowledged that the trustees of Fund B made a distribution to a trust for the benefit of the U.S. beneficiaries ("Trust 4"), the IRS treated the beneficiaries themselves, and not Trust 4, as the indirect owner of the PFIC shares. Because of the deletion of the dates, it is unclear from the TAM whether Trust 4 was in existence on the date of the PFIC liquidation. If Trust 4 was in existence on that date, it—rather than the children of Child I—should have been treated as the indirect owner of the PFIC shares if the indirect ownership rules applied at all.

⁵⁰ See Reg. 1.958-1(c)(2).

distributions from a trust to determine the indirect owners of the trust's PFIC shares, if any.

If the facts in TAM 200733024 had involved a dividend paid by the PFIC that was an excess distribution, the CFC indirect ownership rules would suggest that the beneficiaries who received a distribution from the trust in the year the trust received the dividend should be treated as indirectly having received an excess distribution. The TAM, however, involved the liquidation of the PFIC, the proceeds of which were presumably allocable to principal for fiduciary accounting purposes.

It appears unreasonable for the IRS to say that the children of Child I should be deemed to own one-half of the entire trust principal when principal had not been distributed to them and would not necessarily ever be distributed to them. In fact, the distribution from Fund B was made to Trust 4, not to the children of Child I. The children of Child I had never received substantial principal distributions from Fund B, and there was no suggestion that the trustees would or could distribute one-half of the entire principal of Trust 4 to the children.

Moreover, it appeared there were three other grandchildren of the settlor who were beneficiaries of Fund B for most of the years in question. The trustees of Fund B could have distributed income and principal to any of the beneficiaries, including the non-U.S. beneficiaries and the grandchildren who did not yet have any children, in any portions the trustees wished. The trustees apparently chose not to make any distributions to these beneficiaries, which indicates the discretionary nature of Fund B.

The children of Child I apparently had no vested right to receive principal from Fund B and had no ability to compel the trustees to distribute principal to them. Furthermore, the proceeds of the liquidation were distributed to Trust 4, not to the children of Child I. In light of these facts, deeming those beneficiaries to own and control one-half of proceeds of the liquidation of the PFIC was unreasonable.

One way to test the reasonableness of the Service's application of the facts and circumstances test in TAM 200733024 is to determine whether the tax result to the U.S. beneficiaries would be the same if the trustees of Fund B had invested the trust assets in the trust's name rather than through a holding company. Assume, for example, that instead of making passive investments through a PFIC, the trustees of Fund B purchased and sold investment assets in the trust's name but never distributed any of the realized capital gain to the trust beneficiaries. Under Subchapter J, the realized gains would be part of DNI in the year in which the trustees realized the

gain. To the extent that the trustees did not distribute the gain in that year, the gain would become part of UNI.⁵¹

The utility of the CFC indirect ownership rules to the PFIC indirect ownership rules breaks down when a foreign trust sells or disposes of PFIC shares.

If the trustees later distributed trust principal to Fund B's nonresident alien beneficiaries, the distribution would carry out that UNI and any DNI from the year of the distribution to those beneficiaries as long as the separate share rule of Section 663(c) did not apply. If the separate share rule applied, then 50% of the realized gains would be allocated to the children of Child H and 50% to the children of Child I.⁵² If, however, the trustees did not make any distributions to the children of Child I, they would not be currently taxed on that realized gain. Instead, the gain would have become UNI, and a later distribution to those beneficiaries or a U.S. trust for their benefit could have carried out the UNI as an accumulation distribution.⁵³ Whether or not the separate share rule applied, however, the U.S. beneficiaries would not pay any tax unless the trustees made a distribution to them.

For example, if the trustees of Fund B had a \$1 million gain in 2006 and distributed \$1 million to the children of Child H or a foreign trust for their benefit and the separate share rule did not apply, the distribution would carry out all the gain to those beneficiaries. If in 2007 the trustees distributed \$1 million to the children of Child I or a U.S. trust for their benefit, there would be no basis on which the IRS could argue that the children of Child I or the trust should be taxed on half of the gain from 2006

⁵¹ See Section 665(a).

⁵² See generally Section 663(c) and Reg. 1.663(c)-1(a). Under the separate share rule, a trustee of a trust with more than one beneficiary must allocate DNI pro rata among the trust beneficiaries to the extent that the trust instrument provides for substantially independent and separate shares for the beneficiaries. For example, if a trust instrument provides for the payment of the trust income in equal shares to three beneficiaries, those beneficiaries have separate and independent shares. In that situation, the separate share rule requires the trustee to effectively treat the shares as separate trusts for purposes of allocating DNI, even though the trustee files only one income tax return.

⁵³ See Section 665(b), defining an accumulation distribution. The taxpayers in the TAM argued that Section 667(b) would have achieved the same result as the application of the excess distribution regime because the PFIC distribution would have lost its character once it became UNI and would have been subject to the accumulation distribution tax and interest charge when later distributed to a U.S. taxpayer, whether a trust or an individual. Thus, the application of the Subchapter J rules would have been roughly consistent with the PFIC rules. As discussed in the text, above, however, it is unclear whether the prior years' portion of a PFIC excess distribution can ever be part of UNI given the fact that the prior years' portion is not technically includable in DNI.

unless the separate share rule applied to Fund B. If, however, the separate share rule applied, then the 2006 distribution would have carried out only \$500,000 of the gain to the children of Child H, leaving \$500,000 of the gain to be allocated to the share of DNI allocable to the children of Child I, where it would have become UNI, thereby attracting a throwback tax and interest charge on the distribution in the next year. The U.S. beneficiaries or a trust for their benefit, however, would not be taxable in 2006 on 50% of the realized gain.

The TAM indicates that the taxpayer and the IRS disagreed about the potential application of the separate share rule to Fund B, which would have been an issue if the PFIC indirect ownership rules did not apply. The taxpayers argued that because Fund B was a discretionary trust, the separate share rule did not apply to it.⁵⁴ The taxpayers provided evidence of the law of the country in which the trust was organized, including an opinion of counsel, to support its position. The Service, however, stated that the taxpayers and their counsel were wrong in their interpretation of the trust agreement and of the applicable foreign law. According to the IRS, Fund B was not a discretionary trust within the context of the separate share rule and there were two separate and independent shares, one for the children of Child H and one for the children of Child I.

Whether or not the separate share rule applied to Fund B in the year of the PFIC liquidation is not particularly important to answering the question of whether the tax result in the TAM would have been the same under Subchapter J if the trustees of Fund B directly invested the trust assets instead of investing through a company. The application of the PFIC indirect ownership rules would cause a tax whether or not the trustees of Fund B made a distribution to the children of Child I or a trust for their benefit. If the trustees of Fund B had made the trust investments directly, the taxability of the children of Child I or the U.S. trust for their benefit on the gain would depend on whether and when the trustees of Fund B made a distribution to the children or the trust. If the trustees of Fund B did not make such a distribution, no U.S. tax would be owed, which is the critical difference between the PFIC indirect ownership rules and Subchapter J. Be-

⁵⁴ The separate share rule does not apply to a discretionary trust under which the trustee can select among a class of beneficiaries to whom to distribute income and principal. Reg. 1.663(c)-3(b) provides that "[s]eparate share treatment will not be applied to a trust or portion of a trust subject to a power to: (1) Distribute, apportion, or accumulate income, or (2) Distribute corpus[,] to or for one or more beneficiaries within a group or class of beneficiaries, unless payment of income, accumulated income, or corpus of a share of one beneficiary cannot affect the proportionate share of income, accumulated income, or corpus of any shares of the other beneficiaries, or unless substantially proper adjustment must thereafter be made (under the governing instrument) so that substantially separate and independent shares exist."

cause the PFIC indirect ownership rules would result in taxation without any distributions in this situation, the application of those rules would conflict with Subchapter J and produce an unreasonable result.

The legislative history of the PFIC rules shows the importance of applying the PFIC rules in a way that reaches the same result as the Subchapter J rules. An important purpose of the PFIC rules, according to the Senate Report on TRA '86, was to discourage U.S. investors from obtaining advantages through the investment in a foreign passive investment company that was not a CFC:

"The committee is concerned that U.S. persons who invest in passive assets through a foreign investment company obtain a substantial tax advantage vis-a-vis U.S. investors in domestic investment companies because they avoid current taxation and are able to convert income that would be ordinary income if received directly or received from a domestic investment company into capital gain income. The committee does not believe that tax rules should effectively operate to provide U.S. investors tax incentives to make investments outside the United States rather than inside the United States. In the committee's view, U.S. persons who invest in passive assets should not be able to achieve tax deferral just because they invest in those assets indirectly through a foreign corporation."⁵⁵

The PFIC rules, accordingly, attempt to roughly mimic the tax results that a U.S. investor would have if she directly invested in assets rather than through a foreign corporation. In TAM 200733024, however, the IRS applied the PFIC indirect ownership rules in a way that would result in considerably different—and worse—treatment than would have occurred had the trustees of Fund B invested directly in the trust's name. If the trustees of Fund B had owned the investment assets directly, there would be no question that the children of Child I or a trust for their benefit would not have been taxable on 50% of the notional gain incurred in the liquidation of the company in the year in which the company was liquidated. It is possible that the children of Child I or the trust for their benefit would be required to pay a throwback tax on a distribution from Fund B in a later year, but such a distribution would be a prerequisite to U.S. taxation. The Service's approach in the TAM produced much more onerous tax results than a direct investment by Fund B, which is an unreasonable result.

CONCLUSION

The tax controversy described in TAM 200733024 is likely far from over; perhaps the courts will have an op-

⁵⁵ S. Rept No. 99-313, 99th Cong., 2d Sess. 393-94 (1986), 1986-3 CB (Vol. 3) 393-94.

portunity to weigh in on the reasonableness of the Service's approach to the application of the PFIC indirect ownership rules. In the meantime, tax advisors and their clients should keep in mind that the Service's position in the TAM is nothing more than an articulation of its likely position in litigation. Under Section 6110(k)(3), the TAM is not citable as authority. Rather, like a Proposed Regulation, the TAM is nothing more than a statement of a frequent litigant and is not entitled to any judicial deference.⁵⁶ Taxpayers should not concede the application of the PFIC indirect ownership rules in the manner suggested by the IRS in TAM 200733024.

⁵⁶ See, e.g., *Laglia*, 88 TC 894 (1987) (Proposed Regulations carry no more weight in court than a position advanced on brief).