PFIC Testing—Significant New Guidance but Some Unanswered Questions Remain

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On December 4, 2020, the U.S. Department of the Treasury (Treasury) and the Internal Revenue Service (IRS) published final and proposed regulations providing guidance on the passive foreign investment company (PFIC) rules under Internal Revenue Code sections 1291, 1297 and 1298.

The impetus of the new regulations was the 2017 tax act's modification of Code Sec. 1297(f) to provide specific rules to limit the application of the active insurance exception to PFIC status.[1] Accordingly, the new regulations provide detailed guidance on the application of PFIC to insurance companies, as well as related questions on the application of the active banking exceptions under Code Secs. 1297 and 954(h) to potential PFICs. This specialized guidance on insurance and banking is likely to be of interest to taxpayers in those industry sectors. However, this article focuses on the other areas covered by the regulations that are relevant to U.S. shareholders in foreign corporations more broadly, and the questions answered and unanswered by the final and proposed regulations.

I. Introduction

Generally speaking, the final regulations provide definite answers to longstanding questions of interpretation in application of the PFIC income and asset tests. In some cases, the regulations provide a new and complex regime for applying the subsidiary look-through rule of Code Sec. 1297(c) and the related-party look-through rule of Code Sec. 1297(b)(2)(C) that will require careful analysis for taxpayers to apply in practice. In any event, with the final regulations now in effect, these detailed and objective rules provide more certainty in PFIC testing, but also may limit the areas for interpretation that may previously been possible in light of the limited available guidance. The regulations generally are applicable for taxable years beginning on or after January 14, 2021, apply with the 2022 taxable year for calendar year taxpayers.

However, the final regulations also generally allow taxpayers to adopt the regulations for prior open taxable years. With certain exceptions,[2] the taxpayer may apply the rules to one foreign corporation, but not apply them to another foreign corporation. Given the dearth of guidance on these subjects, and fact that many of the new rules are taxpayer-favorable, it may be desirable to implement the regulations beginning with PFIC analysis done on the 2020 tax return, or even revisit prior year filings.

Further, given the favorable aspects of the regulations and the harsh effects of being subject to the "once a PFIC, always a PFIC" rule of the Code,[3] some commentators asked whether the regulations might be adopted in previous, now-closed years to cleanse PFIC taint. For example, assume that shareholder's taxable years from 2017–2019 are open years. In 2015, the shareholder acquired stock in a foreign corporation and did not make a QEF election. Under prior law, assume that foreign corporation was a PFIC, but that due to a new provision in the final regulations, the corporation would not have been a PFIC at any time. Can the shareholder use the final regulations to redetermine that the foreign corporation is not, and has never been, a PFIC? The preamble states that the taxpayer may *not* apply the PFIC final regulations in this manner to cleanse PFIC taint attributable to ownership of stock in a closed year, and in this situation would need to make a purging election effective no earlier than the first year that remains open under the rules for shares in so-called prior PFICs.[4]

II. PFIC Income Test

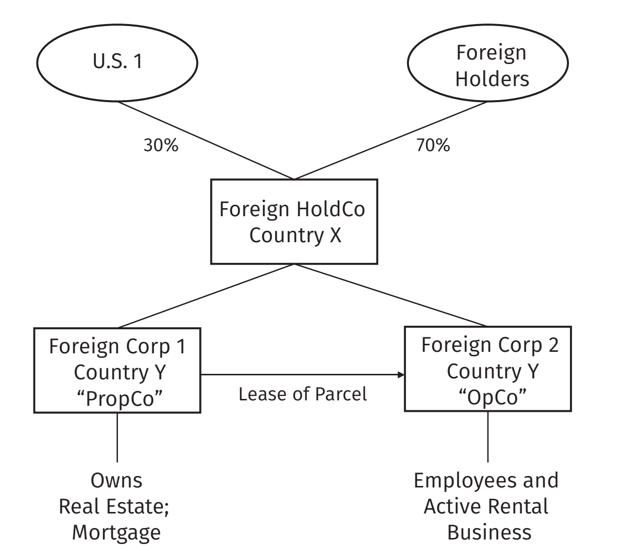
Code Sec. 1297(a) defines passive income for PFIC purposes, generally, as income that would be a of a kind that is "foreign personal holding company income" under Code Sec. 954(c) if the foreign corporation is a CFC. Code Sec. 954(c) contains several exceptions from foreign personal holding company (FPHC) income, including active rents and royalties exceptions (Code Sec. 954(c)(2)), same-country exceptions for interest and dividends between foreign corporations in the same country (Code Sec. 954(c)(3)), a "look-through rule" for interest, dividends, rents and royalties paid between CFCs that are related parties (Code Sec. 954(c)(6)) and an active finance exception (Code Sec. 954(h)). At the same time, Code Sec. 1297(b)(2) contains its own parallel exceptions for PFIC purposes only, including for payments paid or accrued from a related party and income from the active conduct of a banking business. Code Sec. 1297(c) also contains a special "look-through rule" for 25% or greater owned subsidiaries that deems the upper-tier corporation to own the assets and earn the income from lower-tier subsidiaries that are 25% or greater owned (directly or indirectly).

General Definition of Passive Income

The application of the Subpart F exceptions for PFIC purposes and the interrelationship of the PFIC look-through rule with the PFIC subsidiary look-through rule have now been clarified. The active rents and royalties exceptions of Code Sec. 954(c)(2) apply for PFIC purposes. In addition, for purposes of the active rents and active royalties exceptions, as well as the other activities-based exceptions in Code Sec. 954(c), activities are imputed from certain qualified affiliates to the foreign corporation in question.

This exception can be useful in a variety of situations where the conduct of activities and ownership of the income producing assets are located in separate legal entities. One example where the final regulations can provide helpful relief is in a so-called "OpCo-PropCo" structure for ownership of real estate,[5] as depicted in Diagram 1. In such a situation, PropCo derives significant rental income from leasing the real estate to its 100% affiliate OpCo for use in OpCo's active business. While we may stipulate that Foreign Corp 2 conducts activities sufficient to satisfy the active rents exception to Code Sec. 954(c)(2), Foreign Corp 1 does not itself conduct such activities or use the real estate in *its own active conduct of a trade or business*. Read literally, Foreign HoldCo and Foreign Corp 1 may be considered PFICs, even though the group of entities taken as a whole owns real estate for use in an active

DIAGRAM 1.



business. The regulations provide for aggregation of business activities to a foreign corporation from its "qualified affiliates" to deem income to be active (as defined below).

In some cases, taxpayers could have used self-help by "checking the box" to treat relevant entities as disregarded. However, the regulations provide relief for taxpayers that may have overlooked the issue, or due to structural issues, were unable to convert subsidiary corporations to disregarded entities. For example, in Diagram 2, Foreign Corp 1 acts a trading company for resale of commodities acquired from Foreign Corp 2, which Foreign Corp 2 actively manufactures for purposes of the exception in Code Sec. 954(c)(1)(C) for an active commodities business. Foreign Corp 2 cannot be a disregarded entity because it has a third-party owner. Under the regulations, Foreign Corp 2's production activities are imputed from Foreign Corp 2 to Foreign Corp 1 for purposes of allowing Foreign Corp 1 to satisfy the Code Sec. 954(c) exception. Foreign Corp 2, as a partly owned entity, could not of course check the box.

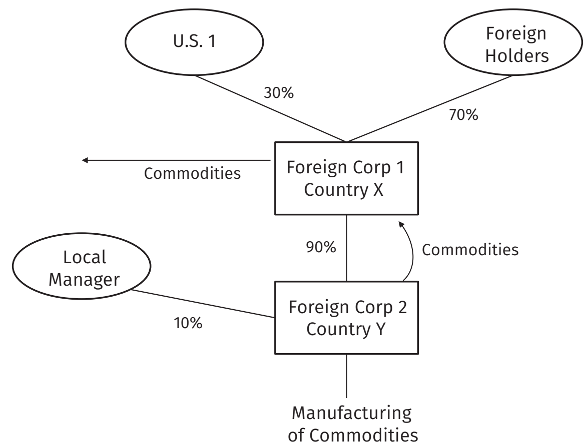
The aggregation of activities applies with respect to "qualified affiliates" of the foreign corporation.[6] Qualified affiliates are defined as foreign corporations or partnerships that would be members of the same "affiliated group" (within the meaning of Code Sec. 1504(a)) as the foreign corporation being tested for PFIC status, except that affiliation is defined based on 50% common ownership by vote and value (rather than 80%) and the affiliated group may include a partnership. The affiliates also must be subsidiaries of a foreign corporation, rather than a domestic corporation or partnership.[7]

For PFIC purposes, the subpart F exception for gain on a sale of a 25% partnership interest also applies for PFIC purposes.[8] The PFIC regulations adopt a similar rule (discussed below) to characterize gain on the sale of stock in a 25% or greater owned subsidiary (a "look-through subsidiary") by reference to the subsidiary's underlying assets.

However, the same-country exception of Code Sec. 954(c)(3) and CFC look-through rule of Code Sec. 954(c)(6) do not apply for PFIC. Instead, the regulations treat the analogous related-party look-through rule in Code Sec. 1297(b)(2)(C) as occupying the field.[9] In many cases, this interpretation will be taxpayer-favorable given that the PFIC regulations (discussed below) do not adopt the "cream-skimming rule" that applies for purposes of Code Secs. 954(c)(6) and 904(d).

The look-through rules apply an exception to passive income treatment of interest, dividends, rents and royalties from a related party that are attributable to the related party's non-passive income. The PFIC look-through

DIAGRAM 2.

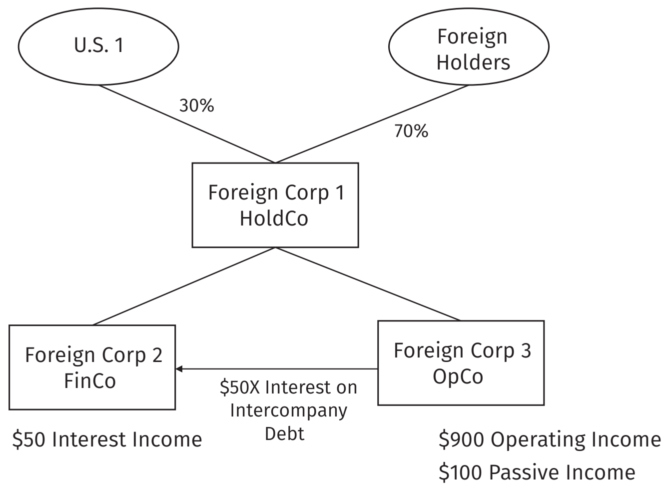


rules were enacted together with similar look-through rules for calculating the foreign tax credit limitation under Code Sec. 904(d). The new regulations follow similar principles to Code Sec. 904(d) for dividends, rents and royalties[10]; however, a different and more favorable approach is taken for interest of allocating interest expense based on the payor's overall gross income. The regulations do not adopt for PFIC purposes the so-called "cream-skimming rule" of Code Secs. 904(d) and 954(b)(5). The regulations' approach seems entirely appropriate in preventing intercompany debt from duplicating passive income within a group of foreign entities, particularly given that PFIC is based on gross income rather than net income.

By way of illustration, assume that in Diagram 3, FC2 is a financing company that makes a loan to its affiliate, FC3, which generates \$50× of interest. FC3 is primarily an operating entity and generates \$900× of operating income and \$100× of passive income. If FC2 and FC3 were CFCs, then for purposes of subpart F and the foreign tax credit limitation, the \$50× of related party interest would be allocated solely to FC3's passive income, causing all \$50× of interest received by FC2 to be passive income and FC3's net FPHC income to be reduced by \$50×. For PFIC purposes, however, where passive income is measured based on gross income, a direct allocation of the related interest to FC3's passive income would have a distortive result. For PFIC purposes, the \$50× of interest paid to FC2 would be characterized as 10% passive income and 90% non-passive income (based on FC3's ratios of gross income in the year of payment of the interest).[11]

The final regulations, in a change from the proposed regulations, provide for netting of gains and losses in

DIAGRAM 3.



different categories of FPHC income under Code Sec. 954(c), both for items generated by the foreign corporation being tested for PFIC status, and for gross income and losses of the corporation and look-through subsidiaries or partnerships.[12]

Subsidiary Look-Through Rules of Code Sec. 1297(c)

For applying both the income test and the asset test, Code Sec. 1297(c) treats an upper-tier entity as earning the income, and as owning assets of, a lower-tier corporation in which it owns, directly or indirectly, at least 25% of the stock by value. This aggregate approach for PFIC purposes in some respects treats separate corporations as though they were branches or divisions, which raises a number of questions of interpretation under the Code. The regulations attempt to provide guidance on these issues, and the extent to which a foreign corporation and 25% or greater owned subsidiaries (so-called "look-through subsidiaries") are treated as if they were single taxpayer.

One question in treatment of look-through subsidiaries is whether their activities are imputed to the shareholder for qualifying the shareholder's income as non-passive income. As discussed above, the regulations provide for attribution of activities from a look-through subsidiary to the upper-tier corporation, but only if the look-through subsidiary is also a 50% or greater owned "qualified affiliate."

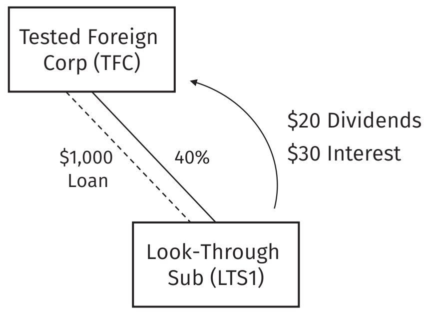
A second important question is how to treat transactions among the upper-tier corporation being tested for PFIC status and one or more of its look-through subsidiaries. This raises an analogous question to that presented under combined or consolidated reporting regimes (such as Reg. §1.1502-13) of whether intercompany transactions should be respected or eliminated. The PFIC regulations provide a detailed set of elimination rules for intercompany transactions between and among the foreign corporation and its look-through subsidiaries. This elimination rule will require careful review of the facts in applying a PFIC analysis, particularly in the case of partly owned entities.

With respect to look-through subsidiary's stock, the PFIC regulations provide that stock in, and dividends from, a look-through subsidiary are disregarded.[13] In addition, defined categories of look-through subsidiary obligations are eliminated for PFIC purposes to the extent of the upper-tier entity's ownership in the look-through subsidiary. The obligations subject to elimination consist of loans, leases and licenses. The partial elimination applies not only to transactions between the upper-tier corporation and its subsidiary, but also transactions between brother-sister subsidiaries that are both look-through subsidiaries as to a shareholder entity.[14] Other transactions, such as provision of services or sale of property, are still given effect and are not eliminated. Actual movement of cash is also given effect for purposes of the asset test.

The regulations provide several examples of how to take into account the partial elimination rules at both the first-tier and lower-tier levels. Diagram 4 depicts one relatively simple example involving an intercompany loan to a partially owned subsidiary:

Example.[15] TFC directly owns 40% of the value of LTS1 stock. Under the subsidiary look-through rule,

DIAGRAM 4.



TFC is treated as owning 40% of LTS1's assets and earning 40% of LTS1's income. TFC has a loan receivable from LTS1 of $1,000 and receives $30 of interest during the year. TFC also received $20 of dividends from LTS1 sourced from income of LTS1 taken into account by TFC under the subsidiary look-through rule.

Since LTS1 is a look-through subsidiary, its stock is disregarded as an asset of TFC. Dividends received by TFC from income taken into account by TFC under the look-through rule are also disregarded.[16] Further, the loan from TFC to LTS1 is partially eliminated to the extent of the 40% stake in LTS1 owned by TFC. Accordingly, for purposes of the asset test, the loan is $600× passive asset and for purposes of the income test, TFC has $18 of passive interest income.[17]

A third question in regard to look-through subsidiaries is how to treat gain on the sale of stock in the look-through subsidiary, given that such stock generally is disregarded as a separate asset. The PFIC regulations adopt a rule eliminating gain to the extent of certain "unremitted earnings" that are similar to the investment adjustment rules of Reg. §1.1502-32.[18]

First, the regulations reduce the gain taken into account under the stock sale to the extent of the unremitted earnings of the subsidiary. Unremitted earnings are equal to the aggregate income of the subsidiary taken into account under Code Sec. 1297(c), less dividends paid to the shareholder out of those earnings.

Second, any remaining gain on the sale (the so-called "residual gain" under the regulations) is characterized as passive or non-passive based on the relative ratio of the subsidiary's underlying assets. Importantly, however, the ratio of subsidiary assets for this purpose is determined using whatever method the corporation uses to measure its assets under the asset test.[19] Thus, if the subsidiary is a CFC or otherwise has chosen to use the tax book value method for PFIC purposes, the residual gain may skew to passive, based on the fact that investment assets, such as cash, may have a higher tax basis than intangible property used in the corporation's conduct of business. In such a circumstance, the taxpayer may be better off "checking the box" and achieving an actual asset sale for tax purposes.

Treatment of Partnership Interests

The regulations provide new and revised guidance with respect to the question of whether a partnership is viewed as an entity or an aggregate for PFIC purposes. Many approaches have been taken to the question of whether a partnership interest causes the partner to be treated as engaged in the partnership's business, such as applying aggregate treatment to partnerships with a certain minimum percentage ownership[20] or looking through partnerships based on a mix of ownership and active involvement in partnership management and operations.[21] No specific guidance is provided by the PFIC provisions themselves. Some practitioners argued for a pure aggregate approach similar to that applied for subpart F under the *Brown Group* regulations, so that any interest in a partnership would be analyzed on a look-through basis. Instead, the final PFIC regulations adopt a two-part test.

First, a partnership is treated as a look-through entity if the foreign corporation owns 25% or more of the partnership; *i.e.*, the same 25% cut-off applied for look-through subsidiaries is applied to partnerships.[22] If the foreign corporation owns 25% or more of the partnership, the corporation is considered to own a *pro rata* share of the partnership's assets and earn a *pro rata* share of the partnership's income.[23] If look-through does not apply, a partnership interest is viewed as a passive asset and as giving rise to passive income for PFIC purposes.[24]

However, under a second look-through test, the final regulations provide that the partnership may be treated as look-through partnership if an active partner test is met. To satisfy the active partner test, the foreign corporation must for the year in question not be a PFIC under either the asset test or income test, *without regard to* its interests in less than 25% partnerships. Thus, if the foreign corporation primarily holds active business assets (or subsidiaries with such assets), the corporation could claim look-through treatment for its smaller partnership interests so that such interests do not cause it to become a PFIC.[25] However, if the foreign corporation is otherwise a PFIC, less than 25% partnership interests will not allow it to avoid PFIC status.

III. PFIC Asset Test

Several notable changes were made to the PFIC asset test both in proposed and final regulations. Specifically, the regulations attempt to remediate the effects of the tax book value method, which can cause foreign entities conducting active business to become accidental PFICs. Some of these changes are in further proposed regulations. The proposed regulations generally are applicable for taxable years beginning on or after the date of filing of the Treasury Decision adopting the proposed regulations as final in the federal register. However, until the proposed are finalized, taxpayers may rely on the proposed rules with respect to a tested foreign corporation for any open taxable year beginning before the date of finalization of the proposed regulations, provided the taxpayer consistently follows each such rule for each such subsequent taxable year before the regulations are finalized.

Relief from Application of Tax Book Value Method for CFCs Through Constructive Ownership

The Tax Cuts and Jobs Act (TCJA) repealed Code Sec. 958(b)(4), which prevented downward attribution of stock owned by a foreign person to a U.S. person, resulting in many more corporations becoming CFCs. With the repeal of Code Sec. 958(b)(4), a foreign corporation may be considered a CFC solely through constructive ownership. Since a foreign corporation tested for PFIC status (a "tested foreign corporation") must measure its assets using their adjusted bases if such corporation is a CFC (the "tax book value method"),[26] the repeal of Code Sec. 958(b)(4) might preclude a foreign corporation from using the fair market value method to determine whether it is a PFIC.

This is significant in that corporations that derive most of their enterprise value from their intangible property, which has zero basis,[27] may often flunk the 50% passive threshold if required to measure assets using the tax book value method, even if the majority of their valuation is attributable to active business property. Therefore, Code Sec. 958(b)(4) repeal could result not only in significantly more companies becoming CFCs (and often becoming CFCs in ways that are difficult to assess or determine), but also in many more companies becoming PFICs.

For example, consider a tested foreign corporation that is 20% owned by a U.S. person, and 80% owned by foreign investors and less than 10% U.S. holders. Prior to the 2017 tax act's repeal of Code Sec. 958(b)(4), the tested foreign corporation would not be a CFC, thus can measure its assets by fair market value, not tax basis. Assume, however, that constructive ownership from foreign investors to U.S. persons caused the tested foreign corporation to be characterized as a CFC. In addition to subjecting the 20% U.S. individual to the CFC rules, the corporation could become a PFIC as to any smaller U.S. holders (including indirect holders through a partnership) by virtue of having to apply the tax book value method.

The final regulations provide relief from measuring assets based on their adjusted bases under Code Sec. 1297(e) where Code Sec. 958(b)(4) repeal caused the company to become CFCs.[28] Corporations that became CFCs solely by reason of Code Sec. 958(b)(4) repeal do not have to measure their assets using the tax book value method. Treasury agreed that Code Sec. 1297(e) favors the use of value as a method to measure assets and the use of value "aligns with the objective of the PFIC rules."[29] However, companies must be consistent in applying Code Sec. 1297(e) measurement methods (*i.e.*, using basis or value) across lower-tier corporations.

Treatment of Cash as a Non-Passive Asset

One longstanding issue in the PFIC rules is that IRS Notice 88-22 has uniformly treated cash as a passive asset for PFIC purposes.[30] In cases where an active business does not carry significant assets on its balance sheet, such as most services businesses and technology-based businesses, this rule, coupled with the use of the tax book value method, can result in PFIC status that may come as a surprise to many taxpayers.

Proposed regulations provide a limited exception to treat cash as a non-passive asset for purposes of the PFIC asset.[31] Currency denominated in the functional currency of the tested foreign corporation held in a non-interest bearing financial account held for the present needs of an active trade or business no greater than the amount necessary to cover expenses incurred in the ordinary course of the trade or business and reasonably expected to be paid within 90 days is a non-passive asset. Cash equivalents however are not eligible for treatment under this rule to the extent that the amounts held for (i) future diversification into a new trade or business, (ii) expansion of trade or business activities, (iii) future plant replacement, or (iv) future business contingencies.

Thus, the proposed regulations will provide little help to companies who raise cash for purposes of one to two years funding requirements, including research and development. Furthermore, with "cash equivalents" not being treated as currency for purposes of the exception, companies that hold low-risk instruments such as treasury bills and certificates of deposit will be required to treat these cash equivalents as passive. Also, if the foreign corporation is operating in a foreign currency as a functional currency, it will not be able to rely on this rule for U.S. dollar balances. Thus, this exception may be of limited help practically for operating companies that are flipped to PFIC status as a result of their cash balances.

For example, consider a foreign corporation that is engaged in development and exploitation of software that is expensed on the balance sheet. The Company has cash reserves of $800,000 and fixed assets of $200,000 at the end of each measuring period. Without the working capital exception, the tested foreign corporation will flunk the PFIC asset test as 80% of its assets will be treated as passive (assuming the fixed assets are non-passive). Under the new working capital exception, part of the $800,000 of cash may be treated as active if held for use of the next 90 days of the business.

Valuation of Intangible Property

The new proposed regulations also provide some guidance on how to value assets for purposes of the PFIC rules. Generally, tested foreign corporations use financial statements (*i.e.*, GAAP or IFRS balance sheets) as a reference for determining the fair market values or adjusted bases of their assets for PFIC asset test computations.[32] However, intangible property such as self-created intellectual property is either not included on financial statements or is included at a value significantly less than the fair market value of such asset. These assets are often treated as non-passive for purposes of the PFIC asset test and using financial statement values may skew the asset mix towards passive.

Under new proposed rules, if a tested foreign corporation or a shareholder has reliable information about the value of asset that differs from its financial statement valuation, that information *must* be used to determine the value of the asset.[33] No further guidance is given in the proposed regulation itself, however the preamble to the proposed regulations states that whether valuation information is more reliable than financial statement valuation is "based on the facts and circumstances, including the experience and knowledge of the source of the information, whether the information is recent and whether there have been intervening developments that would affect the accuracy of the information, and whether the information specifically addresses the value of the asset in question."[34]

For example, consider again the tested foreign corporation that is developing software for sale and has on its financial statements cash of $800,000 and fixed assets of $200,000 at the end of each measuring period. Assume that the value of the corporation's equity as a whole is a $3,000,000 and it has no debt. Using financial statement valuations would still result in Company being a PFIC, since cash (a passive asset, except for the amounts excluded under the working capital safe harbor above) represents 80% of the book value of the Company's assets. However, if the Company is permitted to use the $3,000,000 equity valuation to value its assets, this would create a valuation of $2,000,000 for the company's self-created intangible property, resulting in passive assets only representing only at most 33% of the value of the company, below the 50% passive threshold.

Bifurcation of Assets

The final regulations confirm the approach taken in the 2019 proposed regulations, which established a rule that assets that produce both passive and non-passive income are treated as two assets: one passive, one non-passive (a "dual-character asset").[35] The value of the dual-character asset is allocated between the passive asset and non-passive asset in proportion to the relative amounts of passive and non-passive income produced by the asset during the taxable year.

Valuation of Average Amount of Assets Based on Value or Adjusted Basis for Publicly Traded Corporations

The final regulations adopt as final the guidance from the proposed regulations addressing how to apply the asset test when a corporation changes between CFC and non-CFC status or becomes publicly traded during the taxable year.[36] This resolves an ongoing area of uncertainty, for example, in IPOs of foreign issuers, which were required to use the tax book value method prior to becoming publicly traded and then required to measure assets on the basis of value after a public offering. Similar issues can also arise if changes in the Company's equity ownership cause it to become a CFC (or non-CFC) during the middle of a taxable year.

Specifically, in these situations of change of status, the final regulations provide that companies that are publicly traded for only part of the year are required to measure assets on the basis of value for the entire year if the corporation is publicly traded on the majority of days during the year or if Code Sec. 1297(e)(2) does not apply to the corporation on the majority of days of the year.[37] If the tested foreign corporation is not publicly traded on the majority of days during the year, the tested foreign corporation is required to use adjusted basis to measure assets if it is a CFC or if an election to use adjusted basis is made under Code Sec. 1297(e)(2)(B).[38]

For example, the majority of days rule in the proposed regulations would have required a tested foreign corporation that was a CFC and whose shares were publicly traded for less than the majority of days during the year to use the tax book value method to measure its assets for that taxable year because the corporation would not have been treated as a publicly traded corporation. However, a calendar-year tested foreign corporation that went public in March would be required to measure assets on the basis of value for the entire year, as it was publicly traded on a majority of days during the year.

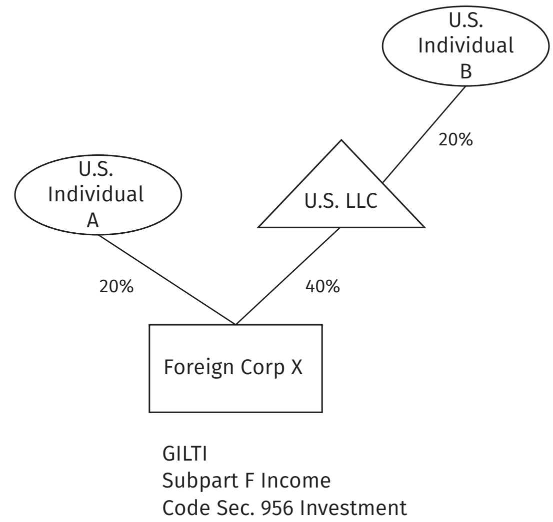
Further, unlike the 2019 proposed PFIC regulations, which merely provided that a publicly traded corporation must use value to measure its assets if publicly traded on a majority of the days during the year, the final regulations also clarify that a non-publicly traded CFC must use the tax book value method to measure its assets, unless the CFC becomes a publicly traded foreign corporation during a taxable year.[39]

IV. Attribution of Ownership and the PFIC/CFC Overlap Rule

While the regulations answer many questions on the income test and asset test, as discussed above, they left open for future guidance a few important questions.

First, one issue of renewed importance following the 2017 tax act is the application of the CFC overlap rule of Code Sec. 1297(d) which "turns off" the PFIC rules in some circumstances. Specifically, Code Sec. 1297(d) provides that a foreign corporation shall not be treated as a PFIC with respect to any person that is a U.S. shareholder of the corporation while it a CFC. Historically, in the context of a U.S. partnership or Subchapter

DIAGRAM 5.



S corporation, the IRS ruled in several private letter rulings that smaller U.S. partners that owned the CFC stock through the U.S. partnership that was a U.S. shareholder were shielded from the PFIC rules by partnership's being a U.S. shareholder subject to the overlap rule.[40] Under pre-2017 tax law, if a CFC earned subpart F income or made a Code Sec. 956 investment, the partnership would calculate an inclusion and pass it through to its owners. Thus, small U.S. partners through a domestic partnership or S corporation that was a U.S. shareholder of a CFC were subject to subpart F rules on an indirect basis.

After the 2017 tax act, regulations have provided that a U.S. partnership is not viewed as an inclusion shareholder for GILTI purposes.[41] This relieves small U.S. partners in a U.S. partnership or S corporation that owns CFC stock from being subject to GILTI. Currently, small U.S. partners are still required to include subpart F and Code Sec. 956 amounts in income. However, regulations have been proposed to adopt the aggregate treatment from the GILTI rules for subpart F purposes (*see* Diagram 5).[42]

In light of the aggregate principles applicable for GILTI (and proposed to be applicable for purposes of subpart F), questions were raised as to whether the logic of the earlier private rulings will continue to apply when and if these proposed regulations go final and small U.S. partners are no longer subject to subpart F inclusions with respect to a CFC. The new regulations do not address the CFC/PFIC overlap rule, and the preamble reserves on the scope of the CFC/PFIC overlap rule as a topic for further guidance.

A second issue on ownership of PFIC stock that was left open by the final regulations is how U.S. beneficiaries of a foreign non-grantor trust that owns a PFIC are treated under the PFIC rules. Code Sec. 1298(a)(3) provides that PFIC stock owned by a trust or estate is considered to be owned proportionately by its beneficiaries. The existing regulations, which were issued in 2013, merely reiterate the "proportionate amount" standard of the Code and state that this determination is made under the facts and circumstances.[43] The new regulations do not shed any further light on this issue, but the preamble, like that under the 2013 regulations, directs taxpayers to use a reasonable method to apply the proportionate interest standard.

V. Change of Business Exception and Other Changes

The final regulations, like the proposed regulations, adopt regulations providing clear published guidance on the change of business exception to PFIC status in Code Sec. 1298(b)(3). Under the change of business exception, generally, a foreign corporation that is not previously a PFIC can be excluded from PFIC status if it demonstrates to the satisfaction of the IRS that substantially all of its passive income for the year at issue is attributable to a sale of an active trade or business and such corporation will not be a PFIC for either of the following two taxable years.[44] Prior to the proposed regulations, the IRS issued a series of private letter rulings interpreting the change of business exception in a taxpayer favorable manner, particularly with respect to sale of stock in look-through subsidiaries.[45] The final regulations follow the proposed regulations in codifying those private letter rulings.

Relevant here, the regulations treat sale of stock in a look-through subsidiary as a sale of an underlying active business conducted by the subsidiary.[46] Consistent with the rule above addressing qualified affiliates, the regulations also allow for attribution of activities from a look-through subsidiary to the tested foreign corporation for this purpose.[47] Finally, a foreign corporation may liquidate to satisfy the requirement of not being a PFIC in either of the succeeding two taxable years.[48]

The regulations also provide detailed guidance and an anti-abuse rule that applies to corporations relying on the special exception in Code Sec. 1298(b)(7) for 25%-owned domestic subsidiaries.[49]

ENDNOTES

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1 *See* P.L. 115-97, §14501.

2 *See*, *e.g.*, Reg. §1.1297-1(g)(2) (providing for a shareholder-level consistency requirement to all foreign corporations for specific rules in Reg. §1.1297-1). Taxpayers desiring to start applying the regulations currently will need to review which rules require a broader shareholder-level consistency requirement.

3 Code Sec. 1298(b)(1).

4 *See* Reg. §1.1298-3.

5 Such a structure might be employed for foreign tax as well as non-tax objectives, such as separating the fee ownership of the real estate from the potential liability exposure associated with the operating business.

6 *See* Reg. §1.1297-2(e).

7 Reg. §1.1297-2(e)(2). Thus, two foreign corporations that are >50% commonly owned by the same domestic corporation or domestic partnership, but not under the same foreign corporation, may not aggregate their activities for PFIC purposes. *See* Reg. §1.1297-2(e)(3), Example 3.

8 Reg. §1.1297-1(c)(1)(i)(C).

9 Reg. §1.1297-1(c)(1)(i)(D).

10 With respect to rents and royalties, Reg. §§1.904-5(c)(3) and 1.1297-1(c)(4)(v) provide that rents or royalties are characterized based on the use of the leased or licensed property in the payor's business, and with respect to dividends, Reg. §1.1297-1(c)(4)(iv) is proportionately passive and non-passive based on the character of the payor's earnings and profits.

11 Reg. §1.1297-1(c)(4)(iii). If the payor does not have gross income in the year of the interest payment, the interest is characterized using the asset method of Reg. §§1.861-9T through 1.861-13T, as reasonably applied taking into account the purposes of the PFIC regime.

12 Reg. §1.1297-1(c)(1)(ii).

13 Reg. §1.1297-2(c)(2)(i). This elimination rule for dividends only applies to the extent that dividends are attributable to income earned by the lower-tier subsidiary that was treated as earned directly to the upper-tier entity under Code Sec. 1297(c). For this purpose, dividends are allocated according to the LIFO method.

14 *See* Reg. §§1.1297-2(c)(1)(ii) and 1.1297-2(c)(2)(ii).

15 Reg. §1.1297-2(c)(4)(ii), Example 2.

16 Dividends sourced from earnings of LTS1 before acquisition of its stock by TFC would still be taken into account. Dividends are allocated to earnings and profits of the subsidiary on a LIFO basis. *See* Reg. §§1.1297-2(b)(2)(i) and 1.1297-1(c)(4)(iv).

17 If TFC owned 50% or more of LTS1's stock, so that LTS1 were a related person for purposes of the related party look-through rule of Code Sec. 1297(b)(2)(C), the interest paid from LTS1 might be considered non-passive income under the look-through rules, discussed above.

18 Reg. §1.1297-2(f).

19 Reg. §1.1297-2(f)(3).

20 *See* Code Sec. 954(c)(4) (interest in a 25% or greater owned partnership is treated as an aggregate for determining a CFC's gain on sale of a partnership interest is FPHC income).

21 *See* Reg. §1.368-1(d)(4)(iii); Proposed Reg. §1.355-3(b)(2)(v).

22 Reg. §1.1297-2(g)(4).

23 Reg. §1.1297-2(b)(3). As with a look-through subsidiary, gain on a sale of the look-through partnership is characterized by reference to the partnership's underlying assets. *See* Reg. §1.1297-2(f)(4).

24 Reg. §1.1297-1(c)(3).

25 *See* Reg. §1.1297-2(g)(4) (defining look-through partnerships). The taxpayer may elect not to apply the active partner exception, in which

case the smaller partnerships would default to passive assets for PFIC purposes. The taxpayer would presumably want to do this only for administrative convenience of not analyzing the assets and income underlying smaller partnership interests.

26 Code Sec. 1297(e).

27 With respect to basis of intangible assets for PFIC purposes, Code Sec. 1298(e) provides some partially helpful rules for valuation intangible property under the tax book value method.

28 Reg. §1.1297-1(d)(1)(v).

29 *See* preamble to final regulations.

30 Note that the in the preamble to the proposed regulations, Treasury indicates an intention to eventually do away with Notice 88-22. ("The Treasury Department and the IRS propose to adopt final regulations that will address the portions of Notice 88-22 that have not already been addressed by regulations, for example the guidance relating to depreciable property used in a trade or business, trade or service receivables, intangible property, working capital, and tax-exempt assets. After the issuance of those regulations Notice 88-22 would be obsoleted.")

31 Proposed Reg. §1.1297-1(d)(2).

32 Reg. §1.1297-1(d)(1)(i).

33 Proposed Reg. §1.1297-1(d)(1)(v)(D).

34 Preamble to the proposed regulations.

35 Reg. §1.1297-1(d)(3)(i).

36 Reg. §1.1297-1(d)(1)(v), modifying Proposed Reg. §1.1297-1(d)(1)(v) from the 2019 proposed PFIC regulations (REG-105474-18).

37 Reg. §1.1297-1(d)(1)(v)(A).

38 Reg. §1.1297-1(d)(1)(v)(B).

39 Reg. §§1.1297-1(d)(1)(v)(A) and 1.1297-1(d)(1)(v)(B), modifying Proposed Reg. §1.1297-1(d)(1)(v) from the 2019 proposed PFIC regulations (REG-105474-18).

40 For a further discussion of this issue in a prior article in the Journal, please *see*, Miller, *Will the Overlap Rule of Code Sec. 1297(d) Still Protect "Small" Partners of Domestic Partnerships?* INT'L TAX J., May–June 2020, at 19. For examples of private letter rulings issued on this issue, *see*, *e.g.*, LTR 201106003 (Nov. 8, 2010), LTR 200943004 (June 26, 2009).

41 Reg. §1.951A-1(e).

42 Proposed Reg. §1.958-1(d), REG-101828-19, June 21, 2019.

43 *See* Reg. §§1.1298-1 and 1.1291-1(b)(8)(iii). *See also* TAM 200733024 (Oct. 26, 2006) (addressing application of this provision prior to the issuance of these regulations).

44 Code Sec. 1298(b)(3).

45 *See* LTR 200813036 (Dec. 29, 2007); LTR 20015028 (Jan. 12, 2000).

46 Reg. §1.1298-2(d).

47 Reg. §1.1298-2(c)(3)

48 Reg. §1.1298-2(c)(4).

49 Reg. §1.1298-4 and Proposed Reg. §1.1298-4.