
IRS and Treasury clarify that ownership of PFIC stock is not attributed through a tax exempt organization or account

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In brief

On April 14, the IRS released Notice 2014-28, in which it announced that the IRS and Treasury will amend the temporary regulations contained in T.D. 9650, 78 Fed. Reg. 79609 (Dec. 31, 2013), relating to the treatment of US persons that own stock of a passive foreign investment company (PFIC) through certain organizations or accounts that are tax exempt. In particular, the Notice provides that the regulations will be amended to clarify that US persons owning stock of a PFIC through a tax exempt organization or account (as described in Treas. Reg. sec. 1.1298-1T(c)(1)) are not attributed ownership of the PFIC for purposes of applying the PFIC rules.

As a result, US persons that are beneficiaries of or have interests in an organization or account exempt from tax (e.g., an individual retirement account (IRA) or a Section 529 plan) that own stock of a PFIC will not be subject to tax and reporting obligations under the PFIC rules.

In detail

Background

Section 1298(a) provides attribution rules pursuant to which a US person is treated as owning PFIC stock that is owned by another person. These attribution rules do not apply to treat stock owned (or treated as owned) by a US person as owned by any other person, except to the extent provided in regulations. Until recently, the only regulations issued under Section 1298(a) were proposed regulations issued in 1992 which contained rules

attributing ownership from one US person to another in certain circumstances, but were never finalized. As such, no effective guidance extended the reach of Section 1298(a) to attribute PFIC stock from one US person to another.

On December 31, 2013, Treasury and the IRS issued temporary regulations contained in T.D. 9650, 78 Fed. Reg. 79609, which provide reporting and ownership attribution rules with respect to US persons owning interests directly or

indirectly in a PFIC. These temporary regulations included portions of the 1992 proposed regulations that provided for attribution from certain domestic and foreign entities.

In particular, the temporary regulations include a rule in Treas. Reg. sec. 1.1291-1T(b)(8)(iii)(C), which was taken from the 1992 proposed regulations, that provides that each beneficiary of a "foreign or domestic nongrantor trust (other than an employees' trust described in Section 401(a) that is

exempt from tax under Section 501(a)) "that directly or indirectly owns stock in a PFIC is considered to own a proportionate amount of such stock (the 'Nongrantor Trust Attribution Rule'). For this purpose, a nongrantor trust is defined as "any trust or portion of a trust that is not treated as owned by one or more persons under Sections 671 through 679." Thus, the beneficiary of a US nongrantor trust is generally attributed ownership of PFIC stock held by the US nongrantor trust.

Trusts that are treated as owned by their grantors under Sections 671 and 679 are generally taxable to the grantors under Sections 671 through 679. Because beneficiaries of tax exempt trusts are typically not subject to tax on the income of such trusts, this suggests that generally a tax exempt trust would be a nongrantor trust for purposes of the Nongrantor Trust Attribution Rule. Furthermore, the exclusion from this attribution rule for "an employees' trust described in Section 401(a) that is exempt from tax under Section 501(a)" suggests (i) that an employees' trust described in Section 401(a) is a nongrantor trust and that other tax exempt trusts are nongrantor trusts; and (ii) that, in the absence of the exclusion, this attribution rule would cause attribution to the beneficiaries of the employees' trust even though the employees' trust is generally tax exempt. Therefore, it appears that the Nongrantor Trust Attribution Rule could attribute ownership through tax exempt investment vehicles that constitute trusts but are not described in Section 401(a).

For example, IRAs are tax exempt trusts (as described in Section 408(a)) that are not "an employees' trust described in Section 401(a)". Therefore, the temporary regulations contained in T.D. 9650 could be interpreted to treat a US person that is

the owner of an IRA as owning PFIC stock held by the IRA directly, without the tax exemption provided by holding the PFIC through the IRA. If so, the US beneficiary or owner could be subject to tax consequences and reporting obligations under the PFIC rules. Similar issues could arise in the context of other tax exempt trusts as well, including, for example, qualified tuition programs defined under Section 529 (Section 529 plans).

This result would be inconsistent with the treatment of an IRA itself, as well as other tax exempt trusts (e.g., Section 529 plans), under the PFIC rules. Pursuant to Treas. Reg. sec. 1.1291-1(e), an organization that is exempt from tax is not subject to taxation under Section 1291 except to the extent a dividend from the PFIC would be taxable under subchapter F. Although the regulations do not define the term 'organization', the term appears to have been intended to have a broad meaning so as to include tax exempt investment vehicles such as trusts that are not seemingly within the ordinary meaning of that term, as the preamble to the temporary regulations introducing Treas. Reg. sec. 1.1291-1(e) specifically contemplates that an IRA is treated as a tax exempt organization for purposes of the rule. See T.D. 8750, 63 Fed. Reg. 6 (Jan. 2, 1998). A list of tax exempt trusts and other tax exempt organizations and accounts are also excepted from reporting under the PFIC rules. See Treas. Reg. sec. 1.1298-1T(c)(1).

Given the exceptions from PFIC tax consequences and reporting obligations provided for tax exempt organizations and accounts, the attribution of PFIC stock through such an organization or account under the Nongrantor Trust Attribution Rule contained in the temporary regulations (i.e., Treas. Reg. sec. 1.1291-1T(b)(8)(iii)(C)) was

presumably unintended. Investors and advisors, however, were nevertheless concerned that this attribution rule could be interpreted to subject investors holding PFIC stock through tax exempt organizations or accounts to PFIC tax consequences and reporting obligations.

Notice 2014-28

Notice 2014-28 provides that the IRS and Treasury will amend the regulations to clarify that US persons owning stock of a PFIC through a tax exempt organization or account (as described in Treas. Reg. sec. 1.1298-1T(c)(1)) are not attributed ownership of the PFIC for purposes of applying the PFIC rules. The Notice explains that the application of the PFIC rules to a US person treated as owning stock of a PFIC through a tax exempt organization or account described in Treas. Reg. sec. 1.1298-1T(c)(1) would be inconsistent with the tax policies underlying the PFIC rules and the tax provisions applicable to tax exempt organizations and accounts. Therefore, US persons that are beneficiaries of or own interests in a tax exempt organization or account, such as an IRA, will not be subject to tax consequences or reporting obligations under the PFIC rules.

The takeaway

Many taxpayers will welcome the proposed amendment to the definition of shareholder in the Section 1291 regulations. The Notice came at a critical time and eased the concerns of financial institutions and investors who were concerned that ownership of PFIC stock through a tax exempt organization or account could subject investors to PFIC tax consequences and reporting obligations.

Let's talk

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