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Old Law, New Tricks: Long-Awaited PFIC Guidance Proposed

On July 11, the IRS and Treasury issued proposed regulations under Code Sections 1291, 1297, and 1298 concerning "passive foreign investment companies" (PFIC). The proposed rules provide overdue guidance on several fundamental issues, including the threshold Income and Asset Tests to determine whether a foreign corporation is a PFIC, ownership attribution, and look-through rules. Until final regulations are published, taxpayers may generally rely on the proposed rules and continue to rely on Notice 88-22. Notably, the recent regulations generally do not update much of the regulatory guidance that remained in proposed form for nearly 30 years. While greater clarity in the PFIC area is welcome, some of the new rules are unfriendly to taxpayers, who may also find themselves ensnared by the PFIC rules due to statutory and proposed regulatory changes to Subpart F after 2017's tax reform.

Background

Generally, a foreign corporation (a "tested foreign corporation" in the regulatory parlance) is a PFIC if, in any given year, either 75% or more of its income is passive income ("Income Test") or 50% or more of its assets produce passive income ("Asset Test"). Direct and indirect U.S. owners of PFICs are subject to special tax rules that limit, if not eliminate, the benefit of tax deferral that might otherwise apply to income derived through foreign corporations. Under the default PFIC tax rules, disposition gains or "excess distributions" are taxed at ordinary income rates and may attract an interest charge. Two elective regimes may allow a taxpayer to escape the default rules, but at the cost of current taxation of the foreign corporation's income (as a qualified electing fund or QEF) or unrealized appreciation (under the mark-to-market election). U.S. owners of PFICs are also subject to reporting on Form 8621.

Proposed Rules for Income and Asset Tests

Under Section 1297(b)(1), passive income is generally defined by reference to "foreign personal holding company income" (FPHCI) in Section 954(c). Previously, whether Section 954 exceptions to FPHCI applied for PFIC Income Test purposes was uncertain. The new rules clarify that only the following exceptions would apply in the PFIC context: active rents and royalties, export financing income, dealer income, sales of partnership interests, commodity hedging, and active banking and finance business. Other Section 954 exceptions for related-party income, income from related

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controlled foreign corporations (CFCs), and insurance companies do not apply; they are preempted by specific PFIC provisions. The new proposed regulations further provide that only net gains for FPHCI items determined on a net basis factor into the Income Test, but the netting occurs on a standalone basis.

Section 1297(c) provides a look-through rule such that a tested foreign corporation is treated as owning and earning its proportionate share of the assets and income of any subsidiary in which it owns 25% or more by value ("Look-Through Subsidiary Rule"). The proposed rules expressly extend the Look-Through Subsidiary Rule to 25% or more owned partnerships. Unhelpfully, partnership interests of less than 25% would be treated as per se passive assets generating passive income—despite the aggregate treatment of partnerships for purposes of Section 954 and many other provisions (e.g., the newly enacted Section 864(c)(8)). In identifying look-through subsidiaries, Section 958(a) principles of indirect ownership apply without regard to whether an entity is foreign or domestic. The proposed regulations would allow attribution of activities to a tested foreign corporation, for purposes of the active rents or royalties exception, only of a more than 50% owned subsidiary, a helpful clarification for many foreign real estate structures. Activities would not be attributed between brother-sister companies or downward from parent companies, though.

The regulations confirm the elimination, in general, of intercompany dividends (and associated stock) and interest (and associated debt receivables) between a tested foreign corporation and a look-through subsidiary, two look-through subsidiaries, and lower-tier look-through subsidiaries. However, dividends would be eliminated under the Look-Through Subsidiary Rule only to the extent attributable to earnings and profits earned while the subsidiary is at least 25% owned, and eliminations would be proportionate to the tested foreign corporation's ownership interest in less than 100% owned subsidiaries.

Gain on the sale of a look-through subsidiary is computed as gain from the sale of stock. To avoid double counting of subsidiary income, the gain taken into account for the Income Test is limited to the excess of the sale gain, reduced by (1) income included by the tested foreign corporation under the Look-Through Subsidiary Rule minus (2) dividends from the look-through subsidiary ("residual gain"). The residual gain is treated as passive or nonpassive income in proportion to the subsidiary's passive or nonpassive assets, adopting the approach taken in prior rulings.

Under Section 1298(b)(7), qualified stock of a domestic C corporation owned by a tested foreign corporation through a 25% or more owned domestic corporation is a nonpassive asset producing nonpassive income if the tested foreign corporation is subject to the accumulated earnings tax (AET) and waives treaty benefits that would prevent application of the AET. Technically, this qualified domestic stock rule could have applied along with the Look-Through Subsidiary Rule. The proposed regulations would turn off the Look-Through Subsidiary Rule for any domestic corporation (and its subsidiaries) if its stock is nonpassive under Section 1298(b)(7). The new rules would also require that a tested foreign corporation own the 25% or more owned domestic subsidiary, through which stock of lower-tier domestic corporations may be qualified, directly or through partnerships, and adopt objective and subjective anti-abuse rules.

Section 1297(b)(2)(C) provides that interest, dividends, rents, or royalties from, and allocable to nonpassive income of, a related party will be treated as nonpassive income to a tested foreign corporation. The proposed regulations clarify the characterization of related-party interest and dividends under this exception and provide that, if the Look-Through Subsidiary Rule applies, relatedness is determined at the level of the look-through subsidiary (not the tested foreign corporation).

The proposed regulations generally adopt the principles of Notice 88-22 concerning the Asset Test, including for dual-character assets, with some clarifications regarding measurement intervals and the use of fair market value versus adjusted basis, among other technical considerations. In general, a tested foreign corporation uses fair market value to apply the Asset Test unless it is a CFC or otherwise elects. With the potential proliferation of CFCs due to the

repeal of Section 958(b)(4), the mandatory use of adjusted basis to determine the PFIC status of a CFC could create PFIC headaches for less than 10% U.S. shareholders, who routinely count on goodwill or other off-balance sheet value to avoid the Asset Test. These small shareholders may need to consider making QEF elections. The proposed rules do not indicate how recently proposed Subpart F regulations generally looking through domestic partnerships that own CFCs might affect the CFC-PFIC overlap rule in Section 1297(d). Previously, less than 10% U.S. owners needn't have worried about PFIC treatment if they owned a CFC through a domestic partnership that was itself a 10% or more shareholder of the CFC. Now that proposed Subpart F regulations would treat the partners, rather than the partnership, as the Section 958 shareholders, U.S. partners with a less than 10% interest in the CFC may also need to consider QEF elections.

Proposed Rules for PFIC Attribution

Section 1298(a) provides rules to attribute PFIC stock to U.S. persons from corporations and other entities. A shareholder is attributed its proportionate share of PFIC stock held through a non-PFIC corporation only if the shareholder owns 50% or more of the non-PFIC corporation, whereas no threshold applies to attribute a lower-tier PFIC held through a PFIC. Under prior regulations, partners, S corporation shareholders, and beneficiaries are generally attributed their proportionate share of PFIC stock held through a partnership, S corporation, estate, or nongrantor foreign trust. The proposed regulations take a top-down approach in applying the corporation attribution rules to a U.S. person that owns non-PFIC stock through a non-C corporation. Under this approach, the partner, S corporation shareholder, or beneficiary is considered to own 50% or more of the non-PFIC (thus enabling PFIC attribution) only if it owns, directly or indirectly, 50% or more of the partnership, S corporation, estate, or trust. The aim of this approach is to achieve the same result as if the intervening partnership, etc., were ignored and the non-PFIC corporation were directly owned by the partner, etc.

Proposed Rules for PFIC Insurance Exception

Code Section 1297(f) provides that income derived by a "qualifying insurance corporation" (QIC) in the active conduct of a trade or business is not treated as passive income for purposes of the Income Test. Whether a foreign corporation is a QIC depends on the ratio of its "applicable insurance liabilities" to its assets. The recently proposed regulations replace rules proposed in 2015 with rules updated for changes under the Tax Cuts and Jobs Act, which generally narrowed the QIC exception. These insurance-related proposed regulations may be applied for tax years beginning after December 31, 2017.

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