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Global Tax Alert

US final and proposed PFIC regulations provide a mix of favorable and unfavorable provisions

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Executive summary

In final and proposed regulations released on 4 December 2020, the United States (US) Treasury Department (Treasury) and Internal Revenue Service (IRS) provide guidance on the passive foreign investment company (PFIC) rules under Internal Revenue Code[1] Sections 1291, 1297 and 1298 (the final PFIC regulations and the 2020 proposed regulations, respectively).

The final PFIC regulations are largely consistent with the proposed PFIC regulations released on 10 July 2019 (the 2019 proposed regulations) but contain several significant changes. For discussion of the 2019 proposed regulations, see EY Global Tax Alert, *US proposed regulations provide guidance on passive foreign investment companies, clarify longstanding PFIC issues and contain both favorable and unfavorable provisions for taxpayers*, dated 18 July 2019.

In particular, the final PFIC regulations:

- Clarify an ambiguity about how ownership of PFIC stock is attributed when owned through a tier of entities
- Eliminate reliance on the Section 954(h) active financing rules when determining whether a foreign corporation carrying on a financial business is a PFIC
- Eliminate rents and royalties from 25%-owned subsidiaries, and the associated assets, from the PFIC income and asset tests

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- Eliminate the ability to treat a less-than-25% (by value) interest in a partnership as an active asset (with exceptions)
- Allow one to take into account activities of related parties when determining whether rents, royalties and certain other types of income are passive or active
- Allow foreign corporations that are only controlled foreign corporations (CFCs) because of the repeal of Section 958(b)(4) in 2017 to measure assets by fair market value for purposes of the PFIC asset test
- Modify the rules on when stock in a second-tier US subsidiary is treated as per se active

The 2020 proposed regulations would notably:

- Provide guidance on when a foreign corporation licensed as a bank can avoid being treated as a PFIC
- Treat as an active asset a limited amount of working capital held in a non-interest-bearing account
- Limit the scope of the rule treating gain on the sale of an interest in certain subsidiaries as active to the extent the subsidiary owns active assets
- Further modify the rules on when stock in a second-tier US subsidiary is treated as per se active

Both the final PFIC regulations and the 2020 proposed regulations materially change the rules for when a foreign insurance company will be treated as a PFIC. For discussion of these changes, see EY Global Tax Alert, *US final and proposed regulations on passive foreign investment companies have both favorable and unfavorable implications for insurance companies*, dated 15 December 2020.

The final PFIC regulations apply to tax years of US persons that are shareholders in certain foreign corporations prospectively, beginning on or after the date of publication of the final PFIC regulations in the Federal Register (e.g., 2021 for a calendar-year taxpayer if the regulations are published in the Federal Register by 31 December 2020).

This Tax Alert describes significant changes in the final PFIC regulations compared to the 2019 proposed regulations and highlights key provisions of the 2020 proposed regulations.

Detailed discussion

Background

A US person that owns, or is treated as owning, stock in a PFIC and either sells the stock or, loosely speaking, receives an "extraordinary" dividend from the PFIC is subject to the following rules. The base rule is that the "extraordinary" portion of the dividend (or gain treated as an extraordinary distribution) is allocated ratably over the US person's holding period. Amounts allocable to the current year and amounts allocable to any prior year during which the foreign corporation was not a PFIC are treated as ordinary income in the current year. Amounts allocable to any prior year during which the foreign corporation was a PFIC are excluded from current-year gross income. Instead, they are subject to an "add-on" tax at the highest rate applicable to ordinary income for that year, plus an interest charge. Alternative elective treatments are available if the PFIC furnishes necessary information (a QEF election) or if stock in the PFIC is "marketable."

A foreign corporation (the tested foreign corporation) is a PFIC if, for its tax year: (1) at least 75% of its gross income is passive income (Income Test); or (2) the average percentage of assets that are held during the tax year and produce, or are held to produce, passive income (Asset Test and, collectively, the PFIC Tests) is at least 50%. Passive income is defined as income that "is of a kind [that] would be foreign personal holding company income" (FPHCI) under the Subpart F rules. For purposes of the Asset Test, publicly-traded corporations must measure assets by fair market value, CFCs must measure assets by adjusted basis and other foreign corporations measure assets by fair market value unless they elect to measure assets by adjusted basis.

Various "look-through" rules apply to a tested foreign corporation's subsidiaries and related parties for purposes of the PFIC Tests. Section 1297(c) (General Look-Through Rule) treats the tested foreign corporation as if it held its proportionate share of the assets and received directly its proportionate share of the income of any corporation (foreign or domestic) for which it owns (directly or indirectly) at least 25% by value (look-through subsidiary). Section 1297(b)(2)(C) (Related-Party Look-Through Rule) provides that passive income does not include interest, dividends, rents or royalties received or accrued from a related person (within the meaning of Section 954(d)(3)) to the extent that amount is properly allocable to the related person's non-passive income. Section 1298(b)(7) (Domestic Look-Through Rule) treats certain stock (qualified stock) that the tested foreign corporation indirectly owns through a 25%-owned second-tier domestic corporation as an asset generating non-passive income for purposes of the PFIC Tests, provided that the tested foreign corporation is subject to the accumulated earnings tax or waives any treaty protections against the imposition of that tax.

A US person is treated as owning shares of any PFICs owned by a foreign corporation if the US person owns (i) any stock in a foreign corporation that is a PFIC, or (ii) at least 50%, by value, of stock in a foreign corporation that is not a PFIC.

The final PFIC regulations

Indirect ownership — tiered entities. If US person A owns stock in corporation X, which in turn owns stock in corporation Y, which is a PFIC, Section 1298(a)(2) treats A as indirectly owning stock in Y in two, and only two, circumstances. First, if X is a PFIC, A always is treated as owning its proportionate share of Y. Second, if X is not a PFIC, A is treated as indirectly owning its proportionate share of Y if, and only, if A owns at least 50% by value of Y.

Before the final PFIC regulations, uncertainty existed about how to apply these corporate attribution rules to tiered entities. Suppose US person B owns stock in corporation P, which in turn owns stock in corporation Q, which in turn owns stock in corporation R, which is a PFIC. When determining whether B is treated as indirectly owning stock in R, does one start with the PFIC (R) and apply the rules going up the chain (bottom-up), or does one start with the US person being tested (B) and apply the rules going down the chain (top-down)? In some cases, this choice can affect whether B is treated as indirectly owning stock in R. Treas. Reg. Section 1.1291-1(b)(8)(iv) settles the issue and provides that one must use the "top-down" rule.

Indirect ownership — partnerships. Section 1298(a)(3) attributes PFIC stock owned by a partnership proportionately to its partners. Section 1.1298-1(b)(8)(iii) of the 2019 proposed regulations would have modified this rule in the following situation. Suppose US person C owned an interest in partnership N, which in turn owned an interest in corporation O, which was not a PFIC. Corporation O, in turn, owned an interest in corporation P, which was a PFIC. As discussed previously, C would only be treated as a 50% shareholder of O, and thus as owning its share of O's interest in P, if O owned at least 50% of the "ownership interests" in N. Prop. Reg. Section 1.1291-1(j)(4) would not permit taxpayers to rely upon this proposed regulation until it was issued in final form. The final PFIC regulations eliminate this rule in the 2019 proposed regulations; for purposes of testing, they also clarify that a partnership's indirect ownership stock is always attributed proportionately to all of its partners, with no ownership threshold.

Financial institutions. Since a financial institution typically would earn interest income, and interest income generally is passive, every foreign financial institution would be prima facie a PFIC. There are two ways under the Code to potentially mitigate this result. First, Section 954(h), which is not limited to banks, and can also cover affiliates, treats certain income derived by a CFC from an active banking, financing, or similar business as passive. Second, Section 1297(b)(2)(A) considers income derived in the active conduct of a banking business by a bank licensed in the US (or, to the extent provided in regulations, any other corporation) as not passive.

The 2019 proposed regulations would have treated income that is active under Section 954(h) as active for PFIC purposes. The final PFIC regulations reversed course by allowing a financial institution to avoid PFIC status only through the Section 1297(b)(2)(A) rules. Since Section 1297(b)(2)(A) only applies to entities licensed as banks, this eliminates the ability of non-bank finance companies that predominantly earn interest income, as well as non-bank affiliates of banks, to avoid PFIC status. It is not entirely clear whether this very major change is consistent with Congress's apparent intent in 1993.[2]

Intercompany rents and royalties. The General Look-Through Rule treats a tested foreign corporation owning at least 25% by value of a second corporation (a look-through subsidiary) as directly owning its share of the look-through subsidiary's assets and deriving its share of the look-through subsidiary's income. So how does one avoid double counting for payments from the look-through subsidiary when the look-through's subsidiary's income had already been taken into account? Historically, no guidance existed under these rules other than a 1988 Notice, issued when the definition of passive income was different, and legislative history from 1988 (Notice 88-22). The 2019 proposed regulations would disregard dividends and interest from look-through subsidiaries for purposes of the income test. The final PFIC regulations expand this exemption to rents and royalties from a look-through subsidiary. This also eliminates the corresponding shares, debt, leases or licenses, as the case may be, from the asset test.

Partnership interests under the asset and income tests. Suppose a foreign corporation owns an interest in a partnership that owns active assets. The final PFIC regulations, by analogy to the General Look-Through Rule and Section 954(c)(4), generally treat a partnership interest

held by a tested foreign corporation as a per se passive asset and the distributive share of partnership income as passive income, unless the tested foreign corporation owns at least 25% by value of the partnership (a look-through partnership). In that case, the foreign corporation is treated as owning its share of the partnership's assets and deriving its share of the partnership's income, characterized as passive or active at the partnership level.

There is one exception (the Active Partner Test) to this rule. If a tested foreign corporation would not be a PFIC if it were to disregard all less-than-25%-owned interests in partnerships, the foreign corporation may treat such less-than-25% partnerships as look-through partnerships, unless the tested foreign corporation elects otherwise.

Attribution of related-party activities. The regulations under the Section 954(c)(2)(A) Subpart F rules for active rents and royalties received from unrelated parties only treat such items as active if substantial activities are performed by officers and employees of the corporation deriving the income. Activities of officers and employees of related entities are not taken into account. The final PFIC regulations allow activities of officers and employees of related entities to be taken into account for this purpose, in a way even more favorable than the 2019 proposed regulations.

Under the 2019 proposed regulations, a tested foreign corporation could apply the active rent and royalty rules by taking into account the activities of the officers, directors and employees of the tested foreign corporation and any other foreign corporation of which the tested foreign corporation owned more than 50% by value. The same rule would apply to activities of any partnership of which the tested foreign corporation owns more than 50% by value of the partnership. The final PFIC regulations broaden this rule to attribute to a tested foreign corporation the activities of any "qualified affiliate" and extend the attribution rule to certain other exceptions from passive income under the Subpart F rule.[3]

A qualified affiliate is generally a member of an affiliated group within the meaning of Section 1504(a), modified by applying an ownership threshold based only on 50% or more of the value of a corporation's stock and including partnerships that are also owned at least 50 percent by value, provided the common parent is a foreign corporation or partnership. In other words, a qualified affiliate must be under at least 50% common ownership under a foreign direct or indirect parent. Thus, activities of parent/higher-tier entities and sibling entities may be taken into account.

Measuring assets. As noted, the statute prescribes how a tested foreign corporation must measure its assets for purposes of the PFIC Asset Test. Some foreign corporations became CFCs due to the repeal of Section 958(b)(4) in 2017. Thus, they would be required to measure assets by adjusted basis. The final PFIC regulations, consistent with proposed regulations released in October 2019,[4] reverse this (probably unintended) side effect of the repeal of Section 958(b)(4) by defining a CFC for purposes of the PFIC asset test as a CFC determined without regard to the repeal of Section 958(b)(4). This will be beneficial for foreign corporations that own valuable self-created goodwill and other intangible property.

The final PFIC regulations specify that a foreign corporation that is both actively-traded and a CFC measures its assets by fair market value. These regulations also address the application of Section 1297(e) to tiered ownership structures. The method used by a parent corporation to measure assets must be used by lower-tier corporations unless a lower-tier corporation must use a different method specified by Section 1297(e). For example, if a publicly-traded parent owns a 25% interest in a non-publicly traded CFC, the subsidiary must measure assets by tax basis even though the parent must measure assets by fair market value. These rules apply for purposes of determining the PFIC status of both the parent foreign corporation (since, under the General Look-Through Rule, it is treated as owning its share of a look-through subsidiary's assets) and the lower-tier corporation.

Domestic Look-Through Rule

In a welcome reversal from the 2019 proposed regulations, the final PFIC regulations do not adopt a rule that would have disregarded the Domestic Look-Through Rule for purposes of determining whether a foreign corporation is a PFIC under the PFIC ownership attribution rules in Section 1298(a)(2).[5]

The final PFIC regulations include an anti-abuse rule (narrower than the one in the 2019 proposed regulations) that turns off the application of the Domestic Look-Through Rule (Principal Purpose Anti-Abuse Rule). Under the Principal Purpose Anti-Abuse Rule, the Domestic Look-Through Rule will not apply if a principal purpose for forming, acquiring, or holding of the stock of the 25-percent owned domestic corporation or the second-tier domestic corporation is to hold passive assets in a way that avoids classifying the tested foreign corporation as a PFIC. The Principal Purpose Anti-Abuse Rule also applies if a principal purpose for the

capitalization or other funding of the second-tier domestic corporation is to hold passive assets in a way that avoids classifying the tested foreign corporation as a PFIC. The proposed regulations would provide additional safe harbors from the Principal Purpose Anti-Abuse Rule.

Stapled entities. Consistent with the 2019 proposed regulations, the final PFIC regulations treat stapled entities as a single entity for purposes of the PFIC Tests. To receive this treatment however, a US person that would be a shareholder of the entities (under the PFIC ownership attribution rules) must also own stock in all entities that are stapled entities relative to each other.

Applicability of the final regulations only to open years. Treas. Reg. Section 1.1297-1(f) allows taxpayers to apply the final PFIC regulations on the definition of a PFIC to all open years. What if a taxpayer owns stock in a foreign corporation that was treated as a PFIC under prior guidance, but is not a PFIC under the final PFIC regulations? If all the relevant years in the holding period are still open, taxpayers can file amended returns for those years. If one or more years in the holding period are closed, however, the Preamble to the final PFIC regulations is adamant that the "once-a-PFIC always-a-PFIC" rule of Section 1298(b)(1) applies.

If the corporation was treated as a PFIC in a closed year, it will continue to be treated as a PFIC. If the corporation ceases to be a PFIC under the new regulations, then the corporation is a "former PFIC" under Treas. Reg. Section 1.1291-9(j)(2)(iv). A former PFIC will continue to be treated as a PFIC unless it elects under Treas. Reg. Section 1.1298-3 to be treated as if it had sold its PFIC shares for fair market value. If the former PFIC is a CFC, the shareholder instead can elect to be treated as if it had received a deemed dividend equal to its pro rata share of the corporation's post-1986 undistributed earnings and profits (regardless of whether the shareholder is a 10% owner of the CFC).

The 2020 proposed PFIC regulations

Definition of an active foreign bank. As noted, the final regulations do not allow Section 954(h) to be used in determining whether a foreign financial institution is a PFIC. So what qualifies for the Section 1297(b)(2)(A) bank exception? The IRS attempted to provide guidance under the "bank" exception in Notice 89-81, proposed regulations (Prop. Reg. Section 1.1296-4) from 1995 that were never finalized, and the provision in the 2019 proposed regulations that would have allowed taxpayers to use Section 954(h) as an alternative to Section 1297(b)(2)(A).

Prop. Reg. Section 1.1297-1(c)(1)(i)(B) of the 2020 proposed regulations specifically prohibits Section 954(h) from applying for PFIC testing purposes. Instead, Prop. Reg. Section 1.1297(c)(2) would treat income derived by a non-US bank from the "active conduct of a banking business," as defined, as active, provided the income would have been excluded under Section 954(h) if the foreign corporation had been a CFC. A qualifying bank must to be licensed in the country of its incorporation or charter to do business as a "bank," including accepting deposits from local residents. The bank must carry on one or more specified activities, and "regularly" receive bank deposits from unrelated customers in the course of those activities. Under these rules, a bank does not necessarily have to make loans if it carries on other specified activities, but a finance company that is not licensed as a bank never can qualify. Also, unlike Section 954(h), affiliates of banks that are not themselves banks cannot qualify.

Although the 2019 proposed regulations have been withdrawn, there are now three sets of guidance outstanding: Notice 89-81, Prop. Reg. Section 1.1296-4 and the 2020 proposed regulations. The Preamble to the 2020 proposed regulations states that taxpayers may choose to rely on any of these three, presumably provided that they do so consistently.

The Preamble also invites comments on the general approach taken for the definition of a "good" bank for PFIC purposes, whether it is too broad or too narrow, and whether Notice 89-81 and Prop. Reg. Section 1.1296-4 should be withdrawn or issued in final form.

Limited working capital exception. The 2020 proposed regulations would provide a narrow "working capital" exception to treat cash deposited in a non-interest-bearing account held for the present needs of an active trade or business (no greater than the amount of cash expected to cover 90 days of operating expenses) as a non-passive asset. Notice 88-22 deemed all cash as a per se passive asset for PFIC-testing purposes; the proposed rule reflects the fact that some amount of cash is needed as working capital to support the day-to-day operations of an enterprise.

Dividends from look-through subsidiaries. The 2020 proposed regulations would extend the intercompany elimination rule in the final PFIC regulations and require all dividends from look-through subsidiaries to be eliminated from the Income Test (whether or not the dividend is attributable to the look-through subsidiary's income that is currently or previously taken into account in the Income Test). Corresponding adjustments to the basis of the stock of

the look-through subsidiary would be required for purposes of determining gain upon the disposition of the look-through subsidiary's stock in applying the Income Test to the year of disposition.

Implications

The final PFIC regulations appear to make it impossible for a finance company to avoid PFIC status if it is not licensed as a bank.

Changing the definition of a CFC to the pre-2017 definition for purposes of the PFIC asset test will provide welcome relief for foreign corporation that own valuable property with a low basis, such as self-created goodwill and other intangible assets.

If a foreign corporation is no longer a PFIC under the new guidance, but a shareholder treated it as a PFIC in a prior year, the shareholder will need to take additional steps to benefit from the new guidance and avoid lingering PFIC taint.

The rules that allow attribution of activities of related parties when determining whether certain types of income are active are welcome. These rules should be especially beneficial for real estate business, whose management might be in a separate entity from the real estate for business reasons. Beware that these rules do not, by their terms, apply for purposes of Subpart F.

The proposed rule on working capital would seem to be of limited practical use, since it requires the funds to be kept in a non-interest-bearing account. This is inconsistent with commercial practice.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. In 1993, Congress ordered the Treasury to study how the PFIC rules relate to financing and credit services businesses. H.R. Rep. No. 103-213, at 641 (1993). This study was never completed.
3. The additional exceptions to FPHCI under Section 954(c) that take into account the activity attribution rules include Section 954(c)(1)(B) (on sale of certain properties), Section 954(c)(1)(C) (on certain commodity transactions), Section 954(c)(1)(D) (on certain foreign-currency gains), Section 954(c)(2)(B) (on export financing), and Section 954(c)(2)(C) (on dealers).
4. REG-104223-18 (2 October 2019).
5. Section 1298(a)(2) generally treats a person owning (directly or indirectly) 50% or more in value of the stock of a non-PFIC corporation as owing their proportionate share of the stock owned (directly or indirectly) by or for that corporation. If the upper-tier corporation is a PFIC, however, the 50% ownership threshold does not apply.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP, International Tax Services, Washington, DC

- Martin Milner martin.milner@ey.com
- Stephen Peng stephen.peng@ey.com
- Chris Ocasal chris.ocasal@ey.com
- John Owsley john.owsley@ey.com

Ernst & Young LLP, Financial Services Organization – International Tax Services, Boston

- Matthew S. Blum matt.blum@ey.com
- Carter Vinson carter.vinson@ey.com

International Tax and Transaction Services

Global ITTS Leader, **Jeffrey Michalak,** *Detroit*

Global Transfer Pricing Leader, **Luis Coronado**, *Singapore*

ITTS Director, Americas, **Craig Hillier,** *Boston*

ITTS NTD Leader, **Jose Murillo,** *Washington, DC*

Transfer Pricing Leader, Americas, **Tracee Fultz**, *New York*

ITTS Markets Leader, Americas, **Laynie Pavio,** *San Jose, CA*

ITTS Regional Contacts, Ernst & Young LLP (US)

West
Sadler Nelson, *San Jose*

East
Colleen O'Neill, *New York*

Central
Aaron Topol, *Atlanta*

Financial Services
Chris J Housman, *New York*

Canada - Ernst & Young LLP (Canada)
Warren Pashkowich, *Calgary*

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