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PFIC Issues for Non-U.S. Real Property Operating Companies

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In this article, Zhu discusses the application of passive foreign investment company rules to non-U.S. real property operating companies. Zhu looks at how to apply the 25 percent subsidiary look-through rule in connection with specified exceptions to the general rule that rental income is passive income.

This article concerns the application of passive foreign investment company rules[1] to non-U.S. real property operating companies (RPOCs).[2]

A. The Basic Rules

1. A common structure for an RPOC. A non-U.S. RPOC is organized in a foreign country. The RPOC, through wholly owned subsidiaries organized in various jurisdictions,[3] owns numerous real property assets. Those subsidiaries are often passive holding vehicles that own real property, hold the leases with third parties, and have no employees. Typically, the RPOC and any subsidiary are each treated as a corporation for U.S. federal income tax purposes.[4] The acquisition, development, ongoing marketing, management, and maintenance of the property are performed by employees of an affiliate, including the RPOC itself, but are sometimes performed by third-party contractors.

We assume that as a group, (i) the RPOC derives nearly all of its income from third-party rents, and other income is de minimis; and (ii) nearly all of the RPOC's assets are real property giving rise to those rents, and other assets are de minimis. This article ignores de minimis income and assets.[5]

2. Definition of a PFIC. A foreign corporation (FC) is a PFIC if it meets either an income or asset test.[6] Under the income test, an FC is a PFIC if at least 75 percent of its gross income for the tax year is passive.[7] Subject to exceptions under the PFIC rules,[8] passive income is defined by reference to the controlled foreign corporation rules[9] and is income that would be foreign personal holding company

[1]The term passive foreign investment company is defined in section 1297(a). For definitions, see Notice 88-22, 1988-1 C.B. 489.

[2]This article also applies to foreign corporations (FCs) with subsidiaries that are special purpose vehicles holding intellectual property. *See* reg. section 1.954-2(d) (rules for active royalties parallel to those for active rents under reg. section 1.954-2(c)). Typically, more attention is paid to U.S. tax when IP is involved. Real property has particular liability concerns that make the use of special purpose holding vehicles common and therefore exacerbate the issues discussed in this article.

[3]For simplicity, this discussion is limited to wholly owned subsidiaries, and it is assumed that there are no indirect U.S. subsidiaries or other stock ownership interests meeting the conditions of section 1298(b)(7) (rules for stock of a U.S. corporation held by a 25 percent (by value) domestic corporate subsidiary of an FC). *See, e.g.*, LTR 201515006.

[4]Reg. section 301.7701-3(b)(2)(i)(B) (providing default rules treating a foreign eligible entity as a corporation if all its members have limited liability). A check-the-box (CTB) election for some of the entities could have alleviated the PFIC concerns, but the election is often not made either because no U.S. tax advice is sought or because the RPOC's U.S. shareholders lack sufficient influence over the affairs of the RPOC. *See infra* note 53. Reg. section 301.7701-3(c) (providing the CTB rules).

[5]Many RPOCs have significant working capital, which is generally a passive asset. Notice 88-22, 1988-1 C.B. 489. *See infra* note 56. They also have significant goodwill, which may be passive or active. *Id.* Whether the fair market value or tax basis of the goodwill is used in applying the PFIC asset test could be critical. *See infra* note 11.

[6]Section 1297(a).

[7]Section 1297(a)(1). Gross income for this purpose, in principle, likely must be determined under U.S. tax principles. *See* LTR 9447016. For a discussion on why it might be appropriate to permit an FC to use publicly available financial accounting information rather than apply U.S. tax accounting rules, see New York City Bar, "Report Offering Proposed Guidance Regarding the Passive Foreign Investment Company Rules," at 29-30 (Sept. 21, 2009).

[8]Section 1297(b)(1). Exceptions include income derived from or by (i) an active banking business (section 1297(b)(2)(A)); (ii) an active insurance business (section 1297(b)(2)(B)); (iii) related-party interests, dividends, rents, or royalties (section 1297(b)(2)(C)); and (iv) export trade corporations (section 1297(b)(2)(D)).

[9]An FC is a CFC if more than 50 percent of its stock, by either value or voting power, is owned by "U.S. shareholders" on any day during its tax year. Section 957(a). The term U.S. shareholder means a U.S. person who owns 10 percent or more of the total combined voting power of all classes of FC stock that is entitled to vote. Section 951(b). To determine whether a U.S. person is a U.S. shareholder and whether an FC is a CFC, specific attribution rules apply. Section 958(b). If an FC were a CFC, it would not be treated as a PFIC for a U.S. shareholder

(Footnote continued on next page.)

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income (FPHCI) as defined in section 954(c) for CFC purposes. Subject to exceptions under the CFC rules, FPHCI includes dividends and rents.[10] Under the asset test, an FC is a PFIC if during the tax year, the average percentage of assets that it holds that either produce or are held for the production of passive income is at least 50 percent.[11] Thus, stock in another corporation and real property that gives rise to rental income are ordinarily passive assets.

3. The 25 percent subsidiary look-through rule. In determining whether an FC that holds stock in another corporation meets either test, a look-through rule applies. If the FC owns at least 25 percent by value of the stock of another corporation (a 25 percent subsidiary), the FC is treated as if it (i) held a proportionate share of the assets of the 25 percent subsidiary, and (ii) directly received a proportionate share of the income of the 25 percent subsidiary.[12]

The term "indirectly" is not specifically defined for those purposes, but ownership interests through an FC's wholly owned and, on a prorated basis, its non-wholly owned subsidiaries should be included in determining whether it meets the ownership threshold.[13] Therefore, all the RPOC's property-holding subsidiaries should be 25 percent subsidiaries.[14]

4. The primary issue. Whether the RPOC is a PFIC turns on whether the third-party rents, when attributed to the RPOC from the property-holding subsidiaries, are passive income to the RPOC under the PFIC rules. The primary issue is how to apply the 25 percent subsidiary look-through rule given the exceptions to the general rule that rental income is passive income.

B. Rental Income as Active Income

1. The CFC rules. As described, the RPOC group has only rental income from third parties, which is paid to the RPOC's subsidiaries and which is attributed to the RPOC under the 25 percent subsidiary look-through rule. Under the CFC rules, the treatment of rental income from third parties is simple: The general rule is that it is FPHCI and therefore passive.[15] The exception is that FPHCI does not include rents from an unrelated person and derived from the active conduct of a trade or business (ATB exception).[16] The general rule is the starting point for the corresponding PFIC analysis. The exception should apply in the PFIC context,[17] albeit with a somewhat uncertain scope given the 25 percent subsidiary look-through rule.

The CFC rules define the ATB exception narrowly. Rents qualify for the ATB exception and are therefore "excluded rents,"[18] only if at least one of

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during a specific "qualified portion" of the shareholder's holding period. Section 1297(d). Also, special PFIC purging rules apply for a prospective "qualified electing fund" election for such an FC. Section 1291(d)(2)(B); reg. section 1.1291-9.

[10]Section 954(c)(1)(A).

[11]Section 1297(a)(2). An FC that is publicly traded must use the value of its assets in determining whether it meets the asset test. An FC that is not publicly traded generally may use either value or adjusted tax bases. Section 1297(e)(1)(A) (publicly traded FCs must use value) and section 1297(e)(2)(B) (providing the election for other non-CFC FCs). A private FC that is a CFC must, however, use adjusted tax bases. Section 1297(e)(2)(A) (non-publicly traded CFCs must use tax basis).

[12]Section 1297(c).

[13]S.R. Conf. Rep. No. 100-445, at 282, 286 (1988). *See* LTR 200604020 (holding an FC's sale of a direct wholly owned subsidiary with its own direct and indirect operating subsidiaries to be a sale by the FC of the assets of the underlying 25 percent subsidiaries); LTR 200813036 (holding the sale by an FC's indirect wholly owned subsidiary which holds the majority of the FC's indirect interests in a 25 percent subsidiary to be a sale by the FC of the proportionate share of the assets of the 25 percent subsidiary). However, the more general constructive ownership rules, such as those under section 318, do not apply. *See, e.g.*, TAM 200733024.

[14]Neither the code nor the regulations describe how, in applying the income test, to treat any dividends the FC may receive from a 25 percent subsidiary. However, dividends from a 25 percent subsidiary should be disregarded and excluded from the FC's gross income. *See* Joint Committee on Taxation, "General Explanation of the Tax Reform Act of 1986," JCS-10-87, at 1026 (May 4, 1987). Thus, all dividends paid by the RPOC's subsidiaries to the RPOC are disregarded in determining the RPOC's PFIC status, and there is no need to determine whether they are passive.

(Footnote continued in next column.)

[15]Section 954(c)(1)(A). It also includes the excess of gains over losses from the sale or exchange of property giving rise to that rent. Section 954(c)(1)(B)(i). Under the CFC rules, rents derived from a related person are subject to two look-through rules. Section 954(c)(3)(A)(ii) (same country exception) and section 954(c)(6) (related CFC income exception, which is subject to sunset). In either case, the term "related person" is defined in section 954(d)(3). All rents here are presumed to be derived from persons other than related persons, and we therefore will not consider whether those rules apply. Also, because the rent is derived from third parties, the PFIC rental income look-through rule does not apply (section 1297(b)(2)(C)), even though the RPOC and the property-holding subsidiaries are themselves related.

[16]Section 954(c)(2)(A); reg. section 1.954-2(b)(6).

[17]*See, e.g.*, JCS-10-87, *supra* note 14, at 1025 (referring to "passive income" for PFIC purposes to include "passive rents" instead of all rents).

[18]Reg. section 1.954-2(c).

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four specific requirements is met,[19] three of which, described below, may apply to rents from real property.[20]

First, under the acquisition and value-adding requirement,[21] the lessor must (i) have acquired and added ''substantial value'' to the real property, and (ii) be ''regularly engaged'' in the acquisition of and addition of substantial value to such real property.[22]

Second, under the managing and operating requirement, the lessor must, ''through its own officers or staff of employees,'' regularly perform ''active and substantial'' management and operational functions while the real property is leased.[23]

Third, under the marketing requirement, the lessor must lease the property by performing marketing functions, but only if the lessor, ''through its own officers or staff of employees located in a foreign country,'' maintains and operates an organization in that country that is (i) regularly engaged in the business of marketing, or of marketing and servicing, the leased property, and (ii) substantial in relation to the amount of rents.[24]

2. Application of the CFC rules to PFICs. Although the PFIC rules that define passive income are generally based on the CFC rules that define FPHCI, the two sets of rules are intended to handle very different U.S. tax issues. The CFC rules seek to address the U.S. tax treatment of specific mobile income, including especially related-party income earned by non-U.S. corporations owned by U.S. persons. The holding company's corporate structure and the allocation of income among the affiliates are critical.[25] However, the PFIC rules ignore the internal corporate structure of an operating company, and a holding company running one or several active businesses is generally not intended to be treated as a PFIC.[26] Incongruities inevitably arise about how to properly apply the CFC rules that specifically target the allocation of business functions and activities, and therefore income, among affiliates in the PFIC context. That allocation is not a concern in the PFIC context, and the 25 percent subsidiary look-through rule applies.

In resolving the incongruities, it is important to recognize that within the context of the PFIC rules, (i) we are determining the PFIC status of the RPOC and not that of its property-holding subsidiaries,[27] and (ii) the RPOC will not be treated as having derived the income at issue but for the attribution under the 25 percent subsidiary look-through rule.

3. The acquisition and value-adding requirement.

a. Two elements of the requirement under the CFC rules. Rental income may qualify for the ATB exception by meeting the acquisition and value-adding requirement, which has two elements. First, the lessor must be ''regularly engaged'' in the acquisition of and addition of value to property of the kind that produces the rental income. There does not appear to be any direct authority on the meaning of the term ''regularly engaged'' in the acquisition and value-adding requirement. We believe that in the absence of more specific regulatory guidance, that element should be measured against the standard of a typical commercial entity in the same or a similar business and in the same or a similar geographical location.[28] If the nature, frequency, and size of the RPOC's acquisition and development efforts are typical for a real property developer, its acquisition and value-adding activities should be treated as sufficient to meet the first element of the requirement.

Second, the lessor needs to have added ''substantial value'' to the real property under the lease. The

[19]Reg. section 1.954-2(c)(1).

[20]The fourth applies only to rental income derived from personal property. Reg. section 1.954-2(c)(1)(iii).

[21]For this purpose, ''the performance of marketing functions will not be considered to add substantial value to property.'' Reg. section 1.954-2(c)(2)(i).

[22]Reg. section 1.954-2(c)(1)(i). After this article was accepted for publication, the IRS issued temporary regulations requiring that the value must be added through a CFC's own officers or staff of employees (reg. section 1.954-2T(c)(1)(i), effective for rents received during tax years of a CFC ending on or after Sept. 1, 2015, but only for property to which substantial value has been added on or after Sept. 1, 2015).

[23]Reg. section 1.954-2(c)(1)(ii).

[24]Reg. section 1.954-2(c)(1)(iv).

[25]*See, e.g.*, David R. Sicular, ''The New Look-Through Rule: W(h)ither Subpart F?'' *Tax Notes*, Apr. 23, 2007, p. 349 (reviewing history and intended target of CFC rules). *See also* New York State Bar Association Tax Section, ''Report on Proposals for Guidance With Respect to Passive Foreign Investment Companies,'' at Section IV.C (May 22, 2001).

[26]H.R. Conf. Rep. No. 99-841, Vol. II, at 644 (1986); LTR 200813036 (describing section 1297(c) as intended to ''address holding company structure'' so that the structure would not *ipso facto* render a holding company a PFIC).

[27]*Compare* section 1298(a)(2)(A) (attribution through an upper-tier corporation of ownership of stock of a lower-tier PFIC applies only if a person directly or indirectly owns 50 percent or more in value of stock of the upper-tier corporation), *with* section 1298(a)(2)(B) (no such 50 percent threshold requirement if the upper tier corporation is itself a PFIC).

[28]The rules regarding unrelated business taxable income are instructive. Some organizations otherwise exempt from tax may be taxed on its UBTI. Section 512(a)(1). UBTI means the gross income derived by such an organization from any unrelated trade or business ''regularly carried on by it,'' less applicable deductions. *Id*. In particular, ''specific business activities of an exempt organization will ordinarily be deemed to be 'regularly carried on' if they manifest a frequency and continuity, and are pursued in a manner, generally similar to comparable commercial activities of nonexempt organizations.'' Reg. section 1.513-1(c)(1).

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regulations state that the performance of marketing functions is not considered to add substantial value for this purpose.[29] Otherwise there appears to be no direct authority on the meaning of substantial value in that context. Typically, an RPOC's activities go above and beyond mere marketing. An RPOC that acquires property, develops it for commercial or residential use, and carries out ongoing maintenance and renovations should also be treated as meeting the second element of the requirement.

b. Business activity aggregation under the 25 percent subsidiary look-through rule. Even if the RPOC meets the acquisition and value-adding requirement on a group-wide basis — when each of the properties acquired and developed is owned by a separate subsidiary treated as a corporation for U.S. tax purposes — an issue arises whether the ATB requirement must be met at the subsidiary level rather than the group level. An example in the CFC regulations considers a CFC that derives rental income from a single apartment complex that it acquired, owned, and then engaged a real estate management firm to manage and lease.[30] The example concludes that the CFC's rental income is not active rental income. Although the example does not discuss whether the CFC could meet the acquisition and value-adding requirement, it suggests that a one-off transaction is not sufficiently "regular." A special purpose vehicle generally is one-off by design in order to isolate and limit liabilities.

In the PFIC context, we believe that rental income derived by an RPOC regularly engaged in the acquisition of and addition of substantial value to real property should not be considered passive income solely because each property is placed in a wholly owned subsidiary of the RPOC that is treated as a corporation for U.S. tax purposes. We believe that the proper application of the 25 percent subsidiary look-through rule requires both the rental income and the business activities related to that income to be aggregated at the RPOC level and the acquisition and value-adding requirement to be assessed at the RPOC level as well.

The intent of the 25 percent subsidiary look-through rule is to ensure "that foreign corporations owning the stock of subsidiaries engaged in active businesses [not] be classified as PFICs."[31] By its terms, the 25 percent look-through rule requires that both the income and the assets be aggregated at the FC level for testing the FC's PFIC status.[32] We believe that the income and asset aggregation is the functional equivalent of the business activity aggregation. The RPOC has no rental income except for that attributed to it through the 25 percent look-through rule. It would be perverse to attribute to the RPOC its subsidiary's income and then to categorize the income by looking solely at the subsidiary directly earning the income when determining the RPOC's PFIC status rather than the subsidiary's PFIC status.

In two private letter rulings, the IRS has adopted the aggregate approach and applied it broadly. In the first ruling,[33] an FC sold 100 percent of its wholly owned non-U.S. subsidiary. The subsidiary owned directly or indirectly other non-U.S. subsidiaries. Under the CFC rules, income from the sale of stock is categorically passive income.[34] Nevertheless, that CFC-based rule was found not to apply in the PFIC context. Instead, the ruling stated that when applying the PFIC income test, the 25 percent subsidiary look-through rule required the assets of the underlying subsidiaries to be aggregated at the level of the FC and required the FC to be treated as if it sold its proportionate share of the business assets held by the subsidiaries.[35]

In the second ruling,[36] the stock of an indirect, wholly owned, non-U.S. subsidiary of an FC was sold. That subsidiary held that the majority of the FC's indirectly held shares in a 25 percent subsidiary, although it is unclear whether the portion held by the subsidiary, and therefore treated as sold by the FC, is itself at least 25 percent or whether the FC retains at least 25 percent of interests in the underlying subsidiary. The second ruling affirmed the first ruling and, citing an earlier ruling involving a sale of a wholly owned subsidiary,[37] further attributed the trade or business of any 25 percent subsidiary to the parent. Under the PFIC rules, section 1298(b)(3) provides a "change of business" exception for an FC that would otherwise meet the PFIC

[29]Reg. section 1.954-2(c)(2)(i).

[30]Reg. section 1.954-2(c)(3), Example 3.

[31]H.R. Conf. Rep. No. 99-841, Vol. II, at 644 (1986).

[32]It requires that the FC "*shall* be treated as if it . . . held its proportionate share of the assets of [the subsidiary], and . . . received directly its proportionate share of the income of" the subsidiary (emphasis added). Section 1297(c).

[33]LTR 200604020.

[34]Section 954(c)(1)(B). *See Dover Corp. v. Commissioner*, 122 T.C. 324 (2004) ("check-and-sell" converts stock sale to asset sale for CFC purposes).

[35]LTR 200604020. This is clearly the right result. Note that the 25 percent look-through rule requires that the dividend income from the 25 percent subsidiary be disregarded. *Supra* note 14. Thus, the stock in the 25 percent subsidiary does not produce passive income and is not held for the production of passive income.

[36]LTR 200813036.

[37]LTR 200015028.

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test. The exception requires that "substantially all of the [FC's] passive income . . . for the taxable year [be] attributable to proceeds from the disposition of [one] or more active trades or businesses."[38] In the ruling, the proceeds from the sale of the subsidiary were sufficient for the FC to meet the asset test.[39] The ruling, however, stated that "it is appropriate that the disposition of stock of [a subsidiary] engaged in an active trade or business . . . constitute the disposition of an active trade or business by" FC itself, and, therefore, the change of business exception may apply.[40] The ruling reached its conclusion even though, absent an agency imputation, the FC is not ordinarily treated as being engaged in its direct or indirect and potentially minority-owned subsidiary's trade or business.

In light of the foregoing,[41] we believe that the acquisition and value-adding activities of the RPOC, as well as those of all the RPOC's direct and indirect wholly owned subsidiaries, should be aggregated to determine whether the rental income attributed to the RPOC under the 25 percent subsidiary look-through rule would meet the acquisition and value-adding requirement. We therefore believe that the RPOC should be treated as earning rental income that typically meets the acquisition and value-adding requirement, if it meets the requirement on the aggregated, group-wide basis.

4. The managing and operating requirement and the marketing requirement. The rental income may also qualify for the ATB exception by meeting either the managing and operating requirement or the marketing requirement. Under either requirement, the CFC rules require that the relevant activities be carried out by employees of the entity that derives rental income and not by employees of an affiliate.[42] Similar to the business activity aggregation issue discussed above for the acquisition and value-adding requirement, a question arises about how to apply the "own employee" requirement given the 25 percent subsidiary look-through rule.

Regarding the income that the RPOC is treated as deriving under the 25 percent subsidiary look-through rule, the RPOC may not meet the "own employee" requirement literally as it exists under the CFC rules. The CFC rules look to the direct income-deriving entity for employees. But under an RPOC, the employees of the group are typically not employees of the property-holding subsidiaries that earn the rental income and may not be employees of the RPOC itself. However, for the same reasons that aggregation is appropriate for the acquisition and value-adding requirement, we believe that the employees of all the 25 percent subsidiaries should be aggregated at the RPOC level to determine whether the RPOC meets either the managing and operating requirement or the marketing requirement.[43]

Even with aggregating employees and activities, it remains to be determined whether the RPOC's management and operational functions are "active and substantial" under the managing and operating requirement and whether its marketing function is "substantial" under the marketing requirement.[44] They often are substantial, but it is not difficult to imagine situations in which they are not.

C. Closing Comments

Section 1297(b)(1)'s reference to section 954(c) is in some sense a historical accident. When introduced in 1986, the PFIC provisions defined passive income by reference to section 904(d), which describes passive income for purposes of the foreign tax credit basket.[45] Proposed and final regulations under section 904(d) issued between 1986 and 1988 stated that rents would be considered active if the ATB requirement was satisfied by either the corporation itself or by a member of the corporation's affiliated group (defined to include FCs).[46] In 1988 Congress changed the reference in section 1297(b)(1) from section 904(d) to section 954(c), noting that the change was intended to clarify that the look-through rules in section 904(d)(3) and

[38]Section 1298(b)(3)(B)(i). More requirements apply. Section 1298(b)(3).

[39]Notice 88-22, 1988-1 C.B. 489 (providing that working capital is generally a passive asset).

[40]LTR 200813036.

[41]A private letter ruling has no precedential value. Section 6110(k)(3). However, while containing the obligatory reference to section 6110(k)(3), the second private letter ruling (i) cites two other private revenue rulings expounding the same aggregate approach, and (ii) states that it represents the view of the IRS. LTR 200813036.

[42]Reg. section 1.954-2(c)(1)(ii), -2(c)(1)(iv), and -2(c)(2)(iii)(A). The marketing requirement refers to a lessor that, "through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country." It is unclear what the relationship of that organization to the lessor/CFC itself must be. Further, if the organization resides in a country different from the CFC's place of incorporation, it is unclear how the CFC can meet the "own employee" requirement without being subject to a significant permanent establishment risk in that country.

[43]On a pro rata basis if any such proration is appropriate.

[44]We believe that the substantiality safe harbor for the marketing requirement, which distinguishes compensation for personal services of a CFC's own employees from that for personal services of a related person, reg. section 1.954-2T(c)(2)(ii) and -2(c)(2)(iii)(A), should be applied by properly including the employees of all 25 percent subsidiaries and should therefore be tested on a functional and not an organizational basis.

[45]*See* section 1296(b)(1) (as enacted in 1986).

[46]Former prop. reg. section 1.904-6(b)(2)(i)(A) and (B); reg. section 1.904-4(b)(2)(ii).

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(d)(5) do not apply for PFIC purposes because the PFIC's own look-through rules were amended at the same time.[47] In changing the reference from section 904(d) to section 954(c), there is no indication that Congress intended to impose an "own employee" requirement for the PFIC rules.[48] To the contrary, to help FCs "that own subsidiaries that are primarily engaged in active business operations" avoid PFIC status, Congress made explicit that the 25 percent subsidiary look-through rule applies regarding an indirect 25 percent subsidiary.[49]

Some practitioners have commented on the inconsistency with congressional intent if the CFC "own employee" requirement is mechanically applied in the PFIC context. Others have advocated more directly that the requirement should not apply in the PFIC context.[50] We agree with those views. We also believe that in some cases, the acquisition and value-adding requirement provides an alternative for treating some rental income as non-passive for PFIC purposes.[51] Despite the IRS's claim of some indication to the contrary based on an example in the regulations, reg. section 1.954-2(d)(3), Example 5, the acquisition and value-adding requirement plainly did not include an "our employee" component in the context of this article until the new temporary regulations, and the IRS appears to recognize it.[52]

The IRS announced in the 2010-2011 priority guidance plan that additional regulatory guidance on the 25 percent subsidiary look-through rule was a priority,[53] but its attention may have since turned elsewhere.[54] When guidance comes, it should be consistent with the views expressed in this article. Any significant deviation can only be prospective and made with a period of transition to allow for taxpayer self-help.

The statute does not suggest, let alone require, anything contrary to the views expressed in this article. The legislative history supports them. There is no policy reason weighing against the approach that we advocate. We take reassurance in the limited taxpayer-friendly administrative guidance, which, in the form of letter rulings, technically has no precedential value.[55] Nevertheless, the rules are unclear at the moment, and the IRS could make new law. What is clear is that a contrary approach would, given the punitive nature of the PFIC regime, inflame the sense of irrationality, unfairness, and almost trickery in some quarters about U.S. tax rules.[56] Cynicism, especially when warranted, does not promote tax compliance or facilitate tax administration.

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[47]S.R. Conf. Rep. No. 100-445, at 285-286 (1988); JCT, "Description of the Technical Corrections Act of 1988," at 289-290, 293 (Mar. 31, 1988); *see also* section 1296(c) (as enacted in 1988).

[48]*See* Mary C. Bennett, "U.S. Definition of 'Active Rents' for PFIC Purposes Creates Problems," *Tax Notes Int'l*, May 5, 1997, p. 1437, 1439.

[49]S.R. Conf. Rep. No. 100-445, at 282 and 286 (1988).

[50]*See, e.g.*, NYSBA, "Report on Select Issues With Respect to the Passive Foreign Investment Company Rules," Part 9 (Mar. 8, 2010); and NYSBA, *supra* note 25, at Section IV.F.

[51]The issue could be addressed if the property-holding special purpose vehicles, the employer of the group (if not the FC itself), and their parent entities under the FC all make a CTB election to be treated as disregarded. In that case, aggregation is achieved because for U.S. federal income tax purposes there is only one entity, the FC, which holds all the property, has all the employees, and conducts all the activities.

[52]*See supra* note 22 (effective date provisions of the new regs).

[53]*See* Treasury, "2010-2011 Priority Guidance Plan," at 16 (Dec. 7, 2010) (referring to guidance under section 1297(c) in particular).

[54]*See, e.g.*, Treasury, "2015-2016 Priority Guidance Plan," at 15 (July 31, 2015) (referring to guidance under sections 1295, 1297, and 1298 in general).

[55]*But see supra* note 41.

[56]Section 1291(a) (imposing the punitive "excess distribution" regime), and section 1298(b)(1) (providing the "once a PFIC, always a PFIC" rule). In our view, the rule that working capital is per se a passive asset, Notice 88-22, 1988-1 C.B. 489, should be revisited. The start-up year exception of section 1298(b)(2) provides limited relief, but the working-capital rule of section 1202(e)(6) for qualified small business stock is much more sensible for the PFIC context as well. It is not entirely clear, however, whether the IRS has the regulatory authority to promulgate a similar rule for the PFIC asset test.

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