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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

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Executive summary

On 10 July 2019, the United States (US) Treasury Department (Treasury) and Internal Revenue Service (IRS) issued proposed regulations (REG-105474-18) under the passive foreign investment company (PFIC) rules (Proposed Regulations), providing guidance under Sections 1291, 1297 and 1298 of the Internal Revenue Code.[1]

In short, the Proposed Regulations:

- Clarify which exclusions from passive income under the Subpart F rules are relevant for PFIC purposes
- Specify that various look-through rules under the Subpart F definition of passive income are irrelevant for PFIC testing purposes, and that the look-through rules under the PFIC provisions are the only ones to be used for PFIC testing purposes
- Discuss in more detail the operation of the PFIC look-through rules for 25% subsidiaries, including 25% domestic subsidiaries, and payments from related parties
- Provide that an interest of less than 25% in a partnership is a passive asset and produces passive income for PFIC testing purposes

Building a better working world

- Clarify application of attribution rules for purposes of determining whether a partner in a partnership is subject to the PFIC rules when the partnership owns PFIC stock through a non-PFIC foreign corporation
- Reduce the likelihood that a foreign real estate corporation will be a PFIC

The Proposed Regulations also offer guidance concerning the Section 1297(b)(2)(B) exception for insurance companies, which will be covered in a separate EY Tax Alert.

The Proposed Regulations would 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 regulations in the Federal Register. Until the regulations are finalized, taxpayers may generally rely on the Proposed Regulations for all open tax years as if they were final regulations, provided the regulations are consistently applied.

This Tax Alert contains:

- An overview of certain aspects of the PFIC rules addressed by the Proposed Regulations
- A detailed discussion of the Proposed Regulations, including their notable implications

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 gain on the sale/"extraordinary" portion of the dividend 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. Alternative elective treatments are available if the PFIC will cooperate (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" under the Subpart F rules. For purposes of the Asset Test, publicly-traded corporations must measure assets by fair market value, controlled foreign corporations (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 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.

Applicability of Subpart F exceptions to foreign personal holding company income, including look-through rules

The Subpart F rules contain various rules that (i) exclude income that otherwise would qualify as foreign personal holding company income (and, thus, passive income for PFIC purposes), and (ii) treat income from related parties on a look-through basis. Since the PFIC rules contain their own exceptions (e.g., for active insurance companies) and look-through rules, and since some Subpart F exceptions by their terms only apply to CFCs, it has not been clear which Subpart F exceptions apply for PFIC purposes. The Proposed Regulations would settle the issue as follows:

Would apply for PFIC purposes	Would not apply for PFIC purposes
Section 954(c)(2)(A) active rents and royalties from related persons[2]	Section 954(c)(3) income from related persons[3]
Section 954(c)(2)(B) export financing income[4]	Section 954(c)(6) income from related CFCs
Section 954(c)(2)(C) dealer income[5]	Section 954(i) insurance companies[6]
Section 954(c)(4) sales of partnership interests	
Section 954(c)(5) commodity hedging	
Section 954(h) banking, financing or similar business.[7]	

Clarifying that Section 954(h)'s active finance exception should apply in the context of PFIC determination is a positive development for non-bank financial institutions and lenders outside the US, as their income and assets should generally be treated as active, and they may not be characterized as PFICs, provided they meet the requirements of the exception.

Operation of look-through rules

Under the General Look-Through Rule, a tested foreign corporation owning at least 25% by value of a second corporation would be treated as directly owning its share of the second corporation's assets and deriving its share of the second corporation's income. The Proposed Regulations confirm the general understanding that the tested foreign corporation's shares in the second corporation would be eliminated as an asset. The Proposed Regulations, however, provide that dividends paid by the second corporation would be eliminated as income of the tested foreign corporation only if the dividends were paid out of earnings accumulated while the second corporation was a 25% subsidiary of the tested foreign corporation.

Suppose foreign corporation X owns at least 25% by value of the stock of foreign corporation Y, such that X is treated as owning its proportionate share of Y's assets. Suppose X sells its stock in Y. In this situation, a 2007 private letter ruling concluded that X would be treated under the Income Test as if it had sold its share of the assets of Y.[8] But other taxpayers may not rely on a private letter ruling that is not addressed to them.

The Proposed Regulations continue the general rule of the 2007 ruling that the sale of a 25%-owned subsidiary would be treated as a sale of the subsidiary's assets for purposes of the Income Test. As a refinement, the Proposed Regulations would reduce, for purposes of the Income Test, gain on sale of the subsidiary by the amount of the subsidiary's undistributed income that had been treated as earned by the tested foreign corporation under the 25% look-through rule. Similarly, the Proposed Regulations provide that the rules in Section 954(c)(4) are taken into account for purposes of determining whether, under the Income Test, gain from a sale of certain partnership interests is passive income. Generally, gain from the sale of a partnership interest is passive income. However, Section 954(c)(4) treats the sale of a partnership interest as a sale of the seller's proportionate share of partnership assets attributable to such interest, provided that the partner owns (directly, indirectly or constructively) 25% or more of the capital or profits interest in the partnership.

If a tested foreign corporation receives dividends, interest, rents or royalties from a 25% related party, the income is classified under the Related-Party Look-Through Rule as active or passive by reference to the payor's income for purposes of applying the Income Test to the tested foreign corporation. The 1988 legislative history could be read to indicate that, if the payor earned passive income, payments of interest (only) to the tested subsidiary would be treated as coming first out of the payor's passive income. The Proposed Regulations would eliminate this rule and treat all payments of income to the tested foreign corporation as coming proportionately out of all the payor's income. The Proposed Regulations also clarify that, for purposes of applying the Related-Party Look-Through Rule to dividends, interest, rents or royalties that are treated (under the General Look-Through Rule) as received by the partner of a look-through partnership (as defined later), the determination of whether the payor is "related" is tested at the level of the look-through partnership.

For the Domestic Look-Through Rule to apply, the tested foreign corporation must be subject to the Section 531 accumulated earnings tax or waive the benefits of any income tax treaty that would prevent it. The Proposed Regulations provide that the question is whether the tested foreign corporation *could be* subject to the accumulated earnings tax if the requirements of Section 531 were met, regardless of whether the tested foreign corporation ever was in fact subject to the accumulated earnings tax. The Proposed Regulations also explain how a tested foreign corporation would waive the benefits of any income tax treaty that blocked application of the accumulated earnings tax. In addition, the Proposed Regulations provide that, when the Domestic Look-Through Rule applies, it ousts the General Look-Through Rule in its entirety. The Proposed Regulations contain additional guidance under the Domestic Look-Through Rule, including rules targeted at what the government perceives as abuses.

Ownership of foreign corporations owned by partnerships

As discussed, the PFIC rules apply to US persons that directly or indirectly own stock in a PFIC. For example, a partner in a partnership may be an indirect PFIC shareholder based on stock owned through lower-tier non-PFIC foreign corporations (i.e., non-PFIC foreign corporations owned, directly or indirectly, by the partnership). However, the interplay between the rules that attribute ownership through partnerships, on the one hand, and through non-PFIC foreign corporations, on the other hand, sometimes led to inconsistent results depending on whether ownership is tested under a "top-down" or "bottom-up" approach.[9] The Proposed Regulations clarify that, for purposes of determining whether a partner in a partnership is treated (under Treas. Reg. Section 1.1291-1(b)(8)(ii)(A)) as owning a portion of PFIC stock owned indirectly by the partnership through a non-PFIC foreign corporation, the partner will be considered to own 50% or more in value of the stock of the non-PFIC foreign corporation through the partnership only if the partner directly or indirectly owns 50% or more of the ownership interests in the partnership. The intended effect of this approach is for the attribution rules to apply consistently whether a US person owns stock of a non-PFIC foreign corporation through a partnership or directly, as they would under the top-down approach.

Application of PFIC tests to partnership interests held by the tested foreign corporation

For purposes of the Income Test, if a tested foreign corporation owns at least 25% of the value of a partnership (a Look-through partnership), the tested foreign corporation would be treated as if directly received its distributive share of any item of income of the Look-through partnership. Whether such income qualifies for the exceptions to passive income under Section 1297(b)(2) (e.g., a dividend received from a related person to the extent properly attributable to non-passive income) or the exceptions to foreign personal holding company under Section 954(c) and (h), would be tested at the partnership level, taking into account only the activities of the partnership. In contrast to the treatment of partners in Look-through partnerships, when a tested foreign corporation owns, directly or indirectly, less than 25% of the value of the partnership, the tested foreign corporation's distributive share of the partnership's income would be treated as passive income.

Similarly, for purposes of the asset test, a tested foreign corporation would be treated as holding directly its proportionate share of the assets held by a Look-through partnership. By contrast, a partner's interest in a 25%-owned partnership would be treated as a passive asset. In general, a corporation's proportionate share of a partnership asset would be treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the partnership's hands, taking into account only the partnership's activities.

Related-party activities and the active rents/royalties exception to Subpart F income

As noted, the Proposed Regulations confirm that PFICs may utilize the Section 954(c)(2)(A) rule, which characterizes active rental and royalty income derived from unrelated parties as not passive. This rule has been of limited practical use for PFICs. Under the current Subpart F regulations, the activities needed to make rents/royalties "active" must be carried on by employees of the same foreign corporation that owns the income-producing assets. The problem is that it is very common for real estate enterprises to house the employees in a separate corporation from the real-estate-owning entities. Thus, no matter how actively the real estate was managed "in house," the rents could not qualify as active because the corporation owning the real estate had no employees of its own.

The Proposed Regulations contain a more liberal rule. For purposes of determining if the active rents and royalties exception applies, the tested foreign corporation can take 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 owns more than 50% by value. The same rule would apply to activities of any partnership of which the tested foreign corporation owns, directly or indirectly, "more than 50%." The Preamble to the Proposed Regulations states that the tested foreign corporation must own more than 50% by value of the partnership; clarity on this issue would be helpful.[10]

It is important to note that the Proposed Regulations do not say anything about taking into account the activities of brother/sister entities or parent entities.

Other provisions

The Asset Test applies based on a quarterly average. In applying this test, the Proposed Regulations provide that taxpayers first determine the tested foreign corporation's percentage of passive assets, and then average the percentages (an "average of the percentages" method). The opposite "percentage of the average assets" method would not be allowed. Furthermore, a tested foreign corporation would be required to use fair market value for measuring assets for a year if it were publicly traded for the majority of the year, even if it were not publicly traded for all of the year.

Although the Asset Test normally applies on a quarterly basis, the Proposed Regulations provide an election to measure assets more frequently if desired.

The Proposed Regulations confirm that when the Subpart F rules speak of "net" income – from commodities, notional principal contracts, and foreign currency transactions – the same applies for the Income Test. Only the excess of gains over losses from commodities, income over expenses from notional principal contracts, and income over losses from foreign currency transactions would be taken into account. Net gains of one subsidiary, however, could not be netted against net losses of another subsidiary for purposes of applying the Income Test to a common parent.

If the stock of two foreign corporations is "stapled" together, the Proposed Regulations would treat the two corporations as a single corporation for purposes of the PFIC Tests.

The Proposed Regulations make various changes to the Section 1298(b)(3) rules for tested foreign corporations changing businesses. It is understood that these change of business rules are very little used, so the relevant provisions of the Proposed Regulations are not discussed in detail here.

Implications

The Proposed Regulations contain guidance clarifying longstanding PFIC issues. In particular, the clarification of which special Subpart F rules are available for PFIC testing purposes is welcome. Similarly, the top-down rule for PFIC testing when partnerships owns a majority interest in a foreign corporation clarifies a technical uncertainty consistent with current industry practice. This is an important development for US investors that are indirectly invested in foreign corporations through partnerships, such as US private equity (PE) and alternative asset management funds.

The rule that dividends paid by a 25%-owned subsidiary will not always be eliminated in applying the General Look-Through Rule will come as a surprise to many. Similarly, the rule treating a tested foreign corporation's distributive share of partnership income as per se passive income, unless the partner owns at least 25% of the partnership, may pose a trap for the unwary.

The rule allowing the activities of certain related entities to be taken into account in determining whether rents and royalties are excluded is a welcome change for US investors, such as PE and alternative asset management funds that invest in non-US real estate developers that potentially could be PFICs. This is also true of the application of Section 954(h)'s active finance exception in the context of PFIC determinations for PE-backed non-bank financial institutions and lenders located outside the US.

As discussed in EY Global Tax Alert, *US final and proposed GILTI and subpart F regulations include favorable and unfavorable provisions for taxpayers*, dated 21 June 2019, the proposed Subpart F regulations that would treat domestic partnerships on a look-through basis may be adopted by taxpayers currently. This could have a major effect on the operation of the Section 1297(d) CFC/PFIC overlap rule if a domestic partnership owned stock in a foreign corporation that meets either or both PFIC tests, but some of whose partners would not be 10% United States shareholders on a look-through basis. The Proposed Regulations do not address these issues. Anyone facing this situation that wants to early-adopt these proposed Subpart F regulations should proceed warily.

Endnotes

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.
2. As discussed later, another provision of the Proposed Regulations would expand the utility of this exception.
3. Thus, only the Section 1297(b)(2)(C) related-party rule and the Section 1297(c) 25% look-through rule are available.
4. The Section 1297(b)(2)(D) exception for export trade corporations is also available.
5. In addition, gain from the sale of assets that produce income governed by Section 954(c)(2)(B) would itself be excluded from passive income.
6. Thus, the only relief for insurance companies would be under Section 1297(f).
7. The Section 1297(b) exception for licensed banks is also available.
8. PLR 200813036 (19 December 2007).
9. A top-down approach starts with a US person (e.g., a US person that is a partner in a partnership), and determines what stock is considered owned at each successive lower tier on a proportionate basis. By contrast, a bottom-up approach starts with a PFIC and attributes ownership of its stock upwards to each successive upper tier until the US person whose ownership in the PFIC is being tested is reached.
10. It is not possible to predict whether the IRS might propose similar guidance under the Subpart F rules.

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