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GLOBAL PUBLIC COMPANY ACADEMY

# INADVERTENT INVESTMENT COMPANY AND PFIC ISSUES IN FOREIGN CAPITAL MARKET TRANSACTIONS

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# Agenda

- The Definition of an Investment Company
  - Orthodox Investment Companies
  - Inadvertent Investment Companies
- Issuers Statutorily Excepted from the Definition of Investment Company
  - Sections 3(b)(1) and 3(b)(2) – Issuers Engaged in a Noninvestment Company Business
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- Issuers Excepted from the Definition of Investment Company by SEC Rule
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SECTION 1

# THE DEFINITION OF AN INVESTMENT COMPANY

# Orthodox Investment Companies

- Section 3(a)(1)(A) of the 1940 Act defines as an investment company "any **issuer** which ... is or holds itself out as being **engaged primarily**, or proposes to engage primarily, in the business of investing, reinvesting, or trading in **securities**."
- An issuer that is an investment company under Section 3(a)(1)(A) sometimes is referred to as an "orthodox investment company," that is "a company that knows that it is an investment company and does not claim to be anything else..." (*SEC v. Fifth Avenue Coach Lines, Inc.* (S.D.N.Y. 1968))
- Section 2(a)(22) of the 1940 Act defines the term **issuer** to mean "every person who issues or proposes to issue any security, or has outstanding any security which it has issued."
- The SEC has stated that, as a general rule, if a company has no more than 45 percent of its assets invested in securities and derives no more than 45 percent of its income from securities, it will not be regarded as being primarily engaged in investing in securities.

# Orthodox Investment Companies (Cont.)

- Section 2(a)(36) of the 1940 Act defines **security** as “any note, stock, treasury stock, security future, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, any put, call, straddle, option, or privilege on any security (including a certificate of deposit) or on any group or index of securities (including any interest therein or based on the value thereof), or any put, call, straddle, option, or privilege entered into on a national securities exchange relating to foreign currency, or, in general, any interest or instrument commonly known as a ‘security’, or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.”
- The SEC and its Staff have interpreted the definition broadly, and have, for example, taken the position that commercial paper, which is exempted from the provisions of the 1933 and 1934 Acts, and loans—even to related companies—are securities for purposes of the 1940 Act.

# Inadvertent Investment Companies

- Section 3(a)(1)(C) of the 1940 Act defines as an investment company "any issuer which ... is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire **investment securities** having a **value** exceeding 40 per centum of the value of such issuer's total assets (exclusive of Government securities and **cash items**) on an **unconsolidated basis**."
- In *Fifth Avenue Coach Lines*, the court stated that Section 3(a)(1)(C) "catches the inadvertent investment company, *i.e.,* a company which does something [other than acting as an investment company] but suddenly comes up against the 40 percent test."
- The SEC has brought actions against companies for operating as unregistered investment companies, based on the Section 3(a)(1)(C) definition of investment company (See *SEC vs. National Presto Industries, Inc.*)

# Inadvertent Investment Companies (Cont.)

- Section 3(a)(2) of the 1940 Act defines "investment securities" as all "all securities except (A) **Government securities**, (B) securities issued by **employees' securities companies**, and (C) securities issued by **majority-owned subsidiaries** of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in [Sections 3(c)(1) or 3(c)(7)]."
- Section 2(a)(16) of the 1940 Act defines **Government security** as "any security issued or guaranteed as to principal or interest by the United States, or by a person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States; or any certificate of deposit for any of the foregoing."
  - Neither the courts, the SEC, nor its Staff has defined the term "instrumentality of the Government of the United States," but many entities have received no-action letters regarding their status as federal instrumentalities.

# Inadvertent Investment Companies (Cont.)

- Section 2(a)(24) of the 1940 Act defines a **majority-owned subsidiary** of a person as a company 50% or more of the outstanding **voting securities** of which are owned by such person, or by a majority-owned subsidiary of such person.
  - Section 2(a)(42) of the 1940 defines a **voting security** as "any security presently entitling the owner or holder thereof to vote for the election of directors of a company."
  - The SEC Staff has taken the position that a limited partnership interest may be a voting security if one or more limited partners have the right to, among other things:
    - Remove or replace the general partner (GP);
    - Vote on the election or removal of the GP in the event of the GP's death, insanity or retirement;
    - Terminate the partnership if one of the initial managing GPs ceases to serve in that role;
    - Take part in the conduct or control of the limited partnership's business.

# Inadvertent Investment Companies (Cont.)

- Section 2(a)(13) of the 1940 Act defines **employees' securities company** as any investment company all of the outstanding securities of which are beneficially owned by (i) the employees or former employees of a single employer or multiple affiliated employers, (ii) members of the immediate families of such employees or former employees, or (iii) such employer(s).
  - Section 6(b) of the 1940 Act establishes a special standard pursuant to which the SEC "shall" grant orders exempting employees' securities companies from provisions of the 1940 Act. Conversely, the SEC "may" grant Section 6(c) orders.
- **Value** is defined in Section 2(a)(41)(A) of the 1940 Act, which generally requires that:
  - Assets acquired during the current fiscal quarter be valued at cost;
  - Any other securities for which market quotations are readily available be valued at their market value at the end of the last fiscal quarter; and
  - Any other securities and assets be valued by the board of directors at their **fair values** as of the last fiscal quarter.
    - The SEC and its Staff have defined **fair value** as the amount the issuer currently could receive for the sale of the securities or assets.

# Inadvertent Investment Companies (Cont.)

- The 1940 Act does not define the term **cash items**, but the SEC has stated that cash items generally would include "cash, coins, paper currency, demand deposits with banks, timely checks of others (which are orders on banks to immediately supply funds), cashier checks, certified checks, bank drafts, money orders, traveler's checks and letters of credit…" (Rule 3a-1 Proposing Release, 1940 Act Release No. 10937)
- The SEC Staff takes the positions that:
  - Certificates of deposit and time deposits typically are not cash items absent convincing evidence of no investment intent.
  - Shares of money market funds that comply with Rule 2a-7 under the 1940 Act generally may be treated as cash items. (*Willkie, Farr & Gallagher*, SEC No-Action Letter (Oct. 23, 2000)).
- In contrast to Section 3(a)(1)(A), Section 3(a)(1)(C) requires an issuer to determine its investment company status on an unconsolidated basis.

# Inadvertent Investment Companies (Cont.)

- Common situations where an operating company may inadvertently become subject to the 1940 Act include:
  - An operating company raises capital to finance its operations and invests the capital in short-term, high quality debt securities.
  - An operating company sells a substantial subsidiary and, pending redeployment of the sale proceeds, invests the funds in securities.
  - An operating company with strong cash flows, particularly irregular cash flows, seeks to increase the earnings on its cash reserves by investing in bonds or equity securities.
  - An operating company invests a substantial portion of its assets in securities of subsidiaries that are less than majority-owned.
  - An operating company that has relatively few “good assets” on its books.

# Inadvertent Investment Companies (Cont.)

- What are the Consequences of Being an Inadvertent Investment Company?
  - In short, not good. A company that operates as an unregistered investment company would violate various substantive provisions of the 1940 Act and could be subject to private litigation and SEC enforcement action. More significantly, Section 47(b)(1) of the 1940 Act provides that any contract made in violation of the 1940 Act, or whose performance involves such a violation, is unenforceable unless a court finds that enforcement would produce a more equitable result and would not be inconsistent with the 1940 Act.
- Can an Operating Company Operate as a Registered Investment Company?
  - Not likely. An operating company that inadvertently comes within the 1940 Act could theoretically register with the SEC, but this option is not practical for most. The 1940 Act is a notoriously complicated statute that is not designed for, and does not work well with, companies whose primary business is not buying and selling securities. Among other things, the 1940 Act severely limits a company's ability to raise equity capital, issue debt, borrow money, and do business with affiliates.

# Inadvertent Investment Companies (Cont.)

- We are asked to render legal opinions in transaction closings that a company:
  - Is not an investment company required to be registered under the 1940 Act.
  - Would not, as a result of the subject transaction, become an investment company required to be registered under the 1940 Act.
- An investment company analysis may also be required when we render a legal opinion about either:
  - The due authorization and enforceability of contracts involved in a transaction.
  - The validity of any securities being issued or indebtedness incurred in a transaction.
- Market practice often will demand a “clean” opinion even though the underlying 1940 Act analysis involves a reasoned conclusion.

SECTION 2

# ISSUERS STATUTORILY EXCEPTED FROM THE DEFINITION OF INVESTMENT COMPANY

# Sections 3(b)(1) and 3(b)(2) – Issuers Engaged in a Noninvestment Company Business

- Section 3(b)(1) of the 1940 Act provides that an issuer is not an investment company as defined in Section 3(a)(1)(C) if the issuer is "**primarily engaged**, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."
- Section 3(b)(2) of the 1940 Act excludes from the definition of investment company in Section 3(a)(1)(C) any issuer which the SEC, upon application by the issuer, finds and by order declares to be **primarily engaged** in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities either directly or (i) through majority-owned subsidiaries or (ii) through **controlled** companies conducting similar types of businesses.
- The SEC has taken the position that a determination under Section 3(b)(1) or 3(b)(2) that an issuer is primarily engaged in a noninvestment company business also necessarily is a determination that the issuer is engaged in a noninvestment company business for purposes of Section 3(a)(1)(C) and that the issuer therefore is not an investment company under Section 3(a)(1)(A).

# Sections 3(b)(1) and 3(b)(2) – Issuers Engaged in a Noninvestment Company Business (Cont.)

- The determination of whether an issuer is primarily engaged in a noninvestment company business for purposes of Sections 3(b)(1) and 3(b)(2) generally is based upon the five-factor test established in the SEC's decision in *Tonopah Mining Co.* (26 S.E.C. 426 (1947)).
- The five factors examined under the *Tonopah* test are:
  - Historical development;
  - Public representations of policy;
  - Activities of the issuer's officers and directors;
  - Nature of assets; and
  - Sources of income.
- Typically, the final two factors are the most important factors.
  - As noted above, the SEC has stated that, as a general rule, a company will not be deemed to be primarily engaged in an investment company business if the company has no more than 45% of its assets invested in, and derives no more than 45% of its income from, investment securities.

# Sections 3(b)(1) and 3(b)(2) – Issuers Engaged in a Noninvestment Company Business (Cont.)

- Section 2(a)(9) of the 1940 Act defines **control** to mean "the power to exercise a controlling influence over the management or policies of a company, unless such power is solely the result of an official position with such company."
  - In addition, Section 2(a)(9) establishes two rebuttable presumptions regarding control:
    i. if a person owns more than 25% of the voting securities of the company, then the person is deemed to control the company; and
    ii. If a person owns 25% or less of the voting securities of the company, then the person is deemed not to control the company.

# Section 3(b)(3) – Certain subsidiaries of issuers that are not investment companies under Sections 3(b)(1) or 3(b)(2)

- Section 3(b)(3) of the 1940 Act excludes from the definition of investment company in Section 3(a)(1)(C) any issuer "all the outstanding securities of which (other than short-term paper and directors' qualifying shares) are directly or indirectly owned by a company excepted from the definition of investment company by [Sections 3(b)(1) or 3(b)(2)]."

- Over the years, the SEC has granted a number of exemptive orders, and the SEC Staff has granted a number of no-action letters, that effectively expanded the scope of the Section 3(b)(3) exception, and the SEC codified many of these orders and no-action letters in Rule 3a-3.

# Section 3(c) Exceptions

- Section 3(c) excludes from the definition of investment company:

**Private Investment Companies – 3(c)(1)**

Underwriters, Brokers. Market Makers and Swap Dealers – 3(c)(2)

Banks and Savings and Loan Associations – 3(c)(3)

Bank Common Trust Funds –3(c)(3)

Credit Unions and Other Consumer Financing Agencies –3(c)(3) and 3(c)(4)

Insurance Companies –3(c)(3)

Commercial Financing and Mortgage Banking Businesses – 3(c)(5)

Bank, Insurance, and Similar Holding Companies and Diversified Operating and Holding Companies – 3(c)(6)

**Qualified Purchaser Funds – 3(c)(7)**

Companies Subject to the Public Utility Holding Company Act – 3(c)(8)

Oil and Gas Funds –3(c)(9)

Charitable, Religious, and Similar Organizations – 3(c)(10)

Qualified Pension, Governmental, and Similar Plans – 3(c)(11)

Voting Trusts – 3(c)(12)

Security Holders' Protective Committees – 3(c)(13)

Church Employee Pension Plans – 3(c)(14)

# Foreign Investment Companies (Section 7(d))

- Section 7(d) of the 1940 Act prevents a foreign investment company from offering its shares publicly in the U.S. and prevents registration absent an order of the SEC.
  - A wholly non-U.S. offering (*i.e.*, under Reg. S) by a foreign investment company will not subject the issuer to the 1940 Act
- Section 7(d) does not prohibit a foreign investment company from making a private offering into the U.S.
- SEC staff no-action letters permit a foreign investment company to make a public offering outside the U.S., while conducting a private offering into the U.S.
  - See Touche Remnant & Co. (pub. avail. Aug. 27, 1984) (Section 3(c)(1) company); Goodwin Procter & Hoar (pub. avail. Feb. 28, 1997)(Section 3(c)(7) company).
    - A private offering into the U.S. may result in the fund's investment adviser being required to register with the SEC.

# Foreign Investment Companies (Section 7(d))

- Foreign investment companies that make a private offering into the U.S. must be prepared to meet the on-going compliance requirements under Section 3(c)(1) or Section 3(c)(7).
  - Numerical and investor qualification limits apply over time.
  - Private secondary trading and non-U.S. exchange listings pose challenges.
- Market practice has developed to focus on written procedures that should allow foreign investment companies to comply with 1940 Act and to permit counsel to provide opinions in connection with foreign offerings.
  - Procedures focus on consideration of likelihood of U.S. secondary market development and effective limitations or expectations regarding transferees.
  - See “Investment Company Act Status of Non-U.S. Issuers,” The Investment Lawyer (March 2012)(summarizing flexible procedural framework for issuer compliance).

SECTION 3

# ISSUERS EXCEPTED FROM THE DEFINITION OF INVESTMENT COMPANY BY SEC RULE

# Rule 3a-1— The 45-Percent Asset and Income Tests

- Rule 3a-1 provides an issuer an exemption from Section 3(a)(1)(C), but not Section 3(a)(1)(A), if no more than 45 percent of the value … of such issuer's total assets (exclusive of Government securities and cash items) consists of, and no more than 45 percent of such issuer's net income after taxes (for the last four fiscal quarters combined) is derived from, securities other than:
  - Government securities;
  - Securities issued by employees' securities companies;
  - Securities issued by certain majority-owned subsidiaries of the issuer that are not investment companies; and
  - Securities issued by companies (i) that are **controlled primarily** by the issuer, (ii) through which the issuer engages in a noninvestment company business, and (iii) that are not investment companies.
    - The SEC Staff has stated that **primary control** under Rule 3a-1 means a degree of control that is greater than that of any other person.
- The assets and income tests are to be determined on an unconsolidated basis, except that an issuer must consolidate its financial statements with the financial statements of any wholly-owned (that is, 95% owned) subsidiaries.

# Rule 3a-2 – Transient Investment Companies

- Rule 3a-2 provides that, for purposes of Section 3(a)(1)(A) and Section 3(a)(1)(C) of the 1940 Act, an issuer will not be deemed to be engaged in the business of investing, reinvesting, owning, holding or trading in securities during a period of time not to exceed one year if the issuer has a *bona fide* intent (evidenced by the issuer's business activities and an appropriate resolution of the issuer's board or other appropriate persons) to be engaged primarily, as soon as is reasonably possible (in any event by the termination of such one year period), in a business other than that of investing, reinvesting, owning, holding or trading in securities.
- The one-year period commences on the earlier of:
  - The date on which an issuer owns securities and/or cash having a value exceeding 50% of the value of that issuer's total assets on either a consolidated or unconsolidated basis; or
  - The date on which an issuer owns or proposes to acquire investment securities having a value exceeding 40% of the value of that issuer's total assets (exclusive of Government securities and cash items) on an unconsolidated basis.
- An issuer may not rely upon Rule 3a-2 more frequently than once during any three-year period.

# Rule 3a-3 – Certain Investment Companies Owned by Noninvestment Companies

- Rule 3a-3 effectively broadens the scope of the Section 3(b)(3) exclusion by excluding a subsidiary from being deemed to be an investment company under both Section 3(a)(1)(A) and Section 3(a)(1)(C) if:
  - All of the subsidiary's outstanding securities (other than short-term paper, directors' qualifying shares, and debt securities owned by the Small Business Administration) are directly or indirectly owned by its parent company; and
  - The parent company satisfies the Rule 3a-1 45% asset and income tests, and is:
    - A company that is not an investment company as defined in Section 3(a);
    - A company that is an investment company as defined in Section 3(a)(1)(C), but which is excluded from the definition of investment company by Section 3(b)(1) or 3(b)(2); or
    - A company that is deemed not to be an investment company by Rule 3a-1.

# Other Exceptions by Rule

- The SEC has also adopted rules excluding from the definition of investment company:
  - Wrap Fee and Other Investment Advisory Programs – 3a-4
  - Finance Subsidiaries – 3a-5
  - Foreign Banks and Foreign Insurance Companies – 3a-6
  - Issuers of Asset-Backed Securities – 3a-7
  - Research and Development Companies – 3a-8

SECTION 4

# TAX TREATMENT OF PASSIVE FOREIGN INVESTMENT COMPANIES (PFICs)

# What is a PFIC?

- "Passive foreign investment company" or PFIC rules were added under Section 1297 of the US Internal Revenue Code, or Code, in 1986
  - Limited amount of binding guidance on various aspects of PFIC rules
  - Various regulations and notice have been outstanding in "proposed" form for decades
  - IRS has recently proposed additional guidance on various PFIC topics, but guidance is of limited relevance to the typical public company
- A PFIC is a non-US corporation if, in any year, either:
  - 75% or more of the non-US corporation's gross income is passive income; or
  - 50% or more of the non-US corporation's assets are passive assets
- Special rules
  - Look through 25% or more owned subsidiaries to their income or loss
  - Special rules for insurance companies, banks

# What is a PFIC? (continued)

- Special rules (continued)
  - "Active" rents and royalties
  - First year "start-up" exception
  - "Check-the-box" elections to treat a parent and/or subsidiary non-US corporations as partnerships or disregarded entity branches for US federal income tax purposes
- PFIC provisions—expected and actual application
  - Routinely apply to non-US corporations that are viewed as "investment funds"
  - Are at risk of applying to non-US corporations that don't look at all like an investment fund
  - Focus of presentation is on the "unexpected" PFIC, which requires describing what PFICs are in some detail

# What are passive income and passive assets?

- “Passive income” includes dividends, interest, and gains from the sale or exchange of investment property and rents and royalties other than rents and royalties which are received from unrelated parties in connection with the active conduct of a trade or business.
  - Income derived from the performance of services does not constitute “passive income” and working capital and similar assets held pending investment in assets used in a business generally will be treated as an asset which produces passive income.
- “Passive assets” are assets that produce passive income

# Adverse consequences of being a PFIC

- Primarily a concern for shareholders of a PFIC that are US taxpayers
  - Applies to indirect shareholders through pass-through (e.g., investment funds treated as partnerships)
- Absent special “QEF” and “mark-to-market” elections, US taxpayer shareholder of a PFIC taxpayers
  - Are liable to pay US federal income tax at the then prevailing income tax rates on ordinary income (currently a top rate of 37%) plus an extra interest charge upon excess distributions and upon any gain from the disposition of shares of the PFIC
  - Extra amounts are determined as if the excess distribution or gain had been recognized ratably over the US taxpayer shareholder’s holding period in the PFIC shares

# Adverse consequences of being a PFIC (continued)

- By contrast, US taxpayer shareholders of a non-US corporation that is not a PFIC
  - Generally qualify for a lower long-term capital gains US federal income tax rate of 20% (without any additional interest charge) on gains on sale of shares of the non-US corporation that have been held more than a year, and
  - with respect to non-US corporations that are either publicly traded or eligible for the benefits of a US tax treaty, are eligible for the same 20% US federal income tax rate (versus the 37% rate that otherwise applies to ordinary income) on dividends received from a non-US corporation that is not a PFIC
- As a result of the adverse tax consequences to US stockholders, a finding by the IRS that a non-US corporation is a PFIC may result in sales of the company's common stock by US taxpayer stockholders, which could lower the stock price and adversely affect the company's ability to raise capital.

# Tax consequences of being a PFIC change with special elections

- “Qualified electing fund” or “QEF” election
- “Mark to market” PFIC election

# QEF election

- A US taxpayer shareholder of a PFIC (including a US partnership or other US person through which US taxpayers hold shares) can elect to treat the PFIC as a QEF, using IRS Form 8621
- A US taxpayer shareholder that has made a QEF election must report each year for US federal income tax purposes its pro-rata share of the PFIC's ordinary earnings and net capital gain, if any, for the PFIC's taxable year that ends with or within the taxable year of the US shareholder
  - Taxable income much be taken into account regardless of whether or not distributions were received from the PFIC by the US taxpayer shareholder
  - Generally, a QEF election should be made on or before the due date for filing the electing US shareholder's US federal income tax return for the first taxable year in which the shareholder is held by such US shareholder and the corporation is a PFIC

# QEF election (continued)

- The electing US shareholder's adjusted tax basis in the PFIC stock will be increased to reflect taxed but undistributed earnings and profits, and the shareholder will not be taxed again once the amount taken into account is distributed
  - QEF election preserves capital gain or loss treatment for the US shareholder on a later sale
- QEF election only possible if the issuer provides the US shareholder with information, calculated in accordance with US tax principles, to determine the US shareholder's share of the PFIC's ordinary earnings and net capital gain
  - Many non-US corporations find this sort of reporting to be challenging

# Mark to market election

- Where the PFIC is publicly traded, a US taxpayer shareholder can make a “mark-to-market” election with respect to the PFIC shares, using IRS Form 8621
- As a result, the US shareholder generally would include as ordinary income in each taxable year the excess, if any, of the fair market value of the PFIC shares at the end of the taxable year over such holder’s adjusted tax basis in the shares
- The US shareholder would also be permitted an ordinary loss in respect of the excess, if any, of the shareholder’s adjusted tax basis in the PFIC shares over its fair market value at the end of the taxable year, but only to the extent of the net amount previously included in income as a result of the mark-to-market election

# Mark to market election (continued)

- The US shareholder's tax basis in his shares would be adjusted to reflect any such income or loss amount
- Gain realized on the sale, exchange or other disposition of the PFIC shares would be treated as ordinary income, and any loss realized on the sale, exchange or other disposition of the common stock would be treated as ordinary loss to the extent that such loss does not exceed the net mark-to-market gains previously included by the United States Holder
- A mark-to-market election under the PFIC rules would not apply to a subsidiary of a PFIC that also is a PFIC

# Risk of “inadvertent” PFIC status

- Large amount of cash or investment assets on hand for an extended period
  - Subject to one-year start-up exception
  - Examples include cash  from investment rounds where cash is being kept on hand to cover R&D expenses (e.g., biotech or other high tech companies) or expected delivery of required equipment (e.g., conventional or alternative power generation facilities, shipping).
- Ownership structure that includes significant equity interest that are less than 25% owned and are treated for US tax purposes as corporations and not pass-through, even if those subsidiaries are themselves not PFIC and are active businesses (because the stock is a passive asset).

# Risk of “inadvertent” PFIC status (continued)

- Extensive real estate assets or intellectual property assets
  - Risk because “active” rather than “passive” rents or royalties requires a significant role in development or management of the assets producing the rents or royalties by employees of the non-US corporation
  - Independent contractor, outsourcing or separate management company arrangements can result in issues
- Investments in shipping or other transportation companies that have significant passive rental income
  - Bareboat charters an issue
  - Case law and practice distinguishes as “active” transportation income time and spot charters
- Investments in financial services companies that do not meet requirements as active banks

# What IPO and other issuers should do about PFIC risks?

- Potential PFIC status should be considered early in the process
  - Analysis requires US tax expert involvement
  - Specifics as to current and projected financial results of the corporation
- Determining what are the passive and active assets and income

# What IPO and other issuers should do about PFIC risks? (continued)

- Focus on structural issues
  - For example, under 25% subsidiaries
- Consider, for asset test, implied “good will” or “going concern” value
  - Key is fair market value, which may not be reflected on financial statements
  - IPO offering price, and going forward trading price, may provide a basis for valuing these “intangible” assets
  - Consider whether “intangible” assets are passive or active

# What IPO and other issuers should do about PFIC risks—determining value?

- Consider the following simplified example:
  - IPO issuer has active assets (property, plant and equipment related to its business) worth $20, and passive assets (cash on hand, investment assets, and investments in under-25% subsidiaries) worth $30, based on book values (and, in this simple example, has no liabilities)
    - Looking just at book values, more than 50% of the value of the IPO issuer is attributable to passive assets ($60/$100 of total value), and the IPO issuer is a PFIC
  - IPO issuer price, however, suggests net equity value of $80, or $30 of value in excess of the $50 value of the IPO issuer's active and passive assets on its books
    - Taking into account this $30 of excess value, if viewed as attributable to the good will or going concern value of the IPO issuer, the portion of the issuer's value attributable to passive assets is less than 50% ($30/$80, or 38%)
  - If the stock price drops, however, so that the equity value goes below $60, and there are no other changes, the IPO issuer may be or become a PFIC

# Foreign Capital Market Transactions

- Surprise!
- Context in which issues commonly arise
    - Tech start-ups with few long-term assets
    - Cash rich companies
    - Minority interest cross-holdings

# Foreign Capital Market Transactions

- Complications applying the rules outside the US
  - US-centric definitions
  - Non-consolidated financials
  - Inability to certificate

- Differences in practice: ICA vs PFIC
  - Consequences
  - Opinions

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# QUESTIONS?

# CLE

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# Biography

With a focus on investment advisers and other financial services firms, Timothy W. Levin counsels clients on the design, development, and management of pooled investment vehicles and investment advisory programs. He also advises fund managers in connection with organization, registration, and ongoing regulatory compliance. Additionally, he represents managers and sponsors of unregistered pooled investment vehicles. He is the managing partner of Morgan Lewis's Philadelphia office.

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Mathew Lewis focuses his practice on capital markets transactions throughout the Asia-Pacific region, with a particular emphasis on Greater China, as well as transactions in India, Korea, Malaysia, and Singapore. Mathew is fluent in English and Mandarin. He is admitted to practice in New York only.

Mathew has extensive experience in initial public offerings (IPOs), Rule 144A/Regulation S placements, issuances of depositary receipts, and other equity, debt and equity-linked transactions including both private placements and registered US securities offerings. His principal clients have included, among others, Morgan Stanley, Credit Suisse, Deutsche Bank, Goldman Sachs and UBS.

# Biography

Working with businesses in industries such as media, financial services, aviation, shipping, and education, Richard S. Zarin counsels clients on tax matters involving international and US transactions. He also advises clients on ongoing tax planning. Richard's experience includes mergers, acquisitions, the formation and operation of joint ventures, debt and equity restructurings, and securities offerings. In addition, he represents organizers of and investors in onshore and offshore investment funds and other alternative investment vehicles.

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