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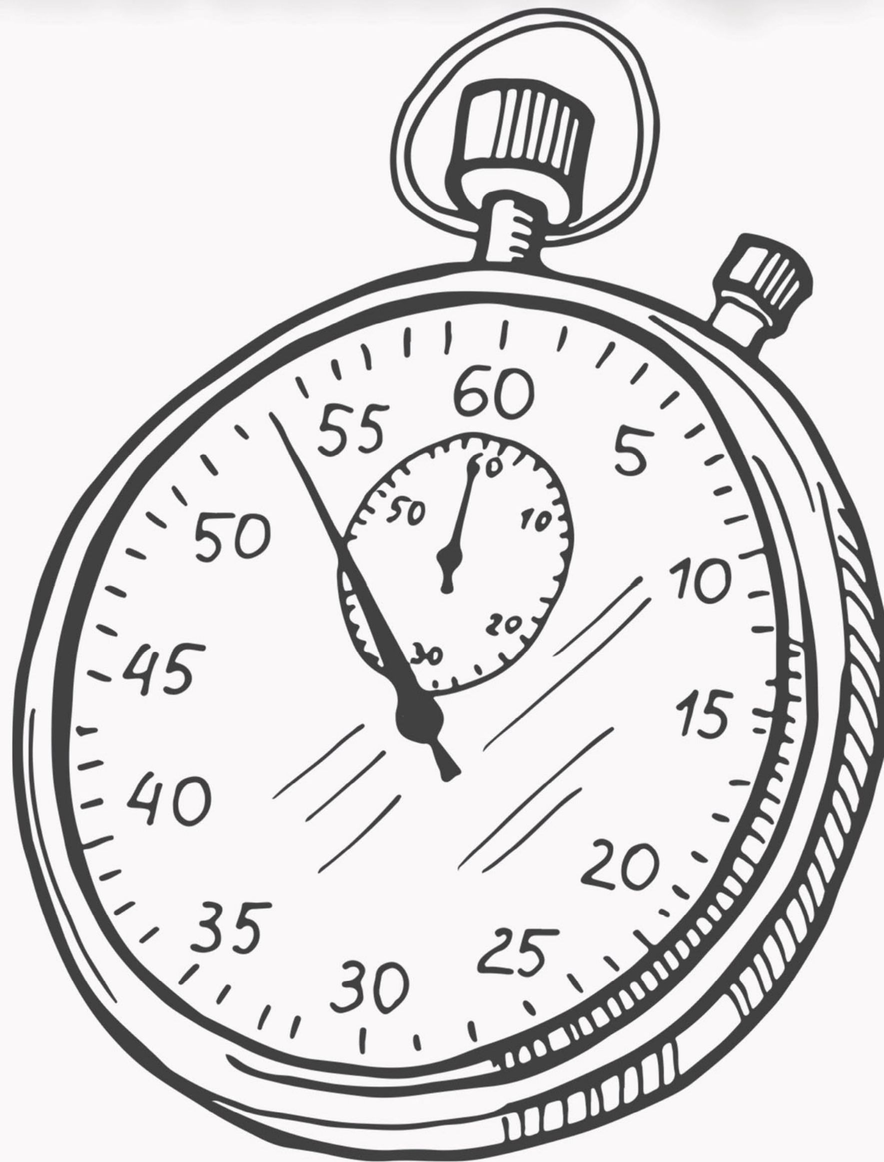
Expanding Access to Retroactive QEFs



A Biden Proposal That Deserves Swift Enactment

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Expanding Access to Retroactive QEFs: A Biden Proposal That Deserves Swift Enactment

by Kevin M. Cunningham

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In this article, Cunningham examines the Biden administration's proposal to expand access to retroactive qualified electing fund elections and explains why that reform is needed.

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On March 28 the Biden administration released its fiscal 2023 budget ("budget")[1] that includes a variety of tax proposals, many of which — raising the corporate income tax rate to 28 percent, for example — were headline-grabbers and well reported in the mainstream press. Also included in the same budget, however, were a number of lesser-known proposals that attracted significantly less attention. These proposals tend to affect fewer people, are less controversial politically, and have a relatively small or no effect on the deficit. Nevertheless, those kinds of proposals are usually included either because they are antiabuse provisions or they improve tax policy in some meaningful way.

The budget was accompanied by a Department of Treasury document describing the budget proposals (the "general explanation").[2] In the general explanation, under the heading "reform business and international taxation," is a proposal described as: "Expand access to retroactive qualified electing fund elections." That provision, although seemingly obscure to the average tax-paying citizen, would improve international tax policy in a very meaningful way. It would remove a significant trap for the unwary, reduce administrative costs on the taxpayer and the IRS, and broaden the opportunities to obtain relief from one of the most punitive provisions in the tax code — the passive foreign investment company rules — without prejudicing the IRS or the U.S. fisc. In fact, even though it would be a relief provision for so many taxpayers, it is actually scored to reduce the deficit, although the reduction is a relatively insignificant $8 million over five years and $39 million over 10 years.[3]

This article discusses why that proposal needs to be enacted and how obtaining relief from the PFIC rules under the current QEF regime is unnecessarily stringent. It then discusses why the need for retroactive QEF elections is likely to increase in the future, taking into account the difficulties taxpayers are likely to encounter in connection with QEF elections for PFICs that are owned through a domestic partnership. Then the article discusses what a statute enacting such a proposal would look like, what regulations would

[1] Office of Management and Budget, "Fiscal Year 2023 Budget of the U.S. Government" (2022) ("budget").

[2] Department of Treasury, "General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals" (Mar. 2022) ("general explanation").

[3] Budget, *supra* note 1, at 131.

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be required, and how the provision would likely affect taxpayers going forward.

Although Congress did not include this proposal in the Inflation Reduction Act (P.L. 117-169), Congress will hopefully include this nonpartisan provision in other tax legislation, such as an omnibus bill, and enact it as soon as is reasonably possible.

I. Background

For holders of shares in a PFIC, the U.S. tax rules, and more specifically section 1291, create a special tax regime with very unfavorable results. Very summarily, a foreign corporation is a PFIC if: (1) 75 percent or more of the gross income of such corporation for the tax year is passive income; or (2) the average percentage of the assets held by such corporation during the tax year that produce passive income or that are held for the production of passive income is at least 50 percent.[4] Passive income is defined as income that would be section 954(c) foreign personal holding company income, subject to specific exceptions.[5] The percentage of assets that is passive generally is measured based on the average of values (or adjusted bases) of the assets on quarterly measuring periods during the foreign corporation's tax year.[6]

If a foreign corporation qualifies as a PFIC, there are a number of bad things that can happen to an owner of the shares that does not make specific elections. The biggest detriments are generally set forth in section 1291 and include the following: (1) gain on sale is not eligible for capital gain treatment (section 1291(a)(2)); (2) distributions cannot qualify for capital gain rates of section 1(h)(11); (3) there is usually an interest charge imposed on taxpayers to compensate the government for the benefit of the deferral of tax on gain on sale or some large distributions (section 1291(c)); (4) distributions can be subject to tax even though they exceed the payer's earnings and profits (section 1291(b)); (5) a taxpayer can be subject to the PFIC rules even if it disposes of the shares in a manner that would ordinarily not be a taxable disposition — for example, by pledging or gifting them (section 1298(b)(6)); and (6) income from such distributions and gain on dispositions are subject to tax at the highest marginal rate in effect for the year (section 1291(c)(2)). And regarding the rule requiring the highest marginal rate, the rules treat such distributions or gains from a disposition as earned ratably over the taxpayer's holding period in the shares such that the highest marginal rate for an amount allocated to an earlier year in which the corporation was a PFIC could be, say, 35 percent for a domestic corporation owner if such amount is allocated to a pretax reform year.

Faced with all these adverse tax consequences, most taxpayers who own shares in a PFIC want out. But the opportunities to get out are, unfortunately, very limited and, even more importantly, often require timely recognition of the PFIC problem.

First, there are the mark-to-market rules of section 1296, but these rules are available only to holders of PFIC shares that are "marketable stock," which is generally defined as shares regularly traded on specific exchanges.[7] Also, although the mark-to-market rules eliminate the interest charge, they do not solve for the unfavorable characterization of gain as ordinary income under the PFIC rules.[8]

The relief mechanism shareholders of PFICs most commonly use are the QEF rules, which are available only if the PFIC provides an annual information statement.[9] The section 1293 QEF rules provide the most complete relief from the PFIC rules, although they treat the taxpayer's investment as more analogous to an investment in a passthrough rather than a corporation:

> (a) Inclusion.
>
> > (1) In general. Every United States person who owns (or is treated under section 1298(a) as owning) stock of a qualified electing fund at any time during the taxable year of such fund shall include in gross income —

[4] Section 1297(a).

[5] Section 1297(b); reg. section 1.1297-1(c).

[6] Reg. section 1.1297-1(d). An election can be made to use measuring periods that are shorter than quarterly.

[7] Section 1296(e); reg. section 1.1296-2.

[8] Section 1296(c)(1); reg. section 1.1296-1(c)(2) (providing that mark-to-market gains and gain on disposition is ordinary).

[9] Reg. section 1.1295-1(g).

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> (A) as ordinary income, such shareholder's pro rata share of the ordinary earnings of such fund for such year, and
>
> (B) as long-term capital gain, such shareholder's pro rata share of the net capital gain of such fund for such year.

Thus, a shareholder in a PFIC that has made a valid QEF election is required to include in its income its pro rata share of the PFIC's annual earnings and profits, which is treated either as ordinary income or, if the PFIC had net capital gain in the year, as long-term capital gain. More importantly, if the shareholder makes the QEF election in the first year that it owns the PFIC, the shareholder of the PFIC will recognize capital gain, rather than ordinary income, on the disposition of the PFIC to the extent the amount a shareholder realizes exceeds its basis, including adjustments for the above inclusions and distributions. In addition to obtaining capital gain treatment on a disposition, the shareholder's election to include the QEF's income in its own income, if made in the first year that the shareholder owns the PFIC, eliminates almost entirely the negative tax consequences of owning a PFIC. For example, the interest charge is no longer required because the current inclusion eliminates any possibility of deferral. Also, inclusions are based on traditional concepts of earnings and profits, which, as discussed earlier, aren't relevant to whether a so-called excess distribution is taken into income under the traditional PFIC rules.[10] And a disposal of QEF shares by pledge or gift would not be considered a taxable transfer. The rules accomplish this differentiation with section 1291(d), which provides:

> (d) Coordination with subparts B and C [sections 1293-1296].
>
> (1) In general. This section [1291] shall not apply with respect to any distribution paid by a passive foreign investment company, or any disposition of stock in a passive foreign investment company, if such company is a qualified electing fund with respect to the taxpayer for each of its taxable years —
>
> (A) which begins after December 31, 1986, and for which such company is a passive foreign investment company, and
>
> (B) which includes any portion of the taxpayer's holding period.

Section 1291(d)(1) is a tough-medicine provision; it basically provides that, unless a shareholder has made a QEF election for the shareholder's entire holding period, a shareholder will still be subject to all the adverse tax consequences in section 1291.

Also, the much dreaded "once a PFIC, always a PFIC" rule of section 1298(b)(1) would be applicable to stock of a shareholder that has failed to make a QEF election for each tax year of its holding period. Section 1298(b)(1) treats stock of a taxpayer as stock in a PFIC if a foreign corporation was a PFIC that was not a QEF "at any time during the holding period of the taxpayer with respect to such stock"; thus, the shareholder's stock cannot move out of PFIC status if the foreign corporation ceases to meet the definition of a PFIC at some later point during the shareholder's holding period.

Because section 1291(d) removes a foreign corporation that would otherwise meet the definition of a PFIC from the adverse tax consequences of section 1291 if and only if the foreign corporation is a QEF for the shareholder's entire holding period, a shareholder that makes an election to be treated as a QEF later than the first year of its holding period will still be viewed as owning stock in a PFIC for purposes of section 1291 and therefore will not escape most of the detriments of the PFIC rules unless the shareholder also makes a "purging election."[11] Specifically, such a shareholder will pick up its pro rata share of ordinary earnings and capital gains of the QEF, as described in section 1293(a)

[10] *See* section 1293(e).

[11] A shareholder can make a deemed sale election or, in certain cases, a deemed dividend election in connection with a QEF election to "purge" the PFIC status of the corporation. Section 1291(d)(2); reg. sections 1.1291-9 and -10.

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above, but the other detriments of PFIC ownership still apply: For example, gain on sale is ordinary, the interest charge on sale is imposed and calculated based on the part of the holding period when the QEF election is not in effect, a pledge or a gift is a taxable disposition, and the once a PFIC, always a PFIC rule is applicable.

To sort out QEFs that have made the election for the entire period from those QEFs that have not, the regulations have coined the term "pedigreed QEF":

> A PFIC is a pedigreed QEF with respect to a shareholder if the PFIC has been a QEF with respect to the shareholder for all taxable years during which the corporation was a PFIC that are included wholly or partly in the shareholder's holding period of the PFIC stock.[12]

Those QEFs that are not pedigreed QEFs are tossed into the definition of a section 1291 fund, and the definition of a section 1291 fund also includes PFICs that have not made a QEF election at all. In that regard, reg. section 1.1291-1(b)(2)(v) provides that "a PFIC is a section 1291 fund with respect to a shareholder unless the PFIC is a pedigreed QEF with respect to the shareholder or a section 1296 election [mark-to-market] is in effect with respect to the shareholder."

To be sure, a pedigreed QEF that satisfies the section 1297(a) definitional test for a tax year is still considered a PFIC.[13] However, notwithstanding the classification of a pedigreed QEF as a PFIC, pedigreed QEF status is still preferable to section 1291 fund status because it eliminates the interest charge, ordinary income treatment on disposition, taxation at the highest marginal rate, deemed dispositions upon gifts or pledges, and the once a PFIC, always a PFIC rule. Absent a QEF election in the first year (or a purging election in connection with a QEF election in a future year), the shareholder's stock will be tossed back into section 1291 fund status and be subject to all those unfortunate consequences, notwithstanding the fact that it will include its pro rata share of ordinary earnings and capital gains for each year the QEF election is in effect. As such, for most taxpayers, electing QEF status in the first year is the best way to escape most of the adverse tax consequences set out in the PFIC rules.[14]

II. The Enigmatic Retroactive Election

If a shareholder fails to make its QEF election in the first year of ownership, a retroactive QEF election is very difficult to make. Section 1295 provides the following on QEF elections:

> (b) Election.
>
> (1) In general. A taxpayer may make an election under this subsection with respect to any passive foreign investment company for any taxable year of the taxpayer. Such an election, once made with respect to any company, shall apply to all subsequent taxable years of the taxpayer with respect to such company unless revoked by the taxpayer with the consent of the Secretary.
>
> (2) When made. An election under this subsection may be made for any taxable year at any time on or before the due date (determined with regard to extensions) for filing the return of the tax imposed by this chapter for such taxable year. *To the extent provided in regulations, such an election may be made later than as required in the preceding sentence where the taxpayer fails to make a timely election because the taxpayer reasonably believed that the company was not a passive foreign investment company*. [Emphasis added.]

Thus, as drafted, section 1295(b)(2) provides that a QEF election must be made on or before the due date, including extensions for the tax return

[12] Reg. section 1.1291-1(b)(2)(ii).

[13] Prop. reg. section 1.1291-1(b)(1)(i) ("A passive foreign investment company (PFIC) is a foreign corporation that satisfies either the income test of section 1296(a)(1) or the asset test of section 1296(a)(2).").

[14] Even if a pedigreed QEF election is made, dividend distributions from the QEF cannot qualify for the capital gain rates of section 1(h)(11). Section 1(h)(11)(C)(iii).

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for the year to which the election will first apply.[15] The legislative history for the PFIC rules does not provide a lot of insight as to why late QEF elections are not permitted, merely restating the requirement that "the election to be a qualified electing fund for any taxable year must be made before the 15th day of the third month of the taxable year following the year for which the election is being made."[16] Although there is an exception in section 1295(b) providing regulatory authority to make a late election, a late election is permitted only when the failure is "because the taxpayer reasonably believed that the company was not a passive foreign investment company."

Of course, it would be very easy for a taxpayer in a later year to certify that it reasonably believed the company was not a PFIC and then move to make a retroactive QEF election on that basis. So instead, Treasury and the IRS interpret section 1295(b)(2) to permit a shareholder of a PFIC to make a retroactive QEF election in limited circumstances when the shareholder either (1) possessed reasonable belief that the corporation was not a PFIC and filed a protective statement at the time or (2) the shareholder demonstrates that it reasonably relied on the advice of a qualified tax professional and concluded, based on that advice, that the company was not a PFIC.[17]

In each case, the requirements to make a proper retroactive QEF election are enumerated in reg. section 1.1295-3. Under that regulation, in order to obtain a retroactive QEF election based on a reasonable belief statement, the shareholder must have: (1) reasonably believed that, as of the election due date, the foreign corporation was not a PFIC for its tax year that ended during the retroactive election date; and (2) unless the shareholder is a qualified shareholder, filed a protective statement with respect to the foreign corporation, applicable to the retroactive election year, in which the shareholder described the basis for its reasonable belief and extends the statute of limitations for the assessment of PFIC taxes.[18] The exception for a qualified shareholder covers a shareholder that directly, indirectly, or constructively owned less than 2 percent of the shares of the foreign corporation by vote and value during the entire holding period, but only if the foreign corporation or its U.S. counsel indicated in a public filing, disclosure statement, or other notice provided to its shareholders that the foreign corporation reasonably believed it is not or should not be a PFIC, or, in other specific circumstances, is "more likely than not" not a PFIC.[19]

The exception for reliance on the advice of a qualified tax professional requires that the taxpayer obtain special consent from the IRS (in the form of a private letter ruling) in order to make a retroactive PFIC election.[20] Special consent will be provided only if: (1) the shareholder reasonably relied on a qualified tax professional; (2) granting consent will not prejudice the interests of the U.S. government;[21] (3) the shareholder requests consent before an IRS representative raises upon audit the PFIC status of the corporation for any tax year of the shareholder; and (4) the shareholder satisfies specific procedural requirements.[22]

Both exceptions are lacking. Regarding the first one, the protective statement is often inadequate because it frequently is not practical for an investor to identify PFIC issues on a timely basis and then file a protective statement. For example, many start-up companies, especially in the biotech industry, can become PFICs even though they undertake operating activities because they have a significant amount of cash reserves and a limited amount of, or even no, gross income.[23] Also, even a company that has been established for years can become a PFIC

[15] A QEF election applies to the year for which it is made and all subsequent tax years in which the corporation is a PFIC unless the election is invalidated, terminated, or revoked. Section 1295(b)(1); reg. section 1.1295-1(c).

[16] H.R. Rep. No. 99-841, Pt. II, at 643 (Conf. Rept.) (1986). As enacted in 1986, the QEF election had to be made by the PFIC by the 15th day of the third month of the tax year following the year for which the election was made.

[17] T.D. 8750 (Jan. 2, 1998).

[18] Reg. section 1.1295-3(b) through (e).

[19] Reg. section 1.1295-3(e).

[20] Reg. section 1.1295-3(f)(1).

[21] The regulations allow the IRS to enter into a closing agreement with the taxpayer in order to eliminate any prejudice to the government for closed years if the retroactive QEF election relates to closed years. Reg. section 1.1295-3(f)(3)(ii).

[22] Reg. section 1.1295-3(f).

[23] "NYSBA Tax Section Sends Treasury Report on PFICs," *Tax Notes*, May 28, 2001, p. 1516.

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under the right circumstances.[24] Tax professionals have coined the term "accidental PFIC" to describe these types of PFICs.[25] Thus, it is often not enough to analyze only investment companies, such as special purpose acquisition companies (SPACs), because operating companies can become PFICs too. And given the complexity of circumstances by which these operating companies can become PFICs, it is often not feasible for an investor to comply with the protective statement requirements.

The second one, the special consent regime, provides a more accessible avenue for relief, but it is relatively expensive, requiring very significant advisory and IRS filing fees. Also, the shareholder must have reasonably relied on a qualified tax professional who failed to identify the foreign corporation as a PFIC or failed to advise the shareholder of the consequences of making, or failing to make, the QEF election.[26] It is not as easy as making a simple statement to that effect; rather, the regulations require "detailed affidavits" from the individuals having knowledge about the failure to make the QEF election (usually the tax adviser who prepared the original tax return), describing how it was discovered.[27]

Indeed, in the general explanation, the Treasury Department identifies these same reasons for why it is proposing broader access to retroactive QEF elections:

> Under current law, individuals who inadvertently did not make a QEF election with respect to a PFIC investment may not be eligible for relief under the special consent procedure. . . . In other cases, an individual may have hired a qualified tax professional who fails to advise the taxpayer of the availability of a QEF election but refuses to provide an affidavit acknowledging that failure.
>
> Additionally, there are large individual and administrative costs under current law for the existing special consent procedure. The existing procedure requires a taxpayer to file a ruling request with the IRS and pay a user fee that is currently several thousand dollars. The IRS receives many requests for consent, which result in the use of IRS time and resources to determine whether consent should be granted and, if so, to issue the private letter ruling. In many cases, allowing the taxpayer to make a retroactive QEF election would be consistent with the proper administration of the law and would promote tax compliance, but the IRS must deny the request because the taxpayer does not qualify for relief under the special consent procedure.[28]

III. A Growing Demand

A. Accidental PFICs — SPACs

Although not specifically mentioned above, recent developments in corporate transactions and U.S. tax law have made it very likely that the need for retroactive QEF elections will increase. In recent years, as briefly mentioned, SPAC entities have been formed to permit future acquisitions of target businesses. Many of these SPACs are formed in foreign jurisdictions because if there is a possibility that a SPAC might acquire a foreign target, it will be much easier to do so if the SPAC is itself a foreign entity. And because the SPAC generally will be widely held and is typically capitalized with cash for an extended period, there is a significant risk that a SPAC organized in a foreign jurisdiction will be viewed as a PFIC.

In the case of a U.S. owner of these foreign SPACs, it might seem like the easy solution would be for a U.S. owner to make a QEF election in the first tax year in which it owns the SPAC. In that case, the SPAC would be a pedigreed QEF, the U.S. owner would merely pick up its ratable share of the earnings and profits of the SPAC until the de-SPAC transaction (that is, the acquisition of an

[24] *Id.*

[25] *See, e.g.*, Lewis J. Greenwald and Brainard Patton, "PFICs, Foot Faults, and the Cash Conundrum," *Tax Notes Int'l*, Jan. 31, 2022, p. 557.

[26] Reg. section 1.1295-3(f)(2).

[27] *See, e.g.*, LTR 202229034 ("affidavits signed under penalties of perjury must be submitted that describe: 1. the events that led to the failure to make a QEF election by the election due date; 2. the discovery of the failure; 3. the engagement and responsibilities of the qualified tax professional; and 4. the extent to which the shareholder relied on [a] professional").

[28] General explanation, *supra* note 2, at 14-15.

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active target business by the SPAC), and because the SPAC would presumably no longer qualify as a PFIC after it acquires the target business and/or operating assets in exchange for the cash held by the SPAC, the U.S. owner would thereafter no longer need to concern itself with the PFIC rules.

There are, however, problems with such a strategy. A foreign corporation might de-SPAC at the end of the foreign corporation's tax year. And because the PFIC asset test generally is applied based on the assets held on quarterly measuring dates, the passive assets held on the first three quarterly measuring dates could cause the corporation to be a PFIC even though it holds significant active assets on the fourth quarterly measuring date, resulting in an unintentional inclusion of a significant amount of income (the QEF inclusion) in the U.S. person's taxable income.

For example, assume a calendar-year SPAC with $300 million invested in a bank account that earns a 3 percent rate of return. In a particular year, the SPAC closes the acquisition of a foreign target on October 1 in exchange for the $300 million. In determining whether the SPAC is a PFIC for that particular year, quarterly averaging would require that the SPAC measure its assets on March 31, June 30, September 30, and December 31. For the first three quarters, the foreign corporation would be holding $300 million of assets, entirely consisting of passive assets. And unless the target and SPAC together have on December 31 greater than $900 million of active assets, the SPAC will be a PFIC for the tax year (that is, average passive assets of ($300 million + $300 million + $300 million + $0 million)/4 = $225 million, divided by ($300 million + $300 million + $300 million + $900 million)/4 = $450 million, and $225 million/$450 million = 50 percent).

In such a case, the consequences of a QEF election could be disastrous to the U.S. owner. The U.S. owner would expect to include the earnings and profits from the passive income earned on the investment for the first three quarters, but the SPAC/target might earn much higher earnings and profits from active gross income in the fourth quarter, in which case the U.S. owner will have a very large phantom income inclusion. Of course, the aforementioned issues would not be a problem if the SPAC's tax year were to close, but because the SPAC does not conduct a trade or business and satisfy the continuity of business enterprise requirement for reorganizations, a reorganization of the SPAC and the foreign target would typically be undertaken as a section 368(a)(1)(F) reorganization, which does not have a continuity of business enterprise requirement and also would not close the SPAC's tax year.[29]

B. Partnerships and QEF Elections

U.S. tax law generally has transitioned to a complicated hybrid regime in which a foreign corporation will be a controlled foreign corporation solely because it is owned, directly or indirectly, by a domestic partnership, but subpart F and so-called global intangible low-taxed income inclusions will be made only at the partner level only if the partner qualifies as a section 951(b) U.S. shareholder of the CFC (a "U.S. shareholder").[30] Under the so-called PFIC overlap rule (section 1297(d)), if a foreign corporation is both a CFC and a PFIC, the CFC will be treated as a non-PFIC during the qualified portion of the holding period of a U.S. person that is a U.S. shareholder of the CFC. The Treasury Department has issued proposed regulations that would provide that the qualified portion of an indirect shareholder of a corporation that is both a CFC and a PFIC does not "include any portion of such indirect shareholder's holding period during which it was not a United States shareholder (as defined in section 951(b)) with respect to the foreign corporation."[31]

Thus, under the proposed regulation, a U.S. person that is an indirect shareholder of a CFC/PFIC through a domestic partnership or an S corporation would qualify for the overlap exception only if the U.S. partner in the domestic partnership (or shareholder in the S corporation) itself is a U.S. shareholder. Existing regulations provide that QEF elections are made at the level of a domestic partnership.[32] However, proposed

[29] Reg. section 1.368-2(m)(2); reg. section 1.381(b)-1(a).

[30] Reg. section 1.951A-1(e)(1); reg. section 1.958-1(d).

[31] Prop. reg. section 1.1291-1(c)(5)(i) (REG-118250-20). The proposed regulations also include a transition rule that would apply to tax years that begin before the date the final regulations are published. *See* prop. reg. section 1.1291-1(c)(5)(ii).

[32] Reg. section 1.1295-1(d)(2).

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regulations would coordinate with the aforementioned proposed rule and provide that "if a partnership (domestic or foreign) holds stock of a PFIC, the section 1295 election with respect to such PFIC is made by a shareholder . . . indirectly owning the PFIC stock by reason of its interest in the partnership."[33] That rule seems simple enough; however, there are at least two reasons why QEF elections are more likely to be missed.

First, most partnerships have more than one partner, and to the extent those partners are U.S. persons, there will need to be multiple QEF elections.[34] More QEF election requirements mean more missed elections, especially because individual partners are likely to be less sophisticated than the partnership. Second, the rules that transition QEF elections from partnerships to partners will be difficult to comply with. For example, if a U.S. person acquires an interest in a domestic partnership, and the domestic partnership has already made a QEF election regarding a PFIC, the U.S. person can rely on the domestic partnership's QEF election to claim pedigreed QEF status as long as "the PFIC has been a QEF with respect to the pass-through entity for all taxable years that are included in the pass-through entity's holding period of the PFIC stock and during which the foreign corporation was a PFIC."[35] Thus, the holder cannot assume it need not make an election itself even if the domestic partnership through which it holds the stock has already made an election. There are also additional rules coordinating the regimes when PFIC stock is transferred between a U.S. partner and a domestic partnership in a nonrecognition transfer.[36]

IV. Simplify the Retroactive Election

The new proposal would simplify a retroactive QEF election considerably. The general explanation describes the budget proposal as follows:

> The proposal would modify section 1295(b)(2) to permit a QEF election by the taxpayer at such time and in such manner as the Secretary or her delegates (Secretary) shall prescribe by regulations.
>
> Taxpayers would be eligible to make a retroactive QEF election without requesting consent only in cases that do not prejudice the U.S. government. For example, if the taxpayer owned the PFIC in taxable years that are closed to assessment, the taxpayer would need to obtain consent and to pay an appropriate amount to compensate the government for the taxes not paid in the closed years on amounts that would have been includable in the taxpayer's income if the taxpayer had made a timely QEF election.
>
> While it is less common for partnerships and other non-individual taxpayers to inadvertently fail to make a QEF election, the Secretary would have authority to allow such taxpayers to make retroactive QEF elections in appropriate circumstances.
>
> The proposal would be effective on the date of enactment. It is intended that regulations or other guidance would permit taxpayers to amend previously filed returns for open years.[37]

Based on this description, if the proposal were enacted, only the following minor amendment to the text of section 1295(b)(2) would seem to be required:

> When made. An election under this subsection may be made for any taxable year at any time on or before the due date (determined with regard to extensions) for filing the return of the tax imposed by this chapter for such taxable year. ~~To the extent provided in regulations, such~~ Such an election may be made later than as required in the preceding sentence at such time and in such manner as the Secretary or her delegates shall prescribe by

[33] Prop. reg. section 1.1295-1(d)(2)(i).

[34] *See* general explanation, *supra* note 2, at 15 ("it is less common for partnerships and other non-individual taxpayers to inadvertently fail to make a QEF election").

[35] Prop. reg. section 1.1295-1(b)(3)(iv)(A).

[36] Prop. reg. section 1.1295-1(b)(3)(iv)(C).

[37] General explanation, *supra* note 2, at 15.

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> regulations ~~where the taxpayer fails to make a timely election because the taxpayer reasonably believed that the company was not a passive foreign investment company~~.

Upon enactment, the proposal would change nothing; the proposal states that an election could be made "at such time and in such manner as the Secretary or her delegates shall prescribe by regulations," and the only regulations providing for a retroactive election are the "special consent" and the "protective statement" already described. However, Treasury and the IRS would now have authority to issue regulations that expand the scope of the retroactive election beyond what is already provided for and without the reasonable belief requirement provided for in the statute.

Under these new regulations, reg. section 1.295-1 would presumably be amended to provide that a taxpayer can file a QEF election on either an original or an amended return, and in the case of an amended return, the return must be filed by a date that is within three years of the due date, as extended under section 6081, of the original return for the election. Indeed, the general explanation states that "it is intended that regulations or other guidance would permit taxpayers to amend previously filed returns for open years."[38] Thus, although an election on an amended return is a retroactive QEF election in a general sense, the regulations would presumably expand the description of timely QEF elections to include QEF elections filed on amended returns.

Even if the original QEF election year is in a closed year, a taxpayer should still be able, in some circumstances, to file a retroactive QEF election. As noted, the general explanation states that "if the taxpayer owned the PFIC in taxable years that are closed to assessment, the taxpayer would need to obtain consent and to pay an appropriate amount to compensate the government for the taxes not paid in the closed years on amounts that would have been includable in the taxpayer's income if the taxpayer had made a timely QEF election."[39]

Model regulations for what might be required of a taxpayer desiring to make a retroactive election into a closed year are set forth in reg. sections 1.1297-3(e) and 1.1298-3(e), the regulations that permit taxpayers to make late purging elections for some PFICs. As generally mentioned, a purging election can be made by a taxpayer to "purge" the PFIC taint by recognizing gain or loss or, in some cases, a deemed dividend regarding its PFIC shares. In addition to purging elections made in connection with QEF elections, a purging election can be made by a U.S. person for a "former PFIC," which is a corporation that is not a PFIC under the asset/income test in the current year, or by a U.S. shareholder of a corporation that is both a CFC and a PFIC.[40] Thereafter, the U.S. person that makes the purging election is no longer subject to the once a PFIC, always a PFIC rule for the PFIC. Further, a U.S. person that makes the election for a former PFIC would not be subject to the PFIC rules going forward, assuming the foreign corporation does not meet the asset/income tests, and the U.S. shareholder of a PFIC that also is a CFC would not be subject to the PFIC rules going forward under the overlap rule.

Importantly, the process for making purging elections for former PFICs and by U.S. shareholders of CFC/PFICs for closed years is more streamlined than the process for obtaining a private letter ruling from the IRS to make a retroactive QEF election for closed years. In particular, Form 8621-A, "Return by a Shareholder Making Certain Late Elections to End Treatment as a Passive Foreign Investment Company," has a built-in closing agreement.[41] A taxpayer who wants to make a late purging election for a closed year submits two copies of the closing agreement (with original signatures)

[38] *Id.*

[39] *Id.* As noted earlier, the protective statement rules generally require the taxpayer filing the protective statement to waive the statute of limitations for assessing PFIC-related taxes for all relevant years. Reg. section 1.1295-3(c)(4). The rules for obtaining a private letter ruling to make a retroactive QEF election allow the IRS to enter into a closing agreement to eliminate any prejudice to the government for closed years. Reg. section 1.1295-3(f)(3)(ii).

[40] Purging elections made in connection with QEF elections cannot be made for closed years. *See* reg. sections 1.1291-9(c) and -10(c).

[41] *See* Form 8621-A, at 3 (rev. Dec. 2013).

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with its Form 8621-A.[42] One copy of the closing agreement is returned to the taxpayer after an authorized IRS official has signed it.[43] The structure of the regulations (reg. sections 1.1297-3(e) and 1.1298-3(e)) providing for a late purging election for former PFICs and by U.S. shareholders of PFICs that also are CFCs, including an IRS form for making retroactive QEF elections for closed years that includes a built-in closing agreement,[44] could be adopted in regulations for a retroactive QEF election as follows:

> *Retroactive QEF elections requiring special consent.*
>
> *(1) In general.* This section prescribes the exclusive rules under which a shareholder of a PFIC may make a section 1295(b)(1) election after the time for making a QEF election has elapsed (retroactive QEF election). Therefore, a shareholder may not seek such relief under any other provisions of the law, including section 301.9100-3 of this chapter. A shareholder may request the consent of the Commissioner to make a retroactive QEF election for a taxable year of the shareholder provided the shareholder satisfies the requirements set forth in this paragraph. The Commissioner may, in his discretion, grant relief under this paragraph only if —
>
> (i) The shareholder is requesting a retroactive QEF election for a tax year ending after December 31, 2017 [a discussion of the appropriate suggested date appears later];
>
> (ii) The shareholder requests such retroactive QEF election before a representative of the Internal Revenue Service raises upon audit the PFIC status of the foreign corporation for any taxable year of the shareholder;
>
> (iii) The shareholder has agreed in a closing agreement with the Commissioner, described in paragraph (3) of this section, to eliminate any prejudice to the interests of the U.S. government, as determined under paragraph (2) of this section, as a consequence of the shareholder's inability to file amended returns for its taxable year in which an earlier closed taxable year in which the shareholder has taken a position that is inconsistent with the treatment of the foreign corporation as a QEF; and
>
> (iv) The shareholder satisfies the procedural requirements set forth in paragraph (3) of this section.
>
> *(2) Prejudice to the interests of the U.S. government.* The interests of the U.S. government are prejudiced if granting relief would result in the shareholder having a lower tax liability (other than by a de minimis amount), taking into account applicable interest charges, for the taxable year or years in which the taxpayer took a position on a return that was inconsistent with the treatment of the foreign corporation as a QEF than the shareholder would have had if the shareholder had properly made the section 1295(b)(1) election in the prescribed time. The time value of money is taken into account for purposes of this computation.
>
> *(3) Procedural requirements.*
>
> (i) In general. The amount due with respect to a retroactive QEF election is determined in the same manner as if the retroactive QEF election had been timely filed. However, the shareholder is also liable for interest on the amount due, pursuant to section 6601, determined for the period beginning on the due date (without extensions) for the taxpayer's income tax return for the

[42] *See* IRS, "Instructions for Form 8621-A," at 1 (rev. Dec. 2018).

[43] *Id.* at 4.

[44] The IRS could either modify existing Form 8621-A to allow retroactive QEF elections for closed years to be made on the form or create a new form for the retroactive QEF election, perhaps numbered Form 8621-B.

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> year in which the retroactive QEF falls and ending on the date the retroactive QEF election is filed with the IRS.
>
> (ii) Filing instructions. A retroactive QEF election is made by filing a completed Form 8621-[], "Return by a Shareholder Making A Retroactive Election to Treat a Passive Foreign Investment Company as a QEF."[45]
>
> *(4) Time and manner of making late election.*
>
> (i) Time for making a retroactive QEF election. A shareholder may make a retroactive QEF election in the manner provided in paragraph (4)(ii) of this section at any time. The date the election is filed with the IRS will determine the amount of interest due under paragraph (3) of this section.
>
> (ii) Manner of making a late retroactive QEF. A shareholder makes a retroactive QEF election by completing Form 8621-[] in the manner required by that form and this section and filing that form with the Internal Revenue Service, DP 8621-[], Ogden, UT 84201.

The new retroactive QEF election, embodied in these suggested regulations, would be especially helpful to a taxpayer who owns a SPAC in the circumstances described. As previously mentioned, there can be a risk that a taxpayer might own an accidental PFIC in a year in which a SPAC acquires an active operating business. If the acquisition occurred later in the year, the company might still qualify as a PFIC, and a taxpayer who had previously made a QEF election would be required to include significant amounts in its income based on earnings and profits attributable to operating income of the corporation. The new retroactive election would give the taxpayer the benefit of hindsight, and the taxpayer could choose to make a QEF election depending on what occurs.

It might be argued that such hindsight is inappropriate as a policy matter, but that argument would overlook the fact that, as an initial matter, accidental PFICs are inappropriate from a policy standpoint. The PFIC rules, and especially the asset test, often pick up PFICs that conduct significant operating businesses in a particular year, even though the PFIC rules were designed to prevent offshore investment through foreign corporations held widely enough to avoid the CFC rules. An unfortunate taxpayer who fails to make a QEF election because he is concerned that the SPAC he owns might, in a later year, continue to be a PFIC notwithstanding the fact it conducts a significant operating business (and earns significant gross income) is exactly the type of taxpayer who should be permitted to make a retroactive election.

Nevertheless, presumably there should be some sort of limit as to how many years a taxpayer can go back — for example, the new regulations should not create a mechanism whereby taxpayers are filing retroactive QEF elections for, say, 1987, one of the earliest years the PFIC rules were effective. In that case, there would never be closure of the tax treatment of PFICs and the unlimited exception for a retroactive QEF election would undermine the policies of a statute of limitations, which is intended to create closure of the tax treatment for a particular year.

Presumably, if the election goes too far back, the IRS could use the grant of discretion in the regulations, which is included in the suggested regulations, to not permit the retroactive QEF election. Also, the IRS might want to add a date, such as December 31, 2017, before which it would not grant retroactive QEF elections. December 31, 2017, was the effective date of the new GILTI rules, after which there were complications regarding the CFC coordination rule when a U.S. partnership owned PFIC stock because subpart F and GILTI inclusions are taken into account at the partner level (as discussed in more detail earlier). Thus, the IRS might want to reserve its discretion to grant a retroactive QEF in years after this date as an acknowledgment of the difficulties taxpayers are likely to encounter.

Of course, all these possibilities depend on getting tax legislation enacted. Unfortunately, a retroactive QEF election was not included in the

[45] As noted, the IRS could either modify existing Form 8621-A to allow retroactive QEF elections for closed years to be made on the form or create a new form for the retroactive QEF election, perhaps numbered Form 8621-B.

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Inflation Reduction Act, but given that retroactive QEF elections are not a politically sensitive topic, to say the very least, and the fact that the provision is scored as basically revenue-neutral, it should be very easy for this Congress or a future Congress to pass such a provision. An omnibus bill would seem to be especially suitable for a provision such as this one. In any case, for the sake of good tax policy, a grant of authority allowing the IRS to permit retroactive QEF elections, without the misguided reasonable belief requirement that is embedded in the current statute, will hopefully be enacted soon.[46] ■

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