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COMMENTARY & ANALYSIS

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In this article, Greenwald and Patton examine the tax treatment of active development companies under the passive foreign investment company rules, focusing on challenges for small U.S. investors and proposing a possible workaround.

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This article addresses the consequences of passive foreign investment company status for foreign companies that have been formed to develop solutions to medical and life sciences problems (active development companies, or ADCs).

To produce and distribute vital medical and life sciences solutions or products in many countries, an ADC must first obtain approval from governmental agencies whose goal is to promote and protect human health. Those agencies include the European Medicines Agency and the U.S. Food and Drug Administration. The approval process can take years and involve considerable expense. To minimize the risk of running short on funds during the costly development and approval processes, ADCs almost always raise significant amounts of capital at inception.

Under the PFIC rules, the initial and ongoing infusions of cash to fund operations can result in a costly foot fault: an unanticipated characterization of a foreign ADC as a PFIC for U.S. tax purposes, with all the attendant U.S. tax consequences.

This article reviews the relevant PFIC rules, describes the typical ADC, highlights U.S. tax reporting problems for small U.S. investors in ADCs, describes the cash conundrum, and proposes an equitable and administrable solution to avoid costly and unexpected PFIC consequences.

I. PFIC Rules

A. Origin and Purpose

Among the dramatic changes made by the Tax Reform Act of 1986 was the codification of the PFIC provisions (sections 1291-1297). Congress believed that the U.S. international tax rules in effect at that time provided U.S. investors with tax incentives to invest outside the United States rather than in U.S. investment companies — that is, U.S. mutual funds. More specifically, lawmakers did not think U.S. persons investing in passive assets should be able to avoid the economic equivalent of current taxation merely because they invested in those assets indirectly through a foreign corporation. Moreover, Congress believed that U.S. persons who invested in passive assets through a foreign corporation obtained a substantial tax advantage vis-à-vis U.S. investors in domestic investment companies because they were not only able to avoid current taxation but were also able to convert income that

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would otherwise be ordinary income into capital gains income.

B. PFIC Defined

The term "passive foreign investment company" is defined under section 1297(a) in simple terms: It means any foreign corporation if at least 75 percent of its gross income for the tax year is passive income,[1] or at least 50 percent of the average percentage of assets held during the tax year produce passive income or are held for the production of passive income.[2]

We note in passing that if the foreign corporation directly or indirectly owns at least 25 percent by value of the stock of another corporation, for determining whether the foreign corporation is a PFIC, it is to be treated as if it held its proportionate share of its assets and directly received its proportionate share of the income of the other corporation.

An important consideration is that once a foreign corporation is characterized as a PFIC during the period the stock is held by a U.S. shareholder, it will always be treated as a PFIC for that shareholder and subjected to the excess distribution rules discussed below, even if later it is no longer a PFIC.[3]

C. PFIC Exceptions

Under the controlled foreign corporation overlap rule, a foreign corporation that is a CFC will not be treated as a PFIC for a U.S. shareholder[4] during the period when the shareholder holds CFC stock that was acquired after December 31, 1997. That is so even if the CFC generated passive income or held passive assets substantially above the 75 percent and 50 percent limits.

Also, under the start-up exception, a foreign corporation is not treated as a PFIC in the first tax year that it has gross income (the start-up year) if none of its predecessors was a PFIC, the IRS is convinced it will not be a PFIC for either of the first two tax years following the start-up year, and the corporation is in fact not a PFIC for either of those next two tax years.

D. Qualified Electing Funds

Assuming a taxpayer or PFIC shareholder is aware that he has an investment in a PFIC, the shareholder (and not the PFIC) may make a QEF election for the PFIC for any tax year. Once made, the election applies to all the taxpayer's subsequent tax years unless revoked with the consent of the IRS.[5]

Under section 1293, each U.S. person who has made a QEF election must include currently in gross income his pro rata share of the PFIC's ordinary income and net capital gain income. That inclusion rule requires the current payment of tax absent a shareholder-level election to defer it. Amounts currently included in income are added to the investor's stock basis, and amounts distributed decrease the basis.

As noted, U.S. investors who have made timely QEF elections may, subject to the payment of interest, elect to defer payment of the U.S. tax. That election is available only for the U.S. tax attributable to the amounts included in income but for which no current distributions have been received.[6]

E. Excess Distributions Rule

Under section 1291(b), U.S. PFIC shareholders who have not made a QEF election must pay U.S. tax on the PFIC's earnings plus an interest charge at the time they receive an excess distribution from the PFIC. Under that rule, income recognized on the receipt of the excess

[1] Originally, the term "passive income" was defined by reference to section 904(d)(2)(A). The Technical and Miscellaneous Revenue Act of 1988 changed the reference to any income that would be foreign personal holding income as defined in section 954(c).

[2] Under section 1297(e), unless the foreign corporation is publicly traded, this determination is based on the adjusted bases (as determined for computing earnings and profits) of the assets of the corporation if it is a controlled foreign corporation or elects to make the determination on that basis.

[3] That is commonly referred to as the "once-a-PFIC-always-a-PFIC" rule.

[4] As defined in section 951(b).

[5] A QEF election is made for any tax year at any time on or before the due date (determined with extensions) for filing the return. Section 1296 provides a mark-to-market election for publicly traded PFICs. Because ADCs are not publicly traded, we will not discuss the mark-to-market election here.

[6] U.S. investors who have made QEF elections after the first year in which they acquired an interest in a PFIC must either make a purging election or be subject to QEF inclusions and the PFIC excess distribution rules concurrently.

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distribution is considered to have been earned pro rata over the shareholder's holding period. An excess distribution is one that exceeds 125 percent of the average amount of distributions during the three preceding years (for a shorter holding period, the total number of years of the taxpayer's holding period before the current tax year). Importantly, U.S. shareholder *gains from the disposition of PFIC shares are also treated as excess distributions*.

The U.S. tax due in the year of excess distribution is the sum of:

- U.S. tax computed using the investor's highest statutory rate (without regard to other income or expenses the investor may have had in those years) on the income attributed to the years of its holding period (other than the current year or years before the foreign corporation was a PFIC);
- interest from the due date of the returns for which income is attributed to the due date of the return for the year of receipt) imposed on the deferred tax; and
- U.S. tax on income attributed to the year of disposition (or year of receipt) and to the years in which the foreign corporation was a PFIC (for which no interest is due).

The excess distributions rule is the cornerstone of the unexpected consequences for U.S. taxpayers who were unaware that they were selling PFIC shares: It deems all gains have been realized as ordinary income in earlier years and subject to tax at the highest statutory tax rate in each of those years, regardless of the amount of taxable income actually reported on the taxpayers' returns. With the accumulation of interest, a U.S. taxpayer with a substantial holding period in a PFIC could face nearly confiscatory tax rates on the unexpected recognition of an excess distribution.

II. Example of an ADC

We describe a "typical" ADC as one commonly seen in life sciences companies — that is, as a start-up venture formed to develop new medicines or medical devices with uncertain outcomes. It can be a biopharmaceutical company developing new medicines for improving healthcare, or a company developing new devices in a broad range of areas such as exoskeletons, wound protection, spinal stability, and lung functioning. Start-up ADCs are routinely formed around the world and funded by investors from virtually every country.

A. Forming an ADC

Although the specifics will differ from venture to venture, the formation of an ADC generally involves a structure with the following nine elements.

1. Purpose

The venture's purpose and objective are generally specified in fundraising documentation as carrying out activities to develop and gain approval to commercialize a medicine or medical device using the related intellectual property rights. The ADC will generally not purchase securities or make investments other than in companies that support or promote its technological objectives.

2. Country of Formation

The ADC's country of formation will be based on several factors, including the founders' country of residence, corporate governance rules, and availability of educated and skilled personnel and clean research facilities. Access to a stock market listing (in the case of success) is also occasionally a factor. Many ADCs are formed in the United States but are also commonly based in Switzerland and Ireland.

3. Capital Structure

The ADC generally will have common stock held by a few founders who have access to (or have developed) know-how, patents, or similar IP related to the ADC's targeted field. Depending on the country of formation and founders' residence, the transfer of the IP rights to the ADC by the founders may give rise to a taxable event, with the value of the IP determined on an arm's-length basis. The founders, who may be residents of more than one country, generally take back common voting stock for their contributions. They generally control ADC operations through their majority common share interest.

4. Preferred Shareholders

The initial risk funding for a typical ADC is often provided by new investors subscribing to preferred shares. There may be a considerable

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number of preferred shareholders from various countries, many of whom invest relatively small amounts on the hopes of a large gain on exit. Commonly, there are several subsequent rounds of funding by investors in new classes of preferred shares when the initial funding proves insufficient. In that case, the new preferred shareholders and classes of preferred shares will dilute the equity interest of the investors in the prior classes of preferred shares.

5. Management

An active and engaged board of directors is key to an ADC's success during the development of the ADC's IP because no revenue is being generated, but costly research and development activities are taking place, often in several countries, to develop the product and commence clinical evaluations. In most cases, the board of directors is composed of skilled professionals from the fields of medicine, engineering, business, finance, and law.

6. Clinical Evaluation Phase

The clinical evaluation phase and related ongoing research are most critical to an ADC's success. An ADC will likely carry on substantial R&D activities and related operations for many years in accordance with its corporate purposes as it develops products and works through the clinical evaluation phase to obtain relevant government agency approval. That requires the attention of management to ensure the processes are properly followed, including negotiations with doctors and hospitals assisting with clinical evaluations.

7. Commercialization

Only after the clinical evaluation phase has been concluded and agency approval granted can an ADC generate revenue through commercialization activities. This phase may involve production and worldwide distribution of the approved pharmaceutical or device or entering into license arrangements and using the resulting revenue to fund a new round of product development and agency approvals.

8. Investor Liquidity

Although the preferred shareholders are entitled to dividends before the common shareholder founders, ADCs generally do not pay any dividends for the first years of their existence because all the ADC's cash is needed to fund product development and obtain the requisite agency approvals. Thus, there are no distributable reserves as required under local law to support a dividend. Further, because an ADC is an unlisted company, there is no market for its shares.

9. Exit Objective

Investments in ADCs are highly risky. Investors must wait out the development period before reaping a reward by selling their shares in connection with an initial public offering or purchase by another company. The ADC could also be acquired by a special purpose acquisition company. Under all those alternatives, an exiting shareholder will have held the shares of the ADC for many years with no cash return.

B. Tax to Preferred Shareholders on ADC Sale

Unless the ADC founders are U.S. tax residents, U.S. PFIC considerations are unlikely to be considered when an ADC is formed outside the United States (foreign ADC, or FADC). As a result, the burden is on the potential U.S. shareholders to consider the PFIC aspects of their investment, even though the information they need to reach a conclusion is likely not available when making the investment decision.

Under the once-a-PFIC-always-a-PFIC rule, and assuming the U.S. investor did not make a QEF election, several U.S. tax consequences can occur on the eventual sale of the ADC shares.

1. FADC Is Not a PFIC

If an FADC was never a PFIC, then its shares will be treated as capital assets under section 1221. In the likely event that the shares were held for more than one year, the gain from their sale will be treated as long-term capital gain and taxed at 0 percent, 5 percent, or 20 percent, depending on the amount of taxable income otherwise reported by the investor in the year of sale.

Given the typical preferred-share structure, it is unlikely that a non-founding U.S. investor would own at least 10 percent of the fair market value or total combined voting power of the FADC and thus run afoul of the gain recharacterization rule of section 1248(a). Further, it is also unlikely that the FADC would have earnings and profits at the date of sale, which

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could cause a portion of the gain to be recharacterized as a dividend.

2. FADC Is a PFIC but With No QEF Election

If the investor was wrong, and the FADC was in fact a PFIC for any of the years the investor held shares, the full gain on the disposition will be characterized as an excess distribution under section 1291(b). In that case — and if the FADC has paid no dividends to the investor — the gain will be treated as if it had arisen ratably on each day during the period the taxpayer held the stock. It will be taxed as ordinary income at the highest marginal rate in each year from the date the FADC was a PFIC and then subjected to interest computed from the due date for each year to the due date for the year of the actual sale generating the excess distribution characterization. Worse, under section 6501(c)(8), if the investor is unaware of the PFIC status and fails to annually report the investment on Form 8621, the statute of limitations for each year remains open indefinitely for IRS adjustments — even those that have no relevance to PFIC matters.

III. Cash Conundrum Foot Fault

A typical FADC will normally not make investments in assets that would create section 954(c) foreign personal holding company income, such as dividends, interest, royalties, rents, or annuities. As a result, the typical U.S. investor might incorrectly conclude that the PFIC rules simply do not apply to the foreign company in which she has invested.

The challenges with a typical FADC arise from the funding arrangements described above, which could cause the FADC to run afoul of the PFIC rules in a single early year (perhaps the year of formation), possibly without the U.S. investors' awareness, triggering the once-a-PFIC-always-a-PFIC characterization and negative consequences in later years. That is so even if the FADC is actively engaged in development and clinical evaluations from formation.

A. Passive Income Test

Given an FADC's lack of sales revenue during the development phase, an insignificant amount of interest income could cause the FADC to run afoul of the 75 percent passive income rule. As an extreme example, an FADC might generate $100 of interest income in a year when it had no operating revenues, thus running afoul of the passive income test and foot-faulting into PFIC status for all minority U.S. investors.

B. Passive Asset Test

Assuming the FADC's shares are not publicly traded and the FADC is a CFC, the value of the FADC's assets for PFIC purposes will normally be the adjusted basis of those assets under section 1297(e)(2). During the development phase, the only assets an FADC would normally have on its balance sheet would be cash held to fund development activities, research equipment, and possibly start-up expenses capitalized under section 195. The question then becomes whether the cash held by the FADC to fund development activities is treated as being held to produce passive income and, if so, whether that cash exceeds 50 percent of the adjusted basis of the FADC's total assets as required by section 1297(a)(2).

C. IRS Guidance on Working Capital

The IRS has provided several forms of guidance on whether working capital — and specifically cash — constitutes a passive asset for PFIC purposes.

1. 1988 Notice

Treasury's initial position on the characterization of cash for PFIC purposes was set forth in Notice 88-22, 1988-1 C.B. 489:

> Cash and other current assets readily convertible into cash, including assets which may be characterized as the working capital of an active business, produce passive income, as defined in section 904(d)(2)(A). These assets are, therefore, passive assets for purposes of the section 1296(a)(2) asset test.

Many comments were received that the notice's approach was inconsistent with the intent of the PFIC regime to distinguish between investments in passive assets and investments in active businesses. For example, it was asserted that the working capital rule in Notice 88-22 causes many foreign corporations otherwise

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engaged in active operating businesses to be classified as PFICs. Other commentators noted that for some IRC purposes, cash is treated as a business (non-passive) asset if it is held as working capital for use in a trade or business.

2. 2021 Proposed Regulations

In January 2021 Treasury addressed the working capital position of Notice 88-22 in proposed regulations (REG-111950-20) that set forth a limited working capital exception. Under prop. reg. section 1.1297-1(d)(2), currency held in a non-interest-bearing financial account for the present needs of an active business will not be treated as a passive asset if it is not greater than the amount necessary to cover operating expenses and reasonably expected to be paid withing 90 days.

While welcome, that exception clearly does not address the problems facing an FADC with significant capital development costs and a long delay before spending the cash or generating operating income.[7] Nor does it provide any guidance on what constitutes an active business.

In the regs' preamble, Treasury indicated that it is aware of the problems with Notice 88-22 and requested comments on the proposed 90-day working capital exception, "including the scope of statutory authority to treat interest-bearing accounts or instruments held as working capital as an active asset and the ways in which the exception might be broadened while maintaining appropriate safeguards."[8]

3. Intangible Development as Active Business

Throughout the code, there are examples in which, like an ADC, a company engaged in product development without any actual revenue can still be engaged in an active business. Four are considered below.

a. Worthless Stock Deduction

Under section 165(g)(3), a domestic corporation may claim an ordinary loss deduction for an investment in an affiliated company (whether U.S. or foreign) if more than 90 percent of its gross receipts for all years are from sources other than passive income. In 2009 the IRS released a technical advice memorandum (TAM 200914021) stating that had the activities of a foreign subsidiary with no gross receipts during its existence been successful, the subsidiary "would have generated substantial gross receipts from operations." The memo concluded that although the foreign subsidiary had no gross receipts (and no disqualifying passive income), it functioned as an operating company, as opposed to an investment or holding company, thus allowing its shareholder to take an ordinary loss deduction for its investment.

b. Active Trade or Business

Under section 355, a corporation may distribute tax-free shares of stock of a controlled corporation if both the distributing corporation and the controlled corporation are engaged in the active conduct of a trade or business. In 2019 the IRS issued Rev. Rul. 2019-9, 2019-14 IRB 925, suspending two 1957 revenue rulings, one of which held that an oil exploration activity did not meet the active trade or business requirement of section 355(b) during the time that it incurred substantial expenditures but did not generate any income.[9] In Rev. Rul. 2019-9 the IRS indicated that it was conducting a study to determine for section 355 purposes "whether a business can qualify as an [active trade or business] if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected."[10]

c. Active Business Requirement

Under section 1202, taxpayers are entitled to an exclusion from taxable gains realized on the disposition of specific qualified small business stock held for more than five years. Stock is not considered qualified unless the corporation meets an active business requirement during substantially all of the holding period, including devoting at least 80 percent by value of its assets in the active conduct of a qualified trade or

[7] *See* New York State Bar Association Tax Section, "Report on the Proposed 'PFIC' Regulations Under Sections 1297 and 1298," Report No. 1450 (Apr. 14, 2021).

[8] This article will be submitted to Treasury as the authors' comments regarding broadening the working-capital exception.

[9] Rev. Rul. 57-464, 1957-2 C.B. 244; and Rev. Rul. 57-492, 1957-2 C.B. 247.

[10] *See also* Benjamin M. Willis, "Taking the Spin Off Income," *Tax Notes*, Apr. 1, 2019, p. 75.

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business. To determine whether the company meets the active business requirement for in-house research expenses, assets used in those activities are to be treated as used in the active conduct of a qualified trade or business. According to the code, that determination is to be made "without regard to whether a corporation has any gross income from such activities at the time of the determination."

d. Trade or Business Requirement

The section 41(a) credit for increasing research activities is available only for expenses incurred by the taxpayer in carrying on its trade or business. A taxpayer engaged in in-house research is treated as meeting the trade or business requirement "if, at the time such in-house expenses are paid or incurred, the principal purpose of the taxpayer in making such expenditures is to use the results of the research in the active conduct of a future trade or business."

IV. Minimizing PFIC Consequences

Given the foregoing, U.S. investors in FADCs should ensure they are aware when the FADC is a PFIC or take affirmative steps to minimize the consequences of PFIC status.

A. QEF Election

Filing a QEF election in the first year an FADC is (or might be) a PFIC would allow the U.S. investor to treat the FADC as a pedigreed PFIC and avoid treatment of any eventual gain as an excess distribution with the lookback consequences discussed above. The QEF election is made for each U.S. investor by having the investor attach a completed Form 8621 to her U.S. federal income tax return in her first year of ownership.[11] Thereafter, the FADC must annually provide E&P and capital gains information to U.S. investors, and each investor filing a QEF election must report that annual information on her U.S. income tax return, even though the typical FADC will not have any positive E&P or capital gains to report.

The problem is that each U.S. investor must evaluate whether the FADC is a PFIC in the year of the initial investment and every year thereafter and comply with the related reporting requirements. Depending on the number of minority investors and the length of the development period, that approach entails filing multiple Forms 8621 simply to protect against the excess distribution consequences discussed above.

B. Partnership Approach

If an FADC is also a CFC, another option is for investors in a class of preferred shares to form a domestic limited liability company to acquire the shares in that class, thus creating a domestic entity holding that class of shares. Whether characterized as a C corporation or a partnership, the LLC will be treated as a U.S. person under section 7701(30), as modified by section 957(c). If the value of the class of shares held by the LLC is at least 10 percent of the total value of shares of all classes of FDAC stock, the LLC will constitute a U.S. shareholder under section 951(b) and thus qualify for the CFC overlap exception of section 1297(d). In that case, the FADC should not be treated as a PFIC for the LLC class of investors. Further, consolidating the group of minority shareholders into an LLC treated as a U.S. shareholder could also convert an FADC into a CFC, assuming the prior U.S. shareholders did not own more than 50 percent of FADC shares by vote or by value.[12]

Although that option should remove the possible PFIC taint and avoid the excess distribution consequences on sale of the FADC shares, it requires setting up the initial structure with multiple LLCs to accommodate the various classes of preferred shares involved with a typical FADC and works only when the investors in that class own at least 10 percent of the total value of all classes of the FADC's shares. It also requires the LLC to annually file Form 1065 and provide Schedules K-1 to each investor.

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[11] Pre-TAMRA, section 1295(b)(1) provided that the QEF election could be made only by the PFIC itself. Inexplicably, TAMRA shifted the election obligation to each separate U.S. investor.

[12] Even if the domestic partnership does not own 10 percent of the FADC, consolidating the holdings of various shareholders could permit the domestic partnership to file a QEF election and thus eliminate the requirement for each U.S. shareholder to file a separate QEF election.

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Thus, although the option has a high likelihood of success, it is cumbersome and requires the FADC promoters to spend time and money to set up the proper LLC structure for each class of preferred shares as it arises.[13]

C. Escrow Option

Under the escrow approach, the investors place the initial funds in escrow with a third party to be made available to the FADC only when specific milestones have been reached. In that case, the FADC should not have sufficient cash or related interest income to be treated as a PFIC under the income or balance sheet tests discussed above.

That arrangement would have to be established at the time of an investment in a new class of preferred shares. It also creates a requirement to monitor cash expenditures and justify to the escrow agent that the milestones have been reached for the funds to be made available to the FADC to fund its development activities.

D. Accounting Option

Under the accounting option, an FADC identifies and capitalizes R&D and start-up expenses to increase the total adjusted basis of its assets — the denominator of the 50 percent passive asset test of section 1298(a)(2). If the total quarterly average cash balance does not exceed 50 percent of the average adjusted tax basis of the total assets as determined under section 1257(e) in a given year, the FADC should not constitute a PFIC for that tax year.

Given, however, that the cash from investors will generally be deposited early on, this option will generally help avoid PFIC status only in later years and will unlikely be of benefit for initial investors in preferred FADC shares. Again, if the FADC is characterized as a PFIC for a year, it will be treated as a PFIC for all years for those investors.

[13] On January 24 the IRS issued proposed regulations (REG-118250-20) that if finalized would treat partnerships as aggregates that are unable to make QEF elections or file Form 8621 on behalf of the partners.

V. Proposal: FADC Exception

All the options discussed above have been implemented to help FADCs avoid PFIC characterization and the excess distribution consequences at the time of disposition of the shares held by the preferred shareholders. However, they are complicated, burdensome, and require sophisticated tax advice. In our experience, the typical Main Street investor in preferred FADC shares lacks the experience or sophistication necessary to identify PFIC issues and take the necessary steps to avoid PFIC status for his investment.

We therefore propose an FADC exception to avoid inadvertent PFIC status, an approach that we believe is consistent with the purposes of the PFIC regime, is administrable and auditable, and is supported by statutory authority. The FADC exception would have the elements discussed below.

A. Formal CFC Election

To qualify for the exception, an FADC would have to be a CFC for U.S. tax purposes and formally claim the exception on its own behalf to provide protection to all shareholders who are U.S. taxpayers holding less than 10 percent by vote or value of the shares of the FADC. This would simplify the process involved with the QEF election, which, post-TAMRA, requires that each investor make his own QEF election.

B. Qualification Requirements

The exception would be available only for a CFC that could:

- demonstrate through formation documents, private offering memoranda, or similar contemporaneous documentation that it was formed to develop specific products and would not generate operating income in the near future;
- show through documents or business plans that government agency approval is required before the developed product can be produced and marketed;
- provide contemporaneously produced cash flow forecasts showing costs anticipated during the development period and how those costs are funded by investment inflows;

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- provide investors with private offering memos or similar documents clearly indicating the purpose and use of cash received for the series of preferred shares;
- provide a formal investment policy approved by the board specifying that cash deposited by shareholders will be used for development purposes and deposited in non-interest-bearing bank accounts or investment-grade short-term money market or similar account, with a maximum maturity of, say, three months; and
- show via minutes of board of directors meetings that the CFC is carrying on business activities in the form of product development and clinical evaluation through the oversight of a qualified board.

While those requirements are moderately burdensome, they are also good business practices. Plus, they would apply at the FADC level, not at the level of the individual preferred shareholders.

C. Safeguards: Reporting and Verification

Because the FADC exception would be available only for CFCs, the IRS would be able to:

- receive annually updated reports via Form 5471 and attachments regarding the FADC and its activities;
- audit and verify that the CFC still meets the requirements for the FADC exception (such as use of cash to meet development expenses and absence of gross revenues);
- verify that interest income is minimal and that cash is invested only in short-term deposits; and
- put the burden on the CFC by adding a question to Schedule G of Form 5471 along the following lines to be answered under penalties of perjury:

> Is the foreign corporation electing for all shareholders the active development company exception for cash balances received from investors? If yes, have procedures been put in place to ensure the cash balances are not held or used to generate significant foreign personal holding company income as set forth in section 954(c)?

D. Termination of FADC Exception

The FADC exception would apply only until the product exits the development stage and commercialization begins. Like the start-up exception of section 1298(b)(2), the CFC would be allowed to transition from the development stage over a two-year period as it generates E&P. At that point, all investor cash should have been consumed, and there should be no interest income to create a continuing PFIC exposure for the CFC or its investors.

E. Impact on U.S. Investors

U.S. resident shareholders of a CFC that qualifies for the FADC exception or otherwise does not constitute a PFIC during the period of their share ownership will be treated for all purposes as owning a minority investment in a foreign corporation. They would not be subject to the PFIC rules and therefore would not be required to make a QEF election, subject to Form 8621 filing requirements, or subject to the excess distribution rules of section 1291(b).

F. Authority

As discussed above, section 1297(a)(2) provides that a foreign corporation will be treated as a PFIC if more than 50 percent of its assets produce passive income or are held for the production of passive income. Although section 1297(b)(1) defines passive income as foreign personal holding company income as defined in section 954(c), Congress provided in section 1298(g) that the "Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of this part."

Because the purpose of the PFIC rules is to prevent U.S. taxpayers from investing in foreign investment companies to the detriment of U.S. investment companies, we believe the secretary should prescribe regulations specifying that any FADC with cash reasonably appropriate for its development activities and minimal interest income shall not be treated as a PFIC.

VI. Conclusion

Investors in ADCs face inherently high risks by forgoing the prospect of a cash return in early years for a possible larger payout later. Investors

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in domestic ADCs at least have the prospect of being taxed at capital gains rates on any resulting gain and an even lower tax bill if the investment is qualified as small business stock under section 1202.

Because of the cash conundrum foot fault, U.S. investors in FADCs face draconian consequences if the FADC is deemed a PFIC in any year. Any gain on sale will be allocated to all years of the investment and taxed at the highest ordinary rate in each year plus interest. And as noted, failure to annually report the investment on Form 8621 causes the statute of limitations for each year to remain open indefinitely for adjustments by the IRS — even those that have no relevance to PFIC matters.

Our proposed FADC exception is designed to address the cash conundrum foot fault while preserving the IRS's ability to ensure the PFIC rules achieve their purpose and are not inappropriately avoided. It is simple in that the CFC itself qualifies for the exception, sparing all U.S. shareholders from individual analysis or exposure; it avoids the need for the multitude of QEF elections and annual Forms 8621 from each minority shareholder; it provides a paper trail showing when the conditions for the exception were met; and it avoids the foot fault issue when an FADC's accidental PFIC classification results in unexpected retroactive excess distribution tax on gain from sale of shares. Finally, the U.S. Treasury has the authority to issue regulations setting forth the FADC exception to allow investment in FADCs consistent with the purposes of the PFIC legislation. ■

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