

Form 8621 PFIC Reporting: Passive Foreign Investment Company Rules

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Form 8621 PFIC Reporting: Passive Foreign Investment Company Rules

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Form 8621 PFIC Reporting: Passive Foreign Investment Company Rules

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Objectives

- **Determining PFIC Status**
- **Purpose of PFIC Rules**
- **Taxation of PFICs**
 - Excess Distribution – Sec. 1291
 - Qualified Electing Fund (QEF) – Sec. 1295
 - Mark to market – Sec. 1296
- **Filing Requirements/ Common Exceptions**

PFIC Definition

Definition. Sec. 1297.

- (a) In general: For purposes of this part, except as otherwise provided in this subpart, the term “passive foreign investment company” means any foreign corporation if—
 - (1) **75 percent** or more of the gross **income** of such corporation for the taxable year is passive income, or
 - (2) the average percentage of **assets** (as determined in accordance with subsection (e)) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least **50 percent**.

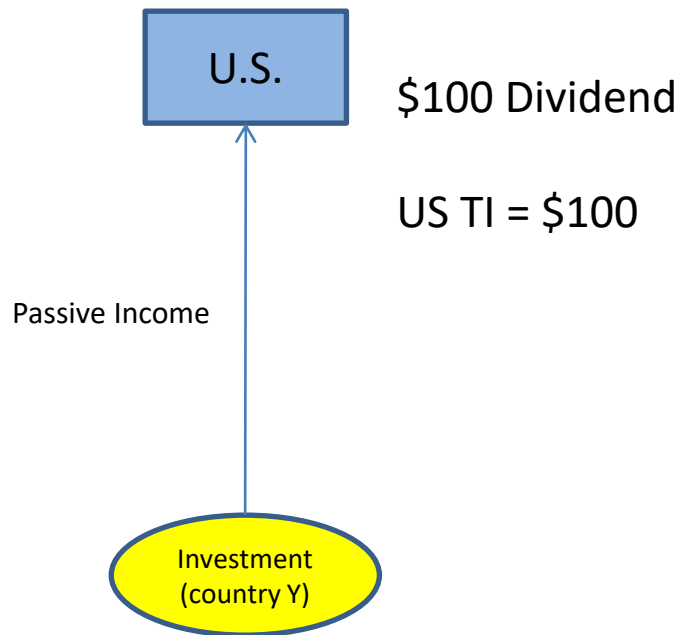
PFIC Definition

Definition. Sec. 1297.

- (b) Passive income: For purposes of this section—
- (1) In general ...the term “passive income” means any income which is of a kind which would be foreign personal holding company income as defined in section 954 (c).
- Sec. 954(c) - the term “foreign personal holding company income” means the portion of the gross income which consists of... Dividends, interest, royalties, rents, and annuities.

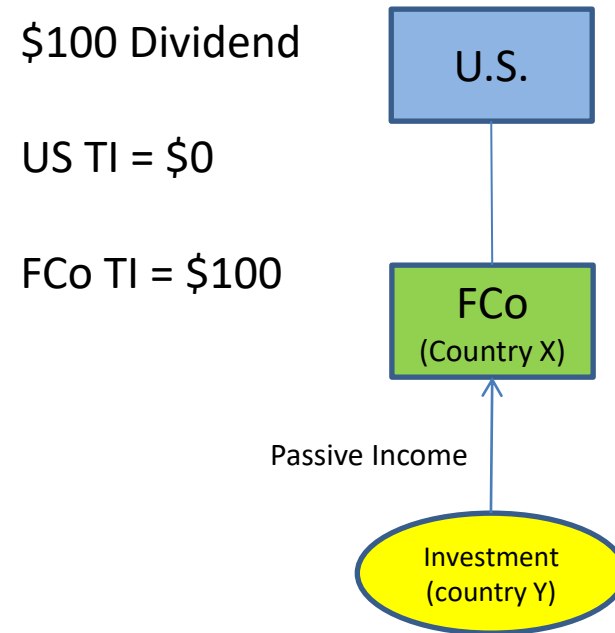
PFIC

Without Foreign Holding Company



With Foreign Holding Company

Without PFIC Rules



PFIC

Purpose of PFIC Regime.

- Stop deferral and Income re-characterization of offshore investment
- Prior to PFIC – US Person could:
 - Invest offshore
 - Accumulate tax-deferred income
 - Sell and recognize gain at long-term capital gains rate

Foreign Corporation Requirement

- PFIC only if a foreign corporation.
- Default classification of a foreign rules.
 - If all members have limited liability, default classification is a corporation. Reg. Sec. 7701-3(b).
- Check-the-box Planning to Avoid PFIC.
 - May elect alternate classification by filing a Form 8832 (“check-the-box”). Reg. Sec. 7701-3(a).
 - Per Se Corporation
 - Reg. Sec. 301.7701-2(b)(8) provides list of “per se” corporations

Income Test

Income Test:

- 75 percent or more of gross income is from passive sources
 - Sec. 954(c) - Personal Holding company ("FPHC") Income
 - Dividends, Interest, Royalties, Rents, Annuities
- Inapplicability of certain CFC exclusions:
 - If income would not have been exempt from Sub F from an exception other than under Sec. 954(c), would still be passive for PFIC purposes
 - Example – high tax exception under Sec. 954(b)(4); de minimis exception under Sec. 954(b)(3).
- Exception if “active” rental or royalty income. Sec. 954(c)(2)(A).

Active Rent/ Royalty Exception

Sec. 954(c)(2)(A).

- Foreign personal holding company income shall not include rents and royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person (within the meaning of subsection (d)(3)).

Active Rental Exception

- **Active Rental Exception Rule:** Rents will be considered for to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following—
 - **Regularly perform substantial management and operational functions.** Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;
 - **Perform marketing function that is substantial in relation to rental income and carried on by employees in foreign country.** Property that is leased as a result of the performance of marketing functions by such lessor through its own officers or staff of employees located in a foreign country or countries, if the lessor, through its officers or staff of employees, maintains and operates an organization either in such country or in such countries (collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.
 - **Proposed Regulations:** Take into account 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. See proposed § 1.1297-2(e)(1).

Asset Test

Asset Test:

- Average percentage of passive income producing assets held during the year equals or exceeds 50 percent of total assets.
 - Applied on gross basis, liabilities not taken into account;
 - Average of assets at end of quarter
 - Cash is a “passive” asset

Look Through Rules

- **Common Look Through Rules:**
- Sec. 1297(c) – 25% Subsidiary Look Through. If Foreign Corp owns at least 25% of other foreign corp; look through to assets of lower tier corp to determine PFIC status.
- Sec. 1297(b)(2)(C) – Related Person Look Through. interest, a dividend, or a rent or royalty, which is received or accrued from a related person (within the meaning of section 954(d)(3)) to the extent such amount is properly allocable (under regulations prescribed by the Secretary) to income of such related person which is not passive income.

Common Exceptions

Common Exceptions

- Sec. 1297(d) – CFC/PFIC overlap rule. If a US Shareholder of CFC and a PFIC, CFC rules control.
 - CFC – Controlled Foreign Corporation. U.S. Shareholders own more than 50% of vote or value. Sec. 957
 - U.S. Shareholder: U.S. person with 10% or more of vote. Sec. 951(b).
- Sec. 1298(b)(2). Start up year exception. Not treated as PFIC if only a PFIC in start up year, and not a PFIC in 2 successive years.
- Sec. 1298(b)(3). Change of business exception.

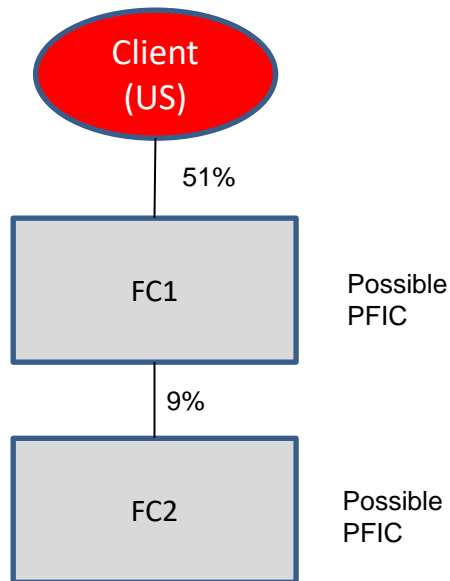
Attribution Rules

- **Attribution Rules:**
- Sec. 1298(a)(2)(A) – If 50 percent or more in value of the stock of a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned directly or indirectly by or for such corporation in that proportion which the value of the stock which such person so owns bears to the value of all stock in the corporation.
- Sec. 1298(a)(2)(B) – 50% limitation not to apply to PFIC. For purposes of determining whether a shareholder of a passive foreign investment company is treated as owning stock owned directly or indirectly by or for such company, subparagraph (A) shall be applied without regard to the 50-percent limitation contained therein. Section 1297(d) shall not apply in determining whether a corporation is a passive foreign investment company for purposes of this subparagraph.

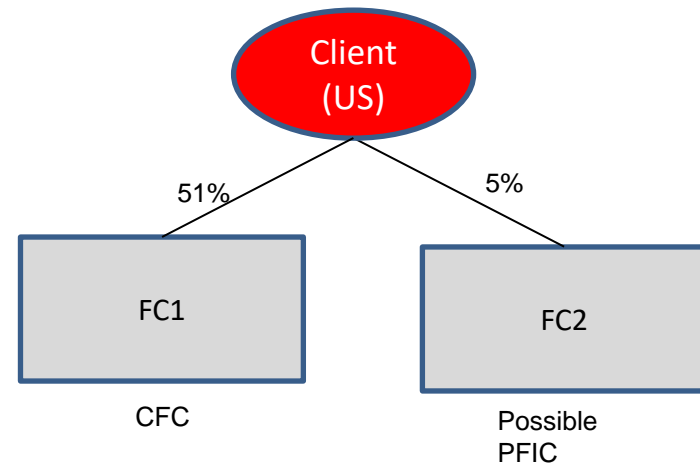
Attribution Rules

- Sec. 1298(a)(2)(A).
 - If 50 percent or more in value of the stock of a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned directly or indirectly by or for such corporation in that proportion which the value of the stock which such person so owns bears to the value of all stock in the corporation.

ACTUAL OWNERSHIP



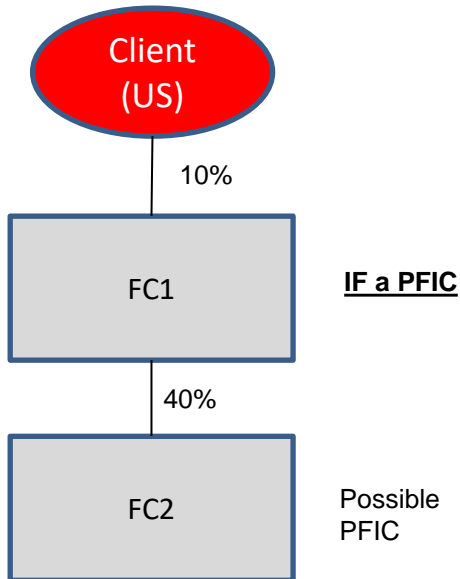
DEEMED OWNERSHIP



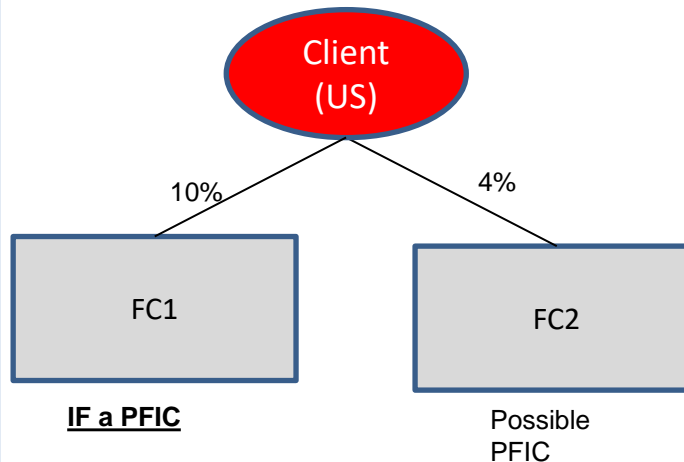
Attribution Rules

- Sec. 1298(a)(2)(B).
 - 50-percent limitation not to apply to PFIC. For purposes of determining whether a shareholder of a passive foreign investment company is treated as owning stock owned directly or indirectly by or for such company, subparagraph (A) shall be applied without regard to the 50-percent limitation contained therein. Section 1297(d) shall not apply in determining whether a corporation is a passive foreign investment company for purposes of this subparagraph.

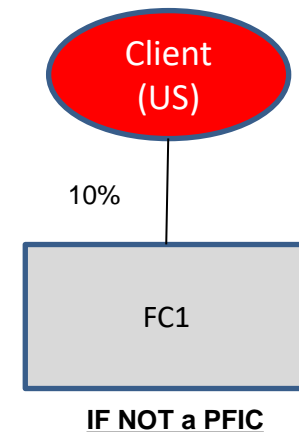
ACTUAL OWNERSHIP



DEEMED OWNERSHIP If FC1 is a PFIC



DEEMED OWNERSHIP If FC1 is NOT a PFIC



PFIC

Sec. 1298(b)(1). Once a PFIC, always a PFIC rule.

- Excess Distribution Regime Applies until PFIC Taint “Purged”
 - Even If PFIC Tests Not Met in Year of Excess
 - Applies even if no longer a PFIC.
- Deemed Sale Election – To Purge Taint
 - Treated As Sold For FMV
 - Gain = Excess Distribution
 - Basis Adjustment For Gain
 - Loss Not Recognized

PFIC

Sec. 1291 Fund.

- (a) Treatment of distributions and stock dispositions: (1) Distributions If a United States person receives an excess distribution in respect of stock in a passive foreign investment company, then—
 - (A) the amount of the excess distribution shall be allocated ratably to each day in the taxpayer's holding period for the stock,
 - (B) with respect to such excess distribution, the taxpayer's gross income for the current year shall include (as ordinary income) only the amounts allocated under subparagraph (A) to—
 - (i) the current year, or
 - (C) the tax imposed by this chapter for the current year shall be increased by the deferred tax amount (determined under subsection (c)).
- (2) **Dispositions** If the taxpayer disposes of stock in a passive foreign investment company, then the rules of paragraph (1) shall apply to any gain recognized on such disposition in the same manner as if such gain were an excess distribution.

PFIC

Sec. 1291 Fund. Excess Distribution.

- (b)(2) Total excess distribution For purposes of this subsection—
 - (A) In general The term “total excess distribution” means the excess (if any) of—
 - (i) the amount of the distributions in respect of the stock received by the taxpayer during the taxable year, over
 - (ii) 125 percent of the average amount received in respect of such stock by the taxpayer during the 3 preceding taxable years (or, if shorter, the portion of the taxpayer’s holding period before the taxable year).
 - For purposes of clause (ii), any excess distribution received during such 3-year period shall be taken into account only to the extent it was included in gross income under subsection (a)(1)(B).

PFIC

Sec. 1291 Fund.

- Tax and Interest Charge
- Gain/Distribution allocated over the entire holding period
- Tax imposed at highest rate in effect for each year in holding period
- Interest charge for “unpaid” tax

Elections

- Default Rule / Section 1291 Fund – distribution or gain on sale triggers punitive “excess distribution” charge. Shares are tainted and produce solely ordinary income.
- Qualified Electing Fund – shareholder picks up ratable share of PFIC’s net earnings on a flow-through basis. Potential to avoid all PFIC taint.
- Mark-to-Market Election – shareholder includes changes in the trading value of PFIC shares as ordinary income annually in lieu of interest charge.

QEF Election

- QEF rules require inclusion of the QEF's earnings on an annual basis (i.e., similar to ownership of partnership). Removes issue of deferral.
- Inclusion generally retains its character as ordinary income or long-term capital gain. Capital gain at time of sale.
- Previously Taxed Income "PTI" eliminates Double taxation - Sec. 1293(c)
- Shareholder must receive either a "PFIC information statement" or access to the company's books and records.

QEF Election

- Sec. 1295(b). Timing of QEF Election.
 - **(1) IN GENERAL** - A taxpayer may make an election under this subsection with respect to any passive foreign investment company for any taxable year of the taxpayer. Such an election, once made with respect to any company, shall apply to all subsequent taxable years of the taxpayer with respect to such company unless revoked by the taxpayer with the consent of the Secretary.
 - **(2) WHEN MADE** - An election under this subsection may be made for any taxable year at any time on or before the due date (determined with regard to extensions) for filing the return of the tax imposed by this chapter for such taxable year. To the extent provided in regulations, such an election may be made later than as required in the preceding sentence where the taxpayer fails to make a timely election because the taxpayer reasonably believed that the company was not a passive foreign investment company.

QEF Election

- QEF – Protective Statement.
 - Can preserve ability to make QEF Election by filing statement if:
 - (1) Reasonably believed, as of the due date for making the QEF election, that the foreign corporation was not a PFIC for its tax year that ended during that year (retroactive election year);
 - (2) Filed a Protective Statement with respect to the foreign corporation, applicable to the retroactive election year, in which the shareholder describes the basis for its reasonable belief;
 - (3) Extended, in the Protective Statement, the periods of limitations on the assessment of taxes under the PFIC rules for all tax years to which the protective statement applies; and
 - (4) Complied with the other terms and conditions of the protective statements

Mark-to-Market Election

- Sec. 1296. Mark-to-Market Election.
 - Election available only for “marketable” stock.
 - Shareholder includes, as ordinary income, any increase in value of the PFIC shares during the year.
 - Losses only to extent of prior unreversed inclusions.
 - All dividends and gain on sale are ordinary income.

Purging Elections

- Making QEF Election or Mark-to Market Election in a year after first year of PFIC ownership.
 - Deemed Sale – Sec. 1291 applies to deemed sale.
 - Election made on Form 8621
 - Purging election can be made on timely filed return or an amended return if within statute of limitations

Filing Requirements

Form 8621

- Sec. 1298(f). Except as otherwise provided by the Secretary, each United States person who is a shareholder of a passive foreign investment company shall file an annual report containing such information as the Secretary may require(F8621).
 - Filing threshold \$50k married filing jointly; \$25k single.
- QEF Fund Election
- Mark-to-Market Election.

PFIC

Common Traps.

- Sales or Service Company.
 - May fail asset test; cash is “passive” asset.
- Manufacturing Company with Losses.
 - May fail income test; if some passive income (interest, dividends, etc.)

Contact Information

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A stylized sun graphic on the left side of the slide. It features a large yellow circle representing the sun, with three yellow curved lines above it representing rays. The sun is partially obscured by a white semi-circular shape that frames the title text.

A Brief Tour of the “New” PFIC Proposed Regulations

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Mr. Freeman is the founding member of Freeman Law, PLLC, a tax, white-collar, and litigation boutique law firm based in the Dallas-Fort Worth Metroplex. He is a trial attorney, author, adjunct professor at SMU's School of Law, and licensed CPA. Mr. Freeman handles federal and state tax controversies and white-collar civil and criminal matters—including computer hacking, money laundering, embezzlement, bank fraud, tax evasion, securities and health care charges, and conspiracy. He also advises clients in tax planning and compliance matters.

Mr. Freeman was recognized by U.S. World News Reports Best Lawyers in America list and was named to the American Bar Association's "On the Rise – Top 40 Young Attorneys" in America list. He has been recognized multiple times by D Magazine as one of the Best Lawyers in Dallas for tax law and white-collar defense, and by Super Lawyers and Texas Monthly magazine as a Texas Rising Star. He is the President of the North Texas chapter of the American Academy of Attorney-CPAs, and the chairman-elect for the Texas Society of CPA's.

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Other Considerations

- Controlled Foreign Corporation (Form 5471)
- Specified Foreign Financial Assets (Form 8938)
- Foreign Financial Accounts (FinCEN Form 114)

The Latest Proposed Regulations

- In July of 2019, the Treasury Department issued proposed regulations on Passive Foreign Investment Companies.
- The regulations provide guidance with respect to a number of issues that are not specifically addressed in the current regulations and resolve some of the complexities that arise in the determination of the ownership of a PFIC and in the application of the Income Test and Asset Test in cases in which the look-through rule of section 1297(c) applies to a Tested Foreign Corporation.

At a High Level

- The determination of ownership in a PFIC within the meaning of section 1297(a).
- The treatment of certain income received or accrued by a foreign corporation and assets held by a foreign corporation for purposes of section 1297.
- The regulations clarify the application and scope of rules that determine whether a United States person that directly or indirectly holds stock in a PFIC is treated as a shareholder of the PFIC, and whether a foreign corporation is a PFIC.
- The regulations affect United States persons with direct or indirect ownership interests in certain foreign corporations.

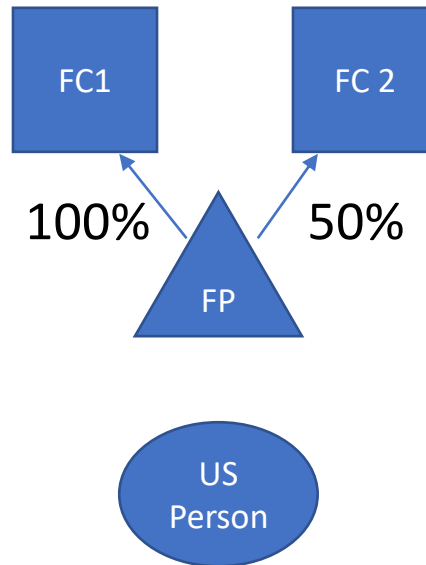
Specific Areas Addressed

- Guidance on the corporate attribution rules when a partnership indirectly holds a Tested Foreign Corporation through a corporation that is not a PFIC.
- The scope of the section 1297(b)(1) cross-reference to section 954(c) for purposes of defining passive income, and computational and characterization issues that arise in applying the Asset Test.
- Rules concerning the treatment of income and assets of a 25-percent-owned subsidiary under section 1297(c).
- Guidance on the application of the section 1298(b)(3) change of business exception.
- The PFIC insurance exception.

Determination of Ownership and Attribution Through Partnerships

- Section 1298(a) provides attribution rules that apply to the extent that the effect is to treat stock of a PFIC as owned by a United States person.
- Except as provided in regulations, the attribution rules do not apply to treat stock owned or treated as owned by a United States person as owned by any other person.
- Under the proposed regulations, the attribution rules apply consistently whether a United States person owns stock of a non-PFIC foreign corporation through a partnership or directly.
- Thus, ownership of a foreign corporation that is a PFIC through a partnership will not change the amount of the stock of the PFIC that the United States person is treated as owning.
- Under the proposed regulations, for purposes of determining whether a partner, S corporation shareholder, or beneficiary in a partnership, S corporation, estate, or nongrantor trust is considered under § 1.1291–1(b)(8)(ii)(A) to own a portion of stock of a PFIC owned indirectly by the partnership, S corporation, estate, or trust through a non-PFIC foreign corporation, the partner, shareholder, or beneficiary will be considered to own 50 percent or more in value of the stock of the non-PFIC foreign corporation through the partnership, estate, or trust **only if the partner, shareholder, or beneficiary directly or indirectly owns 50 percent or more of the ownership interests in the partnership, estate, or trust.**
- See proposed § 1.1291–1(b)(8)(iii).

Example





Example

- Facts. Same Facts, except that U.S. Person owns 40% of the interests in Foreign Partnership.
- Does this change the result?



Income Test

- The proposed regulations indicate that income for purposes of the Income Test includes all dividend income, including dividends that are excluded from gross income under section 1502 and § 1.1502-13.
- See proposed § 1.1297-1(b).

Example

- *Facts.* USP is a domestic corporation that owns 30% of TFC, a foreign corporation.
- The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP.
- TFC owns 25% of the value of USS1, a domestic corporation.
- USS1 owns 80% of the value of USS2, a domestic corporation. USS1 and USS2 are members of an affiliated group (as defined in section 1504(a)) filing a consolidated return.
- USS2 distributes a dividend to USS1 that is excluded from USS1's income pursuant to § 1.1502-13 for purposes of determining the U.S. Federal income tax liability of the affiliated group of which USS1 and USS2 are members.

Exceptions From Passive Income

- The proposed regulations do not incorporate the section 954(c)(3) exception for purposes of determining passive income for PFIC purposes.
- Similarly, under the proposed regulations, the section 954(c)(6) exception also does not apply for determining PFIC status because the section 1297(b)(2)(C) related-person exception is intended to be the sole related-person exception applicable for determining passive income under the PFIC rules.

Exclusion for income derived in the active conduct of an insurance business

- Congress amended the exclusion for income derived in the active conduct of an insurance business in section 1297(b)(2)(B) to require that income be earned by a QIC.
- The proposed regulations provide that the section 954(i) exception to FPHCI does not apply in addition to the PFIC exception. See proposed § 1.1297-1(c)(1)(i)(B).

The FPHCI Exception for Banking and Financing Income

- The proposed regulations provide that the FPHCI exception for banking and financing income under section 954(h) applies for purposes of determining PFIC status. See proposed § 1.1297–1(c)(1)(i)(A).



Passive Income

- The proposed regulations provide that for purposes of section 1297(b)(1), passive income is determined by reference to the items of income listed in section 954(c)(1), subject only to the exceptions found in section 954(c)(1), section 954(c)(2)(A) (relating to active rents and royalties), section 954(c)(2)(B) (relating to certain export financing interest), section 954(c)(2)(C) (relating to dealers), and section 954(h) (relating to entities engaged in the active conduct of a banking, financing, or similar business). See proposed § 1.1297-1(c)(1)(i) and (c)(1)(i)(A).

Section 954(c)

- The rules in section 954(c)(4) (relating to sales of certain partnership interests) and 954(c)(5) (relating to certain commodity hedging transactions) apply for PFIC purposes.
- See proposed § 1.1297–1(c)(1)(i)(C).

Exceptions For Purposes of Section 1297(b)(1)

- Under the Proposed Regulations, the exceptions in section 954(c)(3) (relating to certain income received from related persons), section 954(c)(6) (relating to certain amounts received from related controlled foreign corporations), and section 954(i) (relating to entities engaged in the active conduct of an insurance business) are not taken into account for purposes of section 1297(b)(1).
- See proposed § 1.1297-1(c)(1)(i)(B).

Treatment as CFC

- The proposed regulations provide that an entity is treated as a CFC for purposes of applying an exception to FPHCI and for purposes of determining whether a person is a related person with respect to the entity. *See* proposed § 1.1297–1(c)(1)(i)(D).

Income and Gains From Certain Transactions

- The Income Test is computed based on a Tested Foreign Corporation's gross income.
- However, pursuant to section 954(c), certain categories of income are FPHCI only to the extent that gains exceed losses with respect to the category.
- For instance, under section 954(c)(1)(B) only "the excess of gains over losses from the sale or exchange" of certain property is treated as FPHCI.
- Similar rules apply to income from commodities transactions under section 954(c)(1)(C), foreign currency gains under section 954(c)(1)(D), and income from notional principal contracts under section 954(c)(1)(F).

Income and Gains From Certain Transactions

- The proposed regulations provide that for purposes of the Income Test, items of income under section 954(c) that are determined by netting gains against losses are taken into account by a corporation on that net basis, so that only net gains in a particular category of FPHCI are taken into account. See proposed § 1.1297– 1(c)(1)(ii).
- However, the net amount of income in each category of FPHCI is determined separately for each relevant corporation, such that net gains or losses of a corporation, at least 25 percent of the value of stock of which is owned, directly or indirectly, by a Tested Foreign Corporation (“Look- Through Subsidiary”) may not be netted against net losses or gains of another Look-Through Subsidiary or of a Tested Foreign Corporation.

Income Earned Through Partnerships

- The proposed regulations provide guidance on the treatment of a corporation's distributive share of partnership income for purposes of the Income Test. The regulations provide that income earned by a Tested Foreign Corporation through a partnership should be treated similarly to income earned through a corporate subsidiary.
- Under the Proposed Regulations, if a Tested Foreign Corporation owns a Look-Through Subsidiary, the Tested Foreign Corporation is treated as if it directly received its proportionate share of the income of the Look-Through Subsidiary, and certain items of income received from the Look-Through Subsidiary are proportionately eliminated.
- If a corporation is not a Look-Through Subsidiary, income received from the corporation is characterized in accordance with the general rules, under which dividends generally will be passive.
- Accordingly, the proposed regulations provide that a Tested Foreign Corporation's distributive share of any item of income of a partnership is treated as income received directly by the Tested Foreign Corporation, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the value of the partnership, in which case the partnership is referred to as a "Look- Through Partnership," and income elimination rules similar to those for Look-Through Subsidiaries apply. See proposed § 1.1297-1(c)(2)(i).
- If the Tested Foreign Corporation owns less than 25 percent of the value of a partnership, the corporation's distributive share of any item of income of the partnership is passive income. See proposed § 1.1297-1(c)(2)(ii).

Exceptions to Passive Income

- In cases in which a Tested Foreign Corporation owns at least 25 percent of the value of a partnership, the exceptions to passive income contained in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) and (h) that are based on whether income is derived in the active conduct of a business generally apply if, and only if, the partnership engages in the relevant business activities.
- However, the proposed regulations also include rules that, in certain circumstances, allow the character of income to be determined at the level of the Tested Foreign Corporation, taking into account activities performed by the Tested Foreign Corporation and certain subsidiaries of the Tested Foreign Corporation, whether such subsidiaries are in corporate or partnership form.

Characterization of Distributive Share

- The Proposed Regulations conclude that it is appropriate to generally characterize a corporation's distributive share of partnership income as passive when the corporation owns less than 25 percent of the value of the partnership, consistent with the treatment of Look-Through Subsidiary income, notwithstanding the fact that under the subpart F regulations, such income could have been excluded from FPHCI by virtue of the partnership's activities regardless of the corporation's level of ownership.

Income From a Related Person

- The proposed regulations provide additional guidance on the application of the section 1297(b)(2)(C) related-person exception to dividends, interest, rents, and royalties.
- The proposed regulations provide that the determination of whether the payor of an item of income is a related person should be made on the date of receipt or accrual, as applicable based on the recipient's method of accounting, of the item of income.
- See proposed § 1.1297-1(c)(3)(iv).

Allocation

- Under the proposed regulations, for purposes of the section 1297(b)(2)(C) exception, interest is properly allocable to income of the related person that is not passive income based on the relative portion of the related person's income for its taxable year that ends in or with the taxable year of the recipient that is not passive income. See proposed § 1.1297-1(c)(3)(i).
- Dividends are treated as properly allocable to income of the related person that is not passive income based on the portion of the related payor's current-year earnings and profits for the taxable year that ends in or with the taxable year of the recipient that are attributable to non-passive income. See proposed § 1.1297-1(c)(3)(ii).
- The proposed regulations further provide that rents and royalties are allocable to income of the related person which is not passive income to the extent the related person's deduction for the rent or royalty is allocated to non-passive income under the principles of §§ 1.861-8 through 1.861-14T. See proposed § 1.1297-1(c)(3)(iii).

Asset Test - Methodology of Application of Asset Test

- Section 1297(a)(2) provides that a Tested Foreign Corporation is a PFIC if the average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50 percent.
- Notice 88–22 provides that the average percentage of assets of a Tested Foreign Corporation is calculated by averaging the value of the assets of the corporation, determined as of the end of each quarterly period of the corporation’s taxable year.
- The Proposed Regulations clarify that the average percentage of a Tested Foreign Corporation’s assets is determined using the average of the gross values (or adjusted bases) at the end of each quarter of the foreign corporation’s taxable year. See proposed § 1.1297– 1(d)(1)(i) and (d)(1)(ii)(A).
- Alternatively, the assets of a Tested Foreign Corporation can be measured for purposes of the Asset Test more frequently than quarterly (for example, weekly or monthly).
- The quarter or shorter interval used by a Tested Foreign Corporation is referred to as its “measuring period.”

Asset Test – Methodology of Application of Asset Test

- If a Tested Foreign Corporation has a short taxable year, the quarterly measuring dates for purposes of the Asset Test are the same as they would be for a full taxable year, except that the final quarterly measuring date will be the final day of the short taxable year. See proposed § 1.1297–1(d)(1)(ii)(C).
- Thus, for instance, if a Tested Foreign Corporation for which the election for a shorter period has not been made has a short year of eight months, the corporation would have two quarters ending on the foreign corporation’s normal quarterly measuring dates and a third quarter ending on the final day of the short taxable year.
- The asset amounts for those three quarterly measuring dates would be averaged to determine the average percentage of a Tested Foreign Corporation’s assets that are passive for the year.

Asset Test

- Under section 1297(e), the assets of a Tested Foreign Corporation are required to be measured based on (i) value, pursuant to section 1297(e)(1), if it is a publicly traded corporation for the taxable year, or if section 1297(e)(2) does not apply to it for the taxable year; or (ii) adjusted basis, pursuant to section 1297(e)(2), if it is a CFC, or elects the application of section 1297(e)(2).
- The statute does not specify whether a corporation that is publicly traded during only part of the taxable year is publicly traded “for the taxable year,” and thus whether such a corporation’s assets should be measured for the taxable year based on value or on adjusted basis or whether, if the corporation is a CFC for the remainder of the year, a combination of the two should be used. For instance, a Tested Foreign Corporation that is a CFC at the beginning of its taxable year and became publicly traded during the last month of its taxable year could be required under section 1297(e) to have its assets measured based on either adjusted basis or value for all four quarterly measuring periods or based on adjusted basis for its first three quarterly measuring periods and value for its fourth quarterly measuring period.
- The proposed regulations provide that the Asset Test should apply on the basis of value for the entire year if the corporation was publicly traded on the majority of days during the year or section 1297(e)(2) did not apply to the corporation on the majority of days of the year. Otherwise, the Asset Test should apply on the basis of adjusted basis for the entire year. See proposed § 1.1297-1(d)(1)(v).

Characterization of Dual- Character Assets

- Pursuant to section 1297(a), an asset is considered passive for purposes of the Asset Test if it produces passive income or is held for the production of passive income.
- Notice 88–22 states that an asset that produces both passive income and non-passive income during a Tested Foreign Corporation’s taxable year is treated partly as a passive asset and partly as a non-passive asset in proportion to the relative amounts of income generated by the asset during the year.
- Proposed § 1.1297–1(d)(2) generally adopts the rule set forth in Notice 88–22, and provides that an asset that produces both passive income and non-passive income during a taxable year is treated as two assets, one of which is passive and one of which is non-passive.
- Consistent with the rule in Notice 88–22, for purposes of applying the Asset Test, the value (or adjusted basis) of the asset is allocated between the passive assets and non-passive assets based on the ratio of passive income produced by the asset during the taxable year to non-passive income.

Stock of a Related Person

- The proposed regulation also provides a specific rule for stock of a related person with respect to which no dividends are received or accrued, as applicable based on the recipient's method of accounting, during a taxable year but that previously generated dividends that were characterized as non-passive income, in whole or in part, under section 1297(b)(2)(C). *See* proposed § 1.1297-1(d)(2)(iii).
- The stock is characterized based on the dividends received or accrued, as applicable based on the recipient's method of accounting, with respect thereto for the prior two years. *Id.*

Characterization of Partnership Interests

- The proposed regulations provide that for purposes of the Asset Test, a Tested Foreign Corporation that directly or indirectly owns an interest in a partnership is treated as if it held its proportionate share of the assets of a partnership, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25 percent, by value, of the interests in the partnership. See proposed § 1.1297-1(d)(3)(i).
- A corporation's proportionate share of a partnership asset is 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, unless certain rules apply to allow the character of the income to be determined at the level of the Tested Foreign Corporation, taking into account activities performed by certain subsidiaries of the Tested Foreign Corporation.
- If a Tested Foreign corporation owns less than 25 percent of the value of the partnership, its interest in the partnership is treated as a passive asset. See proposed § 1.1297-1(d)(3)(ii).

Characterization of Dealer Property

- For purposes of the Asset Test, an asset is considered passive if it produces passive income or is held for the production of passive income.
- Under the dealer exception in section 954(c)(2)(C), gain from the disposition of certain dealer property is treated as non- passive income for purposes of the Income Test.
- However, certain other income derived with respect to the dealer property (such as dividends and interest) is treated as passive income. The exception from passive income for dealer property in section 954(c)(2)(C) is predicated on the fact that a dealer holds the property as part of its trade or business and not for the production of passive income.
- Accordingly, the Proposed Regulations determine that, given that the PFIC regime is concerned with whether the asset is part of an active business, it is appropriate to characterize dealer property for purposes of the Asset Test based solely on the character of the gain derived from the disposition of the property.
- Likewise, the proposed regulations provide that property that is subject to the dealer exception is characterized as a non-passive asset for purposes of the Asset Test, notwithstanding the dual-character asset rules. See proposed § 1.1297-1(d)(4).

Stapled Entities

- The proposed regulations provide that for purposes of determining whether any stapled entity is a PFIC, all entities that are stapled entities with respect to each other are treated as one entity.
- See proposed § 1.1297–1(e).

Look-Through Rule for 25-Percent-Owned Subsidiaries

- Section 1297(c) applies when a Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation, a Look-Through Subsidiary. In such instance, the Tested Foreign Corporation is treated as if it directly held its proportionate share of the assets and directly received its proportionate share of the income of the Look-Through Subsidiary.
- Section 1297(c) was enacted to prevent “foreign corporations owning the stock of subsidiaries engaged in active businesses [from being] classified as PFICs.”
- H.R. Rep. No. 99–841, at II– 644 (1986) (Conf. Rep.).

Determining a Tested Foreign Corporation's Ownership of a Look-Through Subsidiary and Proportionate Share of a Look-Through Subsidiary's Assets and Income

- Under section 1297(c), the determination of whether a Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the stock of another corporation **is based on value**.
- The proposed regulations provide that indirect stock ownership for purposes of section 1297(c) is determined under the principles of section 958(a) applicable for determining ownership by value. See proposed § 1.1297-2(b)(1).
- The section 958(a) principles apply without regard to whether entities are domestic or foreign, and thus indirect ownership includes corporate ownership through intermediate corporations, partnerships, trusts, and estates, regardless of whether such intermediate entities are foreign or domestic. *Id.*
- In addition, stock considered owned by reason of applying the section 958(a) indirect ownership rules is generally considered actually owned for purposes of reapplying the indirect ownership rules. See § 1.958-2(f)(1).

Proportionate Share

- Section 1297(c) provides that a Tested Foreign Corporation is treated as holding its proportionate share of the assets of the Look-Through Subsidiary and receiving its proportionate share of the income of the Look-Through Subsidiary.
- The proposed regulations provide guidance on the meaning of “proportionate share” for purposes of section 1297(c).
- Proposed § 1.1297–2(b)(2) provides that a Tested Foreign Corporation is treated as owning a share of each asset, and receiving a proportionate share of each item of income, of a Look-Through Subsidiary proportionate to the Tested Foreign Corporation’s percentage ownership (by value) of the Look-Through Subsidiary.

Measuring Date

- Changes in stock ownership may cause fluctuations in a Tested Foreign Corporation's ownership in a Look-Through Subsidiary during a taxable year.
- For purposes of the Asset Test, ownership of a Look-Through Subsidiary is determined on each measuring date. See proposed § 1.1297-2(b)(2)(i).
- If the requisite 25-percent ownership is not met with respect to a corporation on the last day of a measuring period, the stock of the corporation would be a passive asset for purposes of that measuring period, absent the application of a special rule, such as the new rule for dealer property in proposed § 1.1297-1(d)(4).

Look-Through Status

- For purposes of the Income Test, a subsidiary is considered a Look-Through Subsidiary if the Tested Foreign Corporation owns an average of 25 percent of the value of the subsidiary for the year, taking into account its ownership on the last day of each measuring period of the Tested Foreign Corporation's taxable year. See proposed § 1.1297-2(b)(2)(ii)(A).
- If the Tested Foreign Corporation does not maintain, on average, at least 25-percent ownership of the subsidiary for the taxable year, the Tested Foreign Corporation is not, under the general rule in the proposed regulations, treated as receiving its proportionate share of the income of the subsidiary for that year under section 1297(c).
- However, the Tested Foreign Corporation may be treated as receiving directly its proportionate share of the income of the subsidiary for each measuring period in a taxable year for which the 25-percent ownership requirement is met on the relevant measuring date, provided the taxpayer can establish gross income for each of those measuring periods. See proposed § 1.1297-2(b)(2)(ii)(B).

Overlap Between Section 1297(c) and Section 1298(b)(7)

- The Proposed Regulations determine that the special characterization rule of section 1298(b)(7) should generally take precedence over the section 1297(c) look-through rule when both rules would apply simultaneously because the characterization rule of section 1298(b)(7) is the more specific rule where the Tested Foreign Corporation owns a domestic corporation.
- Thus, the proposed regulations provide that the look-through rule of section 1297(c) does not apply to a domestic corporation, and any subsidiaries of the domestic corporation, if the stock of the domestic corporation is characterized, under section 1298(b)(7), as a non-passive asset producing non-passive income. See proposed § 1.1297-2(b)(2)(iii).
- However, these proposed regulations provide certain limitations on the application of section 1298(b)(7), including a new anti-abuse rule, in which case section 1297(c) would apply.

Elimination of Certain Assets and Income for Purposes of Applying Section 1297(a)

- The proposed regulations provide that intercompany payments of dividends and interest between a Look-Through Subsidiary and the Tested Foreign Corporation and stock and debt receivables are eliminated in applying the Income Test and the Asset Test. See proposed § 1.1297-2(c)(1) and (2).
- In the case of dividends, in order to qualify for elimination, the payment must be attributable to income of a Look-Through Subsidiary that was included in gross income by the Tested Foreign Corporation for purposes of determining its PFIC status. See proposed § 1.1297-2(c)(2).
- Thus, dividends attributable to income of the Look-Through Subsidiary earned in a year before the Tested Foreign Corporation owned, on average, at least 25% by value of the Look-Through Subsidiary would generally not qualify for elimination.
- As a result of the elimination rule, for example, interest and dividends received by a Tested Foreign Corporation from a wholly owned Look-Through Subsidiary are eliminated from the Tested Foreign Corporation's gross income for purposes of applying section 1297(a)(1), except to the extent that dividend amounts are attributable to income that has not been treated as received directly by the Tested Foreign Corporation under the section 1297(c) look-through rule.
- Additionally, the proposed regulations extend this treatment to intercompany payments between two Look-Through Subsidiaries of a Tested Foreign Corporation and the associated stock and debt receivables.
- Similarly, stock and debt investments in a lower-tier Look-Through Subsidiary are eliminated for purposes of applying the Income Test and Asset Test to the Tested Foreign Corporation.
- In the case of a Tested Foreign Corporation that owns less than 100 percent of a Look-Through Subsidiary, the proposed regulations provide that while stock and dividends are eliminated in their entirety, eliminations of debt receivables and interest are made in proportion to the shareholder's direct and indirect ownership (by value) in the Look-Through Subsidiary.
- The proposed regulations also provide for eliminations under these principles for ownership interests in a Look-Through Partnership, as well as intercompany debt receivables and interest paid or accrued thereon between a Tested Foreign Corporation and a Look-Through Partnership. See proposed § 1.1297-2(c)(3).

Section 1297(b)(2)(C) Related Person Determination With Respect to Interest, Dividends, Rents, and Royalties Received by Look-Through Subsidiaries and Certain Partnerships

- Section 1297(c) provides that a Tested Foreign Corporation is treated as receiving directly its proportionate share of the income of a Look-Through Subsidiary for purposes of applying the Income Test to the Tested Foreign Corporation. Section 1297(b)(2)(C) provides that, for purposes of the Income Test, 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 such amount is properly allocable to income of the related person that is not passive income.
- The statute and current regulations do not address the level at which the “related person” determination is made if a Look-Through Subsidiary receives or accrues an item of income that is treated as directly received by a Tested Foreign Corporation pursuant to section 1297(c). Thus, the interaction and application of the two rules is unclear in cases in which the payor of an item of income is a “related person” with respect to either the Look-Through Subsidiary or the Tested Foreign Corporation, but not with respect to both.
- The Treasury Department and the IRS have determined that, because section 1297(c) generally applies by classifying an item at the level of Look-Through Subsidiary and then carrying that classification up to the Tested Foreign Corporation, it is appropriate to determine whether the section 1297(b)(2)(C) exception applies (and, thus, determine the passive or non-passive character of an item of income) at the Look-Through Subsidiary level, and then flow up the passive or non-passive character of the item to the Tested Foreign Corporation for purposes of applying the Income Test.
- Accordingly, proposed § 1.1297-2(d)(1) provides that, in applying section 1297(b)(2)(C), “related person” status is tested with respect to the payor of the item of income and the Look-Through Subsidiary. The same rule applies for items of income received by a partnership and treated as received directly by a Tested Foreign Corporation pursuant to proposed § 1.1297-1(c)(2).

Attribution of Activities of a Look- Through Subsidiary and Certain Partnerships

- The interaction of section 1297(c) and certain exceptions from passive income also raises issues that require a threshold determination of whether an exception should apply at a Look-Through Subsidiary level or a Tested Foreign Corporation level.
- Under current law, the character of income or assets is determined at the level of the entity that directly earns the income or holds the assets based on the activities of that entity.
- The proposed regulations provide that an item of rent or royalty income received or accrued by a Tested Foreign Corporation (or treated as received or accrued by the Tested Foreign Corporation pursuant to section 1297(c)) that would otherwise be passive income under the general rule is not passive income for purposes of section 1297 if the item would be excluded from passive income, determined by taking into account the activities performed by the officers and employees of the Tested Foreign Corporation as well as activities performed by the officers and employees of certain Look-Through Subsidiaries and certain partnerships in which the Tested Foreign Corporation or one of the Look-Through Subsidiaries is a partner. See proposed § 1.1297-2(e)(1).

Gain on the Disposition of Stock of a Look- Through Subsidiary

- Section 1297(c) does not address the treatment of a Tested Foreign Corporation's gain from the disposition of stock of a Look-Through Subsidiary for purposes of the Income Test.
- The proposed regulations provide that, for purposes of the Income Test, the disposition of a Look-Through Subsidiary is treated as the disposition of stock, and gain is computed accordingly.
- However, the proposed regulations limit the amount of the gain taken into account for purposes of the Income Test in order to avoid double-counting any income that the Tested Foreign Corporation takes into account under section 1297(c) in determining the PFIC status of the Tested Foreign Corporation during the year of the disposition or took into account for such purpose in a prior year that has not been distributed as a dividend to the Tested Foreign Corporation.
- Thus, the amount of gain taken into account for purposes of the Income Test ("Residual Gain") is equal to the total gain recognized by the Tested Foreign Corporation on the disposition, reduced (but not below zero) by the amount (if any) by which (A) the aggregate income (if any) of the Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent stock in such other Look-Through Subsidiary is owned indirectly through the Look-Through Subsidiary) taken into account by the Tested Foreign Corporation under section 1297(c)(2) with respect to the disposed Look-Through Subsidiary stock exceeds (B) the aggregate dividends (if any) received by the Tested Foreign Corporation from the Look-Through Subsidiary with respect to the disposed stock (including dividends attributable to stock of any other Look-Through Subsidiary owned indirectly through the Look-Through Subsidiary).
- The Residual Gain is computed on a share-by-share basis with respect to income of a Look-Through Subsidiary that was taken into account by the Tested Foreign Corporation and dividends received from a Look-Through Subsidiary. See proposed § 1.1297-2(f)(1).

Disposition of Interests in a Look- Through Partnership

- Gain from the disposition of stock generally is treated as FPHCI under section 954(c)(1)(B)(i). However, section 954(c) does not contain a look-through rule comparable to section 1297(c).
- Proposed § 1.1297–2(f)(2) provides that the Residual Gain taken into account by the Tested Foreign Corporation will be characterized as passive income or non-passive income in proportion to the passive assets and non-passive assets of the disposed-of Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent owned indirectly through the Look-Through Subsidiary) treated as held by the Tested Foreign Corporation pursuant to section 1297(c) on the date of the disposition, measured using the method (value or adjusted bases) that is used to measure the assets of the Tested Foreign Corporation for purposes of the Asset Test.
- Pursuant to proposed § 1.1297–1(c)(1)(i)(C), section 954(c)(4) applies with respect to the disposition of interests in a Look-Through Partnership.

Change-of-Business Exception (Including Dispositions of Stock of a Look-Through Subsidiary)

- The proposed regulations provide general guidance with respect to the Change-of-Business Exception. First, the proposed regulations provide that for purposes of section 1298(b)(3)(B), the existence of an active trade or business and the determination of whether assets are used in an active trade or business is determined by reference to Treas. Reg. § 1.367(a)–2(d)(2), (3), and (5), except that officers and employees do not include the officers and employees of related entities as provided in § 1.367(a)–2(d)(3). See proposed § 1.1298–2(c)(3).
- If, however, the activity attribution rules would apply to cause the activities of another entity to be taken into account, they are taken into account for purposes of determining the applicability of the Change-of-Business Exception. *Id.*
- In addition, the proposed regulations provide that income attributable to proceeds from the disposition of an active trade or business means income earned on investment of such proceeds but does not include the proceeds themselves. See proposed § 1.1298–2(c)(1).
- The regulations also provide that section 1298(b)(3) may apply to either a taxable year of the disposition of the active trade or business or the immediately succeeding taxable year, but in any event may apply to only one year with respect to a disposition. See proposed § 1.1298–2(e).
- Thus, a Tested Foreign Corporation that receives proceeds from a disposition in more than one taxable year may apply the Change-of-Business Exception to only one year. A Tested Foreign Corporation can choose which year it applies the Change-of-Business Exception if the exception can apply in more than one year.

Change-of-Business Exception

- The proposed regulations expand the Change-of-Business Exception in section 1298(b)(3) to apply if, on the measuring dates that occur during the taxable year to which the Change-of-Business Exception is proposed to apply and after the disposition, on average, substantially all of the passive assets of a corporation are attributable to proceeds from the disposition of one or more active trades or businesses. See proposed § 1.1298–2(b)(2)(ii).
- In the case of a corporation, substantially all of the passive assets of which are attributable to proceeds from the disposition of one or more active trades or businesses, proposed § 1.1298–2(c)(4) provides that a Tested Foreign Corporation will be deemed to satisfy the requirement that the Tested Foreign Corporation not be a PFIC for the two years following the year for which it relies on the Change-of-Business Exception if it completely liquidates by the end of the year following the year for which it relies on the Change-of-Business Exception. U.S. Federal income tax principles apply to determine whether a Tested Foreign Corporation has completely liquidated.

Domestic Subsidiary Stock Rule

- Section 1298(b)(7) provides a special characterization rule that applies if a Tested Foreign Corporation owns at least 25 percent of the value of the stock of a domestic corporation and is subject to the accumulated earnings tax under section 531 (or waives any benefit under a treaty that would otherwise prevent imposition of such tax).
- The proposed regulations clarify that stock of the 25-percent-owned domestic corporation and the qualified stock generally must be owned by the Tested Foreign Corporation and the 25-percent-owned domestic corporation, respectively, either directly or indirectly through one or more partnerships.
- See proposed § 1.1298-4(b)(1) and (c).