

# U.S. Tax and Capital Markets: PFIC, FATCA and TEFRA

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# Agenda

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- This discussion reviews three U.S. federal income tax regimes relevant to capital markets transactions by non-U.S. private issuers: “*PFIC*,” “*FATCA*” and (briefly) “*TEFRA*”.
- The focus will be on the aspects of those regimes most relevant to capital markets offerings.
  - **Not a complete discussion of all the details of these rules**, especially as they apply to indirect investors (e.g., the investors in investment funds).
- The PFIC regime is most important of the three, and will be the main focus of the discussion.

# PFICs - Background

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- Generally, U.S. shareholders of corporations are subject to tax on corporate stock:
  - When dividend distributions are actually declared and paid by the corporation to the shareholder (as dividends, return of capital, or as capital gains); and
  - When the shareholder sells the shares of the corporation (as capital gain or loss).
- These general rules apply to both domestic and foreign corporations.
- As a result, there is a broad potential opportunity for U.S. shareholders to defer paying tax on the undistributed income of a foreign corporation until the stock is sold.

# PFICs - Background

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- In response to this perceived deferral opportunity, there are two broad anti-deferral regimes applicable to U.S. shareholders in foreign corporations:
  - The controlled foreign corporation (CFC) rules limit the opportunity for deferral by “United States shareholders,” who are very generally shareholders that hold, directly or by attribution, more than 10% of the voting stock of the foreign corporations.
    - It is longstanding practice for securities offerings and disclosure documents to carve potential “United States shareholders” under the U.S. CFC rules out from the disclosure.
    - 2017 tax reform substantially changed the CFC regime for corporations, but these rules (and their reform) are not discussed here as not usually directly relevant in equity capital markets offerings.
  - The passive foreign investment company (PFIC) rules potentially apply to all shareholders of foreign corporations that are not United States shareholders of a CFC.
    - The potential effect on individual holders being subject to the PFIC rules is substantial, and so is a major focus of foreign equity offering tax disclosures addressed to U.S. persons.
    - **Every equity capital markets offering by a non-U.S. corporation needs to consider the effect of the PFIC rules if the potential market for the stock includes the U.S. market.**

# PFICs - Background

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- There are limits to the scope of the PFIC regime:
  - Only applies to foreign corporations, not partnerships.
  - Generally does not apply to U.S. nonresident taxpayers that do not hold the stock of the foreign corporation in connection with the conduct of a U.S. trade or business.
  - Only applies to shareholders – **not the foreign corporation itself.**
    - **BUT the status of the foreign corporation as a PFIC, or not, determines whether the PFIC rules apply to the shareholder.**

# PFICs – What is it?

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A foreign corporation is treated as a PFIC for U.S. federal income tax purposes if it meets either the income test or the asset test:

- A foreign corporation satisfies the income test if 75% or more of its gross income for the taxable year is passive income.
- A foreign corporation satisfies the asset test if 50% or more of the assets held by the corporation generate passive income.

There is a very limited “start-up exception:” a foreign corporation that would otherwise be a PFIC in the first year that it has gross income will not be treated as PFIC for either of the first two taxable years following the startup year.

# PFICs – What is it?

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Passive income generally includes

- Dividends (including payments in lieu of dividends);
- Most interest (including interest on bank deposits but not interest from an active financing business);
- Most rents and royalties (other than rents and royalties from an active business);
- Annuities;
- Gains and losses from sales of property generating the preceding types of income;
- Commodities transactions (other than hedging transactions or from an active commodities business);
- “Nonfunctional” (i.e., foreign) currency income (defined from the point of view of the corporation); and
- Income from a narrow universe of personal services contracts.

# PFICs – What is it?

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An asset than can produce passive income generally includes any asset that could produce passive income, ***whether or not it does***.

- The single most vexing category of asset that can produce passive income is, by far, cash.
  - Cash is expressly carved into the scope of this definition by administrative guidance that is over 30 years old and which has never been modified, withdrawn or codified into regulations.
  - The absurd result this creates has been an issue in countless equity offerings over the last three decades.
- An asset that can produce passive income must be included in the asset test even if no income is expected to be generated from the asset for years, if ever.
  - Land not held in an “active business” is a major example.
  - Intellectual property not currently being exploited also raises issues.
- If an asset can produce both passive and nonpassive income, the asset must be bifurcated.
  - Can be a significant issue for natural resources and mining companies.



# PFICs – Significant Negative Investor Consequences.

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- A U.S. shareholder of a PFIC is subject to significant negative U.S. tax consequences:
  - Preferential rates on long-term capital gain are unavailable.
  - Gain allocated over the investors holding period; and the amount allocable to prior taxable years is taxed at the highest ordinary income rate for that year, plus an interest charge imposed.
  - “Excess distributions” subject to the same general rule as for gains.
    - Excess = distribution over 125% of the average distribution for the prior three years.
    - Qualified dividend treatment (offering lower rates in some circumstances) is unavailable.
  - The interest charge effectively imposes a penalty tax on excess distributions.

# PFICs – What can you do about it?

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- Once a PFIC, always a PFIC.
- PFIC status is tested on an investor-by-investor basis.
- The PFIC status of a foreign corporation is relevant every year to potentially affected holders.
- There are limited “purging elections” that holders of PFIC stock can make if a foreign corporation ceases to be a PFIC in a future taxable year...BUT they are complicated and potentially unavailable depending on the facts.
- The important elections are the “qualified electing fund” election and the “mark-to-market” election.

# PFICs – What can you do about it?

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- QEF Election:
  - A QEF election is made by each individual shareholder. It generally has the effect of turning the foreign corporation into a “modified” pass-through entity:
    - the shareholder takes into account their allocable share of net ordinary income and net capital gain of the foreign corporation each year, whether or not a dividend is paid; BUT
    - losses, deductions and credits generally do not flow-through.
  - Whether a shareholder can make a QEF election depends on both how the shareholder holds the shares (not the issuer’s problem) and the foreign corporation providing two things:
    - provide a “PFIC Annual Information Statement” setting forth the information the shareholder needs to report the net ordinary income and net capital gain (ISSUE: this costs money); and
    - allow access by the shareholder to the foreign corporations books and records necessary to verify the information (ISSUE: management may not like this).

# PFICs – What can you do about it?

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- Mark-to-market election:
  - A mark-to-market election is made by each individual shareholder.
  - It generally has the effect of requiring to take into account ordinary gain or loss on the foreign corporation stock by marking the stock to market at the end of each year, and a correlating basis adjustment is made each year as well, until disposition.
  - Whether a shareholder can make a mark-to-market election depends on whether the stock is “marketable stock,” which in turn depends on whether the stock is traded on a qualifying securities exchange (which is not well defined).

# FATCA – An update

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- FATCA has now been on the books for ten years.
- The purpose of the statute was to ensure that foreign financial institutions meet certain U.S. information reporting requirements to their U.S. investors and the U.S. tax authorities, or suffer a U.S. withholding tax on a wide range of U.S. – source “withholdable payments.”
- The compliance burden created by FATCA, in combination with similar efforts by other tax authorities around the globe, has been enormous.
- The amount of additional tax collected by various global tax authorities is uncertain – however, the *in terrorum* effect of these laws generally has been viewed as successful in reducing the ability of U.S. taxpayers to “hide” assets through foreign banks and other holding structures.

# FATCA – An update

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- Withholdable payments have always included U.S. source interest, dividends, rents, salaries and other “fixed and determinable annual or periodical income”.
- Withholdable payments were to begin to include the gross proceeds from the sale or other disposition of property that can produce the above categories of income, such as the sale of U.S. stock or U.S. debt instruments – but this requirement has been eliminated.
  - This eliminated the biggest risk relating to FATCA – withholding on gross proceeds would effectively have potentially taxed invested capital, not just return on investment.
- Withholding on so-called “pass-thru payments” has been deferred indefinitely.
  - Defining the scope of pass-thru payments subject to withholding is a hugely problematic exercise.

# Death of TEFRA and the great beyond

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- U.S. taxpayers that hold “registration required obligations” (which includes virtually all debt instruments with a maturity of greater than one year issued in the capital markets) are subject to severe penalties if they hold debt issues in bearer form.
- There used to be an exception for “foreign targeted” offerings – there were the (in)famous(?) TEFRA C and TEFRA D rules, but this was repealed in 2012.
- As a result, U.S. companies (and non-U.S. companies that wish their bonds to be held by U.S. persons effectively must issue debt securities in registered form.
- The biggest issue this raised was the effectiveness of “dematerialized book entry systems”.
  - 2012 administrative guidance provides protection for such systems so long as the bonds are “effectively immobilized.”

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## Education

New York University  
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## Admissions & Qualifications

New York State Bar, 2004

**Martin T. Hamilton** is a partner in the Tax Department. He primarily handles U.S. corporate, partnership and international tax matters.

Martin's practice focuses on mergers and acquisitions, cross-border investments and structured financing arrangements, as well as tax-efficient corporate financing techniques and the tax treatment of complex financial products. He has experience with public and private cross-border mergers, acquisitions, offerings and financings, and has advised both U.S. and international clients, including private equity funds, commercial and investment banks, insurance companies and multinational industrials, on the U.S. tax impact of these global transactions.

In addition, Martin has worked on transactions in the financial services, technology, insurance, real estate, health care, energy, natural resources and industrial sectors, and these transactions have involved inbound and outbound investment throughout Europe and North America, as well as major markets in East and South Asia, South America and Australia.

Prior to joining Proskauer, Marty practiced at Sullivan & Cromwell LLP in their New York and London offices.

## **Memberships**

New York State Bar Association, Executive Committee (since 2020)

International Fiscal Association, New York Steering Committee (since 2019)

## **Languages Spoken**

French

## **Other Distinctions**

*Chambers USA*: New York: Tax 2016

*The Legal 500 United States*: U.S. Taxes: Non-Contentious 2018-2020

*The Legal 500 United States*: Tax: Domestic Tax: East Coast 2013, 2015-2016

*The Legal 500 United States*: International Tax 2016-2020



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