KPMG report: Proposed passive foreign investment company (PFIC) regulations; initial impressions and observations

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Proposed regulations (REG-105474-18) from the U.S. Treasury Department and IRS relating to passive foreign investment companies (PFICs) were published in the Federal Register on July 11, 2019.

Read the text of the **proposed regulations** [PDF 515 KB] as published in the Federal Register.

This report provides initial impressions and observations about these proposed regulations (in this report, referred to as "proposed rules").

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Background

The PFIC rules, enacted in 1986 as a counterpart to the anti-deferral regime in subpart F, target U.S. owners of foreign corporations with primarily passive income or assets. The PFIC rules, unlike the rules in subpart F, aim to remove the economic benefit of deferral with respect to all U.S. investors in a PFIC, not just those with significant ownership. Notoriously broad and complex, the PFIC rules generally

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discourage U.S. taxpayers from investing in PFICs—if they can identify that a foreign corporation is a PFIC in the first instance.

Generally, a PFIC is a foreign corporation that has, during the tax year, at least 75% passive income (the "Income Test") or an average percentage of assets that produce passive income of at least 50% (the "Asset Test"). Passive income is any income of a kind that would be foreign personal holding company income ("FPHCI") as defined in section 954(c), subject to certain exceptions in the PFIC rules. One such exception from the definition of passive income is income derived in the active conduct of an insurance business by a qualifying insurance corporation ("QIC"), as revised in the 2017 U.S. tax law (Pub. L. No. 115-97, enacted December 22, 2017, and often referred to as the "Tax Cuts and Jobs Act").

For many years, taxpayers have relied on Notice 88-22 for crucial guidance on the application of the PFIC rules. Treasury also issued proposed regulations in 2015 on the prior version of the PFIC insurance exception; those proposed regulations were never finalized and are withdrawn in connection with issuing the proposed rules.

The proposed rules (discussed in detail below) include guidance on: (1) the determination of ownership and attribution through partnerships; (2) the Income Test; (3) the Asset Test; (4) the look-through rule for 25%-owned corporations and certain domestic subsidiaries; (5) the change-of-business exception; and (6) the PFIC insurance exception.

Although the proposed rules address many lingering PFIC issues, they leave untouched certain other longstanding unresolved PFIC issues, including: (1) qualified electing fund ("QEF") guidance; (2) mark-to-market regime guidance; (3) the PFIC stock transfer non-recognition override rule under section 1291(f); and (4) ownership attribution by reason of options. Further, it is notable that the proposed rules do not mention any potential coordination with the aggregate domestic partnership approach included in the recently released subpart F proposed regulations, which appear to increase the relevance of the PFIC rules by decreasing the availability of the PFIC/controlled foreign corporation ("CFC") overlap rule in certain circumstances.

PFIC proposed regulations

General rules

Determination of ownership and attribution through partnership

The statute generally provides ownership attribution rules that may apply to treat stock of a PFIC as owned by a U.S. person. Under one attribution rule, stock owned by a partnership, estate, or trust is considered owned proportionately by its partners or beneficiaries. Under another attribution rule, a U.S. person that owns a non-PFIC corporation is treated as owning stock owned by the non-PFIC in proportion to its ownership in the non-PFIC corporation only if the U.S. person owns at least 50% of the value of the non-PFIC. Thus, a U.S. person that owns a partnership is treated as owning a proportionate share of the stock owned by the partnership regardless of its ownership in the partnership, while a U.S. person that owns a non-PFIC corporation is treated as owning a proportionate share of the stock owned by the corporation only if it owns at least 50% of the value of the non-PFIC.

There has been some uncertainty as to whether the ownership attribution rules should be applied to a

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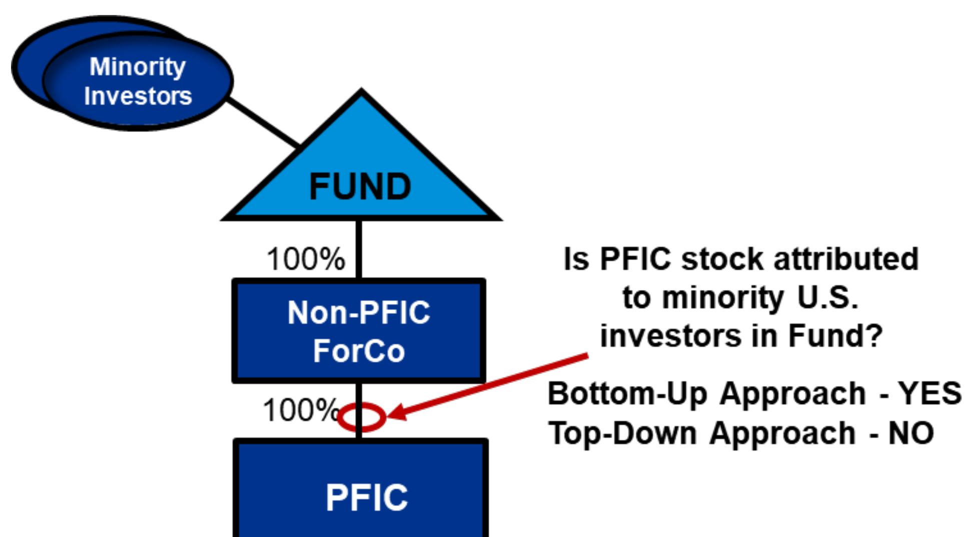
tiered ownership structure on a "top-down" versus "bottom-up" basis. Under a "top-down" approach, the ownership attribution analysis starts with a U.S. person and then the U.S. person's ownership interest is sequentially determined for each successive lower-tier beginning at the upper-tier entities and proceeding down the ownership chain(s). Conversely, the "bottom-up" approach starts with a PFIC and attributes ownership of its stock upwards to each successive upper-tier until reaching the U.S. person(s).

The preamble notes that the two approaches can result in different ownership consequences when a partnership indirectly owns stock of a foreign corporation that is being tested for PFIC status (a "tested foreign corporation") through a non-PFIC corporation.

PFIC Ownership Attribution Rules – Bottom-Up vs. Top-Down



Consistent with an aggregate theory of partnerships, the proposed rules effectively limit application of the attribution rules to the "top-down" approach when a U.S. person owns stock of a non-PFIC corporation through a partnership. Accordingly, the proposed rules produce the same result as if the partnership were disregarded and the U.S. partners were treated as if they directly or indirectly owned the partnership's direct and indirect interests in the non-PFIC foreign corporation. It is notable that the explicit rejection of the "bottom-up" approach is limited to attribution through partnerships, and the proposed rules effectively reserve on whether it should similarly apply in a purely corporate structure.

KPMG observation

The exclusive application of the "top-down" approach to the ownership attribution through partnerships is a significant and favorable result. This proposed rule is particularly relevant (and helpful) to private equity and asset management structures; in such structures it is fairly common for the fund to hold or acquire a majority interest (by value) in a top-tier non-PFIC holding corporation that itself directly or indirectly owns underlying PFICs. In such a fact pattern, application of the "bottom-up" approach generally would result in the attribution of the underlying PFIC stock to the U.S. investors in the fund, regardless of the size of their interest in the fund partnership. Conversely, the proposed rules generally would apply to preclude attribution of the underlying PFIC stock to any such U.S. investor provided the U.S. investor owns less than 50% of the value of the non-PFIC foreign corporation stock on a diluted basis.

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In addition, this should be viewed as particularly helpful guidance given the recently issued proposed regulations [read *TaxNewsFlash*] on attribution through domestic partnerships for subpart F purposes ("CFC proposed rules"), which would result in fewer instances when the CFC/PFIC overlap rule of section 1297(d) would apply. Under the CFC proposed rules, many typical private equity and asset management structures would be treated as resulting in indirect PFIC ownership by U.S. tax investors if a "bottom-up" approach was applied. Now, however, there may be more instances of taxpayer favorable results where, as a result of reliance on the CFC proposed rules, private equity or asset management structures no longer will be treated as generating subpart F or GILTI inclusions, and, in addition, as a result of the proposed rules, fund investments into offshore corporate structures can be tested with a "top-down" approach, generally resulting in fewer PFIC determinations.

Income test

As described above, under the Income Test, a tested foreign corporation is a PFIC if at least 75% of its income for a tax year is passive income. Income that is FPHCI under the subpart F rules generally is passive for purposes of the Income Test, subject to exceptions for related-party, insurance, banking, and export income in the PFIC rules. The proposed rules address a number of issues regarding the application of the Income Test, including guidance on the application of the FPHCI exceptions, the PFIC related-party exception, and the treatment of a distributive share of partnership income.

- **FPHCI exceptions**. The proposed rules explicitly address the application of the FPHCI exceptions for Income Test purposes. As described in the preamble, the FPHCI "same-country" exception for related-party payments (section 954(c)(3)) and the "look through" exception for payments from related controlled foreign corporations ("CFCs") (section 954(c)(6)) *do not* apply for PFIC purposes because the PFIC related-party exception is meant to provide the only rules for excluding related-party income from passive income. Similarly, the proposed rules turn off the FPHCI insurance exception (section 954(i)) for Income Test purposes in favor of the sole application of the PFIC insurance exception. Helpfully, the proposed rules explicitly provide that the other FPHCI exceptions do apply for PFIC purposes, including the active finance exception (section 954(h)), which applies in addition to the PFIC banking exception. Further, the FPHCI exceptions apply without regard to whether the tested foreign corporation is a CFC.

KPMG observation

The application of the active finance exception in section 954(h) had not been entirely clear because the definition of passive income cross-references only section 954(c). In addition, the active finance exception could be read to apply only to PFICs that also are CFCs. The proposed application of the FPHCI active finance exception (and its application to all tested foreign corporations) for Income Test purposes is welcomed and appropriate because income derived in an active business should not be considered passive income. The inclusion of the FPHCI active finance exception in addition to the arguably similar PFIC banking exception is notable in light of the decision to exclude the FPHCI related-party and insurance exceptions due to their similarity to exceptions in the PFIC rules. Nonetheless, the preamble notes the lack of final regulations under the PFIC banking exception in describing its decision to include the FPHCI active finance exception. Treasury and IRS have issued Notice 89-81 and proposed §1.1296-4 on the PFIC banking exception, but have yet to issue any final or temporary regulations. The statement in the preamble

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seems to raise the potential for future guidance to remove the FPHCI active finance exception for Income Test purposes if final regulations are issued under the PFIC banking exception.

- **Sale of partnership interest**. The proposed rules provide that the FPHCI partnership look through rule (section 954(c)(4)) applies for PFIC purposes. Under this rule, a tested foreign corporation that owns at least 25% of a partnership characterizes the gain on the sale of its partnership interest as passive or non-passive based on the partnership's assets.

- **Net items of FPHCI**. Although the statute provides that the Income Test applies based on a corporation's gross income, certain categories of FPHCI are determined on a net basis (for example, the excess of gains over losses from certain property transactions). Under the proposed rules, the net item of FPHCI is taken into account in applying the Income Test, notwithstanding the general rule that the Income Test applies on a gross basis. For this purpose, the netting occurs at an entity level for each tested foreign corporation and look-through subsidiary (as defined later in this document) and net losses in a look-through subsidiary cannot offset net income in a tested foreign corporation.

- **PFIC related-party exception**. Under the statute, interest, dividends, rents, and royalties received or accrued from a related person are excluded from passive income to the extent properly allocable (under regulations) to non-passive income of the related person. The proposed rules include long-awaited guidance on allocation for purposes of the PFIC related-party exception.

  - *No "cream skimming".* The subpart F foreign base company income rules include a priority rule for passive income (the "cream skimming" rule) that generally allocates related-party interest expense to passive income before non-passive income. The proposed rule *do not* adopt the cream skimming rule for Income Test purposes. Instead, interest expense is allocated pro rata, based on the relative amounts of the payor's passive and non-passive income for the year.

  - *Allocation of dividends.* Under the proposed rule, dividends are allocated based on the extent to which current year earnings and profits are attributable to passive or non-passive income.

  - *Allocation of rent/royalty.* The proposed rules cross-reference the principles of the section 861 regulations (§1.861-8 through §1.861-14T) for purposes of allocating rents and royalties.

  - *Related-party determination.* The proposed rules provide that the related-party determination is made on the date the relevant item is received or accrued.

KPMG observation

The lack of a cream-skimming rule for Income Test purposes is helpful for companies that otherwise would need to monitor a related payor's passive income in order to avoid characterizing the recipient tested foreign corporation's income as passive, such as private equity structures where a finance company is brother sister to an operating company.

KPMG observation

The proposed rule for allocating dividends is consistent with the legislative history, which provides that dividends should be allocated based on earnings and profits. Under the proposed rule, even

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dividends that are paid out of accumulated earnings and profits are allocated based on current year earnings and profits. This rule seems reasonable from an administrative perspective because it avoids the potential burden of determining whether a PFIC's accumulated earnings and profits are passive or non-passive. The application of the rule is expected to be quite limited because, in most cases, a dividend that would qualify for the related-party dividend rule also would be subject to the Look-Through Rule (discussed later in the document), which generally would result in the elimination of the dividend.

- **Partnership income.** The statute does not provide guidance for determining whether a distributive share of partnership income is passive for Income Test purposes. The proposed rules provide two standards, based on whether the tested foreign corporation directly or indirectly owns at least 25% of the value of the partnership. If the ownership threshold is satisfied, the tested foreign corporation's distributive share of partnership income is characterized as passive or non-passive based on the underlying income of the partnership (as if the tested foreign corporation directly received its share of the partnership's income). For purposes of applying the passive income exceptions that are based on the active conduct of a trade or business, only the activities of the partnership are taken into account. The distributive share of partnership income for a tested foreign corporation that does not satisfy the 25% ownership threshold in the partnership is *per se* passive.

KPMG observation

The treatment of a distributive share of partnership income as passive when a tested foreign corporation owns less than 25% of a partnership is sure to attract comments. Indeed, the inclusion of this rule (along with the corollary rule for partnership interests in the asset test, discussed below) arguably turns this regulatory package from one that is generally "taxpayer-friendly" to one that gives and takes, as many will see the inclusion of this rule resulting in more passive income than they may have understood to be the case under prior law. The proposed rule departs from the general treatment of a distributive share of partnership income for subpart F purposes, which does not have an ownership threshold. On the other hand, as noted in the preamble, the 25% threshold is consistent with the threshold for the corporate look through rule, and seems to reflect an intent to neutralize choice of entity considerations in the PFIC context; this threshold presumably will neutralize the benefit of a common joint venture structuring technique where parties elect to treat the joint venture holding vehicle as a partnership to avoid passive treatment of less than 25% corporate stock positions. Comments were specifically requested on the 25% threshold, which could indicate an openness to consider lower thresholds or no thresholds.

- **Consolidated group dividends**. The proposed rules provide that intercompany dividends received from a consolidated group member are taken into account for PFIC income test purposes, even though the dividends would be excluded from gross income under the consolidated return rules.

KPMG observation

It is curious that a rule on consolidated group dividends was included in the proposed rules because of the very limited situations in which the rule would apply.

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Asset test

Methodology

As mentioned above, a PFIC is a foreign corporation that meets the Income Test (discussed above) or the Asset Test. A tested foreign corporation satisfies the Asset Test if the average percentage of assets held by the corporation during the tax year that produce passive income or that are held for the production of passive income is at least 50%. For this purpose, assets may be measured based on either their fair market value or adjusted bases, depending on the particular tested foreign corporation.

The proposed rules are generally consistent with Notice 88-22, but also offer additional guidance with respect to the application of the Asset Test.

- **Weighted average.** The proposed rules provide that the average percentage of assets held by a tested foreign corporation during its tax year is determined based on the average of the fair market values (or the average of the adjusted bases, if required) of the passive assets and total assets held by the foreign corporation on the last day of each measuring period ("measuring date") of the foreign corporation's tax year.

  The average of the fair market values (or the average of the adjusted bases, if applicable) of the foreign corporation's passive assets or total assets for the tax year is equal to the sum of the values (or adjusted bases) of the passive assets or total assets, as applicable, on each measuring date of the foreign corporation's tax year, divided by the number of measuring dates in the tax year.

KPMG observation

The proposed rules do not provide an example, but it appears that the rules work thus: Assuming a tested foreign corporation has a quarterly measuring period (discussed below), and has passive/total assets at the end of each quarter of w/r, x/s, y/t, and u/z, the average for the tax year is expressed as $(w + x + y + z)/4$ divided by $(r + s + t + u)/4$, whereas an alternative approach would be expressed as $(w/r + x/s + y/t + u/z)/4$.

KPMG observation

This new guidance from the proposed rules largely follows the averaging method of Notice 88-22, but clarifies that a taxpayer cannot use the average of quarterly asset value ratios to calculate the percentage of passive assets for the Asset Test. This restriction arguably was ambiguous both under Notice 88-22 and the statute, and may be consequential for taxpayers that have previously been using an alternative method—as in many circumstances different methods produce different results.

- **Quarterly measuring, but election available for more frequent measuring.** The proposed rules generally provide for quarterly measuring periods, consistent with Notice 88-22, but also allow a taxpayer to elect a shorter period, such as a weekly or monthly measurement period. If a shorter period is elected, the shorter period must be used consistently for all subsequent years, unless the election is revoked.

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- **Short tax year rules.** If a tested foreign corporation has a tax year that is less than 12 months, the average values are determined based on the measuring dates of the short tax year by treating the last day of the tax year as a measuring date. For example, the preamble explains that, absent an election for more frequent measurement, a foreign corporation with a short tax year of eight months (that began on its "normal" date) would have two "normal" quarter end measuring dates and a third quarter ending on the last day of the short tax year.

- **Foreign corporations that are publicly traded for less than entire year.** The statute provides that a tested foreign corporation must use the fair market value of its assets for the Asset Test if it is a publicly traded corporation for the tax year. A CFC must use the adjusted bases of its assets for the Asset Test, unless it is publicly traded for the year. Tested foreign corporations that are neither publicly traded nor CFCs use fair market value unless an election to use adjusted basis is made.

  The proposed rules provide that a tested foreign corporation that is publicly traded for less than the entire year must use the fair market value for the entire year if the corporation was publicly traded on the majority of the days of the year.

KPMG observation

The application of the Asset Test to a CFC that is publicly traded for only part of the year raises issues because CFCs are required to use adjusted basis while publicly traded corporations are required to use fair market value. This issue is more common under the new U.S. tax rules, which increased the number of CFCs as a result of a change to the subpart F constructive ownership rules. The proposed rule resolves the issue by requiring the use of fair market value only if the CFC is publicly traded for more than half the year. This arguably departs from the legislative history, which indicates that the publicly traded rule should apply if the tested foreign corporation is publicly traded on *each* quarterly measuring date.

- **Procedural rules for elections and revocations.** The proposed rules provide guidance for making the election to use a shorter measuring period or to use adjusted bases of assets for the Asset Test. Under the proposed rule, a taxpayer makes an election either on Form 8621 (if the taxpayer is required to file that form) or by filing a written statement. An election generally may be revoked at any time in the same manner for making the election. However, once an election is revoked, either by the taxpayer or the Commissioner, a new election cannot be made until the sixth tax year following the year for which the previous election was revoked, and the new election cannot be revoked until the sixth tax year following the year for which the new election was made.

KPMG observation

The statute provides that a non-publicly traded corporation may elect to use adjusted basis to measure its assets, but prior to the proposed rules there was no guidance no how to make the election. Rather than having the tested foreign corporation make the election, the proposed rules allow an *owner* of the corporation to make the election. Both elections are made on an owner by owner basis, and although not explicit, appear to apply only to the owner that makes the election.

Dual-character assets

- **Assets that produce passive income and non-passive income.** The proposed rules generally

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follow the approach of Notice 88-22 with respect to assets that produce both passive and non-passive income during a tax year, generally providing that the assets are treated as two assets – one that is passive and one that is non-passive. The fair market value (or adjusted basis) of the asset is then allocated between the hypothetical passive and non-passive assets based on the ratio of passive income to non-passive income produced by the asset during the tax year.

- **Special rule for certain stock.** The proposed rules provide a special rule for stock of a related person for which no dividends are received or accrued during the tax year, but that previously generated non-passive income. The stock is similarly treated as two assets, one of which is passive and the other non-passive. The value is allocated between the two assets based on the dividends paid or accrued with respect to the stock for the two prior years, in proportion to the average percentages of the dividends that are characterized as passive and non-passive.

- **Assets that produce income and no income.** When only a portion of an asset produces income for the tax year, the proposed rules similarly treat the asset as two assets – one that is passive or non-passive based on the income that it produces and one that is characterized based on the income that it is held to produce. The proposed rules require the allocation between the two assets to be made using a method that "most reasonably reflects the uses of the property," which for real property is generally its physical use.

KPMG observation

Absent the proposed rule, an asset that produces both income and no income presumably would be characterized entirely based on the income that it generates. Under the proposed rule, the asset is characterized partly in accordance with the income it generates and partly in accordance with the purpose for which it is held, which seems more reflective of the true economics.

Partnership interests

As is the case with the treatment of a distributive share of partnership income for the Income Test, the proposed rules apply a 25% threshold for purposes of determining whether a partnership interest is a passive or non-passive asset. Under the proposed rule, for purposes of the Asset Test, a tested foreign corporation that owns (directly or indirectly) at least 25% of the value of a partnership is treated as if it held its proportionate share of the assets of the partnership. The tested foreign corporation's proportionate share of the partnership's asset generally is treated as passive or non-passive to the extent it was characterized as such in the hands of the partnership. If a tested foreign corporation owns less than 25% of a partnership, its interest in the partnership is treated as a passive asset for purposes of the Asset Test.

Dealer property

Under the exception for dealer property in section 954(c)(2)(C), gain from the disposition of property held in the dealer's trade or business is treated as non-passive income for purposes of the Income Test, while other types of income (such as dividends and interest) are treated as passive. For purposes of the Asset Test, the proposed rules follow the approach of Notice 88-22, and treat dealer assets that are subject to the exception in section 954(c)(2)(C) as non-passive. This means the dual-character asset rules discussed above are not applied to bifurcate such assets into passive and non-passive components.

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Treatment of stapled entities

Under section 269B, entities are considered "stapled" if, because of their ownership structure, restrictions on transfer, or other requirements, the entities must be transferred together. The proposed rules provide that for purposes of determining whether any stapled entity is a PFIC, stapled entities are treated as a single entity that holds all of the assets of the stapled entities, conducts all of the activities of the stapled entities, and derives all of the income of the stapled entities.

The preamble notes that this approach comports with the general understanding that stapled interests represent a single economic interest to their shareholders, and is consistent with the determination under section 269B(a)(3) of whether a stapled entity is a regulated investment company ("RIC") or real estate investment trust ("REIT"). The preamble also requests comments as to whether similar treatment should be provided for purposes of the subpart F rules.

KPMG observation

The proposed rules do not include any guidance under section 1298(b)(4), which provides Treasury with the authority to issue regulations to treat separate classes of stock in a corporation as interests in separate corporations for PFIC purposes. Nonetheless, Treasury chose to issue the stapled stock rule, which generally runs contrary to the section 1298(b)(4) authority. Rather than increasing the number of tested foreign corporations, the proposed stapled stock rule has the result of decreasing the number of tested foreign corporations (by treating separate corporations as a single corporation for PFIC purposes).

Look-through rules for 25% owned subsidiaries and certain domestic subsidiaries

Look-through subsidiary rules

In determining PFIC status when applying the Income Test and Asset Test, the statute provides a general look-through rule when a tested foreign corporation owns, directly or indirectly, at least 25% of the value of the stock of another corporation (a "Look-Through Subsidiary" or "LTS") (the "Look-Through Rule"). Under the Look-Through Rule, a tested foreign corporation generally is treated as directly owning its proportionate share of the assets and directly receiving its proportionate share of the income of the LTS. The proposed rules provide helpful guidance for applying the Look-Through Rule.

- **Constructive ownership rules.** The statute does not provide a methodology to calculate a tested foreign corporation's indirect ownership in another corporation for purposes of determining whether the subsidiary corporation is an LTS. The proposed rules provide that indirect stock ownership for this purpose is determined in accordance with section 958(a) ownership principles, applied without regard to whether intermediate entities are domestic or foreign.

KPMG observation

Prior to the proposed rule, there may have been some uncertainty as to whether a subsidiary held

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through a chain could be an LTS when a tested foreign corporation did not indirectly own 25% of a lower-tier subsidiary, but did own 25% of an intermediate corporation that owned 25% of the lower-tier subsidiary. Although not directly addressed in the preamble or the operative sections of the proposed rules, it seems the tested foreign corporation in the structure would not be treated as owning the lower-tier subsidiary under the proposed rules, as reflected in Prop. Reg. §1.1297-2(b)(3), *Example 1*.

- **Determination of ownership in an LTS.** For purposes of the Asset Test, a subsidiary is treated as an LTS for a measuring period if the 25% ownership threshold is satisfied on the last day of the measuring period. For purposes of the Income Test, a subsidiary generally is treated as an LTS if the tested foreign corporation owns an average of 25% of the value of the subsidiary, based on the ownership on the last day of each measuring period during the year. If the 25% threshold is not satisfied, a special rule can apply in certain cases that would treat the subsidiary as an LTS for only some of the periods during the year. These rules are meant to address situations in which a tested foreign corporation's ownership in a subsidiary varies during the tax year.

- **"Proportionate share" of an LTS's assets and income.** The statute does not provide guidance on the meaning of the term "proportionate share" for purposes of the Look-Through Rule. The proposed rules address this issue by providing 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 LTS in proportion to the tested foreign corporation's percentage ownership interest by *value* in the LTS.

- **Elimination of intercompany assets and income.** Notwithstanding that the legislative history to the PFIC rules provides that the Look-Through Rule should be applied in a manner that does not result in double-counting, the statute does not explicitly address the double-counting of income and assets between a tested foreign corporation and an LTS.

  - *Elimination of dividends and interest (and related assets).* The proposed rules provide that intercompany payments of dividends and interest between an LTS and a tested foreign corporation (and the corresponding stock and loan receivables) generally are eliminated in applying the Income Test and Asset Test. Similarly, intercompany payments of interest and dividends between LTSs of a tested foreign corporation are eliminated. The proposed rules, however, provide that dividends are not eliminated to the extent they are attributable to income of an LTS generated before the tested foreign corporation owned 25% of the value of the LTS (and, thus, before the tested foreign corporation was treated as directly receiving the income of the LTS for PFIC purposes). Further, if a tested foreign corporation owns less than 100% of an LTS, the proposed rules limit the elimination of the interest and debt receivables in proportion to the tested foreign corporation's direct ownership in the LTS. Similar elimination treatment applies to certain intercompany transactions between a tested foreign corporation and a partnership in which the tested foreign corporation owns at least 25% of the value ("Look-Through Partnership" or "LTP").

  - *Elimination of other income items (and related assets).* Treasury requested comments on whether the proposed income and asset elimination mechanism under the Look-Through Rule should be expanded to apply to rents, royalties, or any other types of intercompany income (and related assets).

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KPMG observation

The proposed rules on the elimination of dividends and interest payments (and the corresponding assets) are generally consistent with the legislative history. The lack of a similar rule for other types of income (and related assets) is surprising because similar policy reasons could support eliminating the items. The request for comments could raise questions as to Treasury's views on the elimination of such items under current law.

FPHCI active rent/royalty exception: attribution of activities from certain LTS and LTP

Rents and royalties that satisfy the FPHCI active rent or royalty exception are considered non-passive for PFIC purposes. Under the FPHCI rules, the exception generally applies only if officers and employees of the relevant entity perform certain activities. For this purpose, activities of officers and employees of related entities are not taken into account. The proposed rules modify the application of the FPHCI active rent and royalty exception for PFIC purposes by allowing the activities of the officers and employees of any LTS and LTP in which the tested foreign corporation owns more than 50% (by value) to be taken into account by the tested foreign corporation, in addition to the activities of the officers and employees of the tested foreign corporation. Comments were requested on whether the rule attributing activities of related entities should be extended to other provisions, such as the PFIC banking exception.

KPMG observation

The real estate industry has long advocated for a rule that would allow attribution of activities for purposes of the FPHCI active rent exception. The proposed activities attribution rule is favorable and particularly significant for non-U.S. corporate groups engaged in real estate and certain IP trades or businesses that generally locate property (e.g., real property) in separate entities from those entities with the employees and activities. Absent this rule, the rent and royalty income generated by such active businesses (and the related assets) would be treated as passive, resulting in increased PFIC exposure. Nonetheless, the favorable rule is somewhat limited; it applies only if a tested foreign corporation owns at least 50% of an LTS or LTP. Further, the rule doesn't apply to attribute activities of a tested foreign corporation to an LTS, or to attribute activities between two LTSs of a tested foreign corporation. It is worth considering whether it would have been more appropriate to expand the rule to a broader related-party concept, similar to the active commodities related-party rules in §1.952-2(f)(2)(iii)(D). Under the rule as proposed, many typical existing structures would not benefit from the new relaxed activities testing rules, because activities are in the "wrong" place in the structure, even if business exigencies otherwise require them to be there. Taxpayers should review current and pending structures to identify the location of activities and assets within the holding structure for PFIC testing purposes and determine whether those assets or activities are located in such a manner as to take advantage of this new proposed provision.

Gain on the disposition of LTS stock

The statute does not explicitly address the treatment of a tested foreign corporation's gain on the disposition of an LTS. The proposed rules treat the disposition of an LTS as the disposition of stock, and compute gain accordingly, with certain adjustments for "undistributed earnings" in order to avoid double-counting. The proposed rules treat the adjusted gain amount as passive or non-passive in proportion to

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the passive and non-passive assets of the LTS (and any other indirectly transferred LTS) on the date of the disposition.

KPMG observation

The proposed rule generally is favorable and consistent with private letter rulings issued by the IRS. In addition, it is consistent with a rule that applies to the disposition of an LTP under the FPHCI partnership look-through rule.

Application of related-party exception to LTS and LTP income

For purposes of applying the PFIC related-party exception to LTS or LTP income taken into account by a tested foreign corporation, the proposed rules provide that the relatedness determination is made with respect to the LTS or LTP, and not the tested foreign corporation. As a result, the related-party exception could apply if the payor is related to the LTS or LTP, regardless of whether the payor is related to the tested foreign corporation.

KPMG observation

The application of the related-party look-through exception to LTS income taken into account by a tested foreign corporation arguably has been unclear where the payor of an item of income is a "related person" with respect to either the tested foreign corporation or the LTS, but not with respect to both. The proposed rule is helpful clarification on the interaction of the related-party exception with the LTS and LTP rules.

Overlap of "Look-Through Rule" and "Domestic Subsidiary Stock Rule"

In addition to the generally applicable Look-Through Rule, the statute also provides a special look through rule that that can apply when a tested foreign corporation owns at least 25% of the value of a domestic corporation that, in turn, owns stock of a domestic corporation (other than a RIC or REIT). In that case, provided the tested foreign corporation is either subject to the accumulated earnings tax ("AET") or otherwise waives any treaty benefits that would otherwise preclude application of the AET, the stock of the second-tier domestic corporation is treated as a non-passive asset, and dividends from the second-tier domestic corporation are treated as non-passive income, regardless of the character of the corporation's underlying assets and income (the "Domestic Subsidiary Stock Rule"). In many instances, the Look-Through Rule and Domestic Subsidiary Stock Rule by their terms both apply to a second-tier domestic corporation. Curiously, neither the statute nor the current guidance provide an ordering rule between the two look through rules. The proposed rules provide guidance on the interaction of the two rules, as well as the application of the Domestic Subsidiary Stock Rule.

- **Domestic Subsidiary Stock Rule has priority over Look-Through Rule.** The proposed rules provide that the Domestic Subsidiary Stock Rule generally takes precedence over the 25% Owned Look-Through Rule when both rules would otherwise each apply. However, the proposed rules would introduce new anti-abuse rules that significantly restrict the potential application of the Domestic Subsidiary Stock Rule. First, the proposed rules include a per-se anti-abuse rule that precludes application of the Domestic Subsidiary Stock Rule if the tested foreign corporation would be a PFIC if the second-tier domestic corporation stock (or any income received by the first-tier

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domestic corporation with respect to the stock) were disregarded. The proposed rules also include a second anti-abuse rule that applies if "a principal purpose" for the tested foreign corporation's formation or acquisition of the first-tier domestic corporation is to avoid classification of the tested foreign corporation as a PFIC. A principle purpose is deemed to exist if the if the domestic corporation is not engaged in an active trade or business in the United States.

- **AET and waiver of treaty benefits.** The proposed rules clarify that the AET does not need to be imposed on a tested foreign corporation in order for the corporation to apply the Domestic Subsidiary Stock Rule. In addition, the proposed rules provide a procedure for waiving treaty benefits for purposes of the Domestic Subsidiary Stock Rule.

KPMG observation

For some taxpayers, the Domestic Subsidiary Stock Rule has been an attractive planning tool to avoid PFIC classification for corporate holding or investment companies that otherwise have substantial passive assets. In light of the proposed anti-abuse rules, the rule prioritizing the Domestic Subsidiary Stock Rule over the Look-Through Rule may be a pyrrhic victory for taxpayers. Broadly speaking, the anti-abuse rules largely may preclude taxpayers from availing themselves of the Domestic Subsidiary Stock Rule as a means to avoid PFIC treatment.

KPMG observation

In the preamble discussion, Treasury appears to justify prioritizing the Domestic Subsidiary Stock Rule over the Look-Through Rule solely based on a canon of statutory interpretation: a more specific rule controls a general rule. There was no discussion of any policy reason for prioritizing the Domestic Subsidiary Stock Rule or any explanation of the policy underlying the rule itself. It would be useful to understand Treasury's view on the underlying policy and benefits of the Domestic Subsidiary Stock Rule, particularly because some taxpayers will be disadvantaged by not being to apply the Look-Through Rule to a second-tier domestic subsidiary.

Change of business exception

Under the statute, a foreign corporation generally is not treated as a PFIC if (1) neither the corporation (nor its predecessor) was a PFIC for any prior tax year, (2) it is established to the satisfaction of the Secretary that substantially all of the passive income of the corporation for the tax year is attributable to proceeds from the disposition of one or more active trades or businesses and the corporation will not be a PFIC for either of the first two tax years following such tax year; and (3) the corporation is not a PFIC for either of the two tax years ("change of business exception"). The proposed rules provide guidance on the change of business exception, including the application of the exception to LTS.

KPMG observation

Although the title of the subsection for the change of business exception is "certain corporations *changing business*," and the legislative history describes the exception as a rule for corporations switching businesses, there is no such requirement in the statute. The preamble helpfully

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acknowledges that a tested foreign corporation does not need to engage in a new business in order for the change of business exception to apply.

- **Extension to assets.** Under the proposed rules, the change of business exception can apply based on either income or assets. Consistent with the statute, the exception can apply if substantially all of the passive income of the tested foreign corporation is attributable to proceeds from the disposition of an active trade or business. As an alternative, the exception also can apply if, following the disposition of an active trade or business, substantially all of the passive assets of the tested foreign corporation on the remaining measuring dates in the year of disposition are attributable to the proceeds from the disposition.

KPMG observation

In its current formulation, the statutory rule has very limited application. The proposed rules' extension of the exception to assets is a helpful expansion of the exception. However, the proposed rules supply no definition of "substantially all" for purposes of the change of business exception. This is a particularly unhelpful omission as the term is widely-used throughout the Code, and does not have a consistent meaning.

- **Income attributable to disposition proceeds.** The proposed rules provide that income is attributable to the disposition of an active trade or business only to the extent that the income is derived from the disposition proceeds.

- **Extension to LTS.** The proposed rules extend the change of business exception to apply to the disposition of stock of a LTS that was engaged in an active trade or business. Under the proposed rule, for purposes of the change of business exception, a disposition of stock of an LTS is treated as a disposition of a proportionate share of the assets held by the LTS on the date of the disposition. Accordingly, for purposes of the change of business exception, the proceeds attributable to assets used by a LTS in an active trade or business are proceeds from the disposition of an active trade or business.

KPMG observation

The proposed rule for gain on the disposition of LTS stock is consistent with private letter rulings issued by the IRS on the subject.

- **Definition of active business**. Under the proposed rules, the term active trade or business is defined by cross-reference to the section 367 regulations, with certain modifications relating to officers and employees of related entities.

- **Year of applicability.** The proposed rules provide that the change of business exception can be applied to either the tax year of the disposition of an active trade or business, or the immediately succeeding tax year (but cannot be applied with respect to more than one tax year). As described in the preamble, this rule is meant to address situations where the proceeds from the disposition are received over a two year period.

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Insurance rules

As described above, the proposed rules include guidance relating to whether a foreign insurance company may be treated as a QIC engaged in the active conduct of an insurance business. Income derived from the active conduct of an insurance business by a QIC is excluded from passive income for purposes of determining if the foreign insurance company is a PFIC. The proposed rules provide guidance on whether a foreign corporation is a QIC, and what constitutes the "active conduct" of an "insurance business". The proposed rules also provide guidance on the application of the Look-Through Rule in the insurance context, and on the treatment of a domestic insurance subsidiary of a foreign insurance company.

Sections 1297(b)(2)(B) and 1297(f)

Section 1297(b)(2)(B) was amended in the new U.S. tax law to require that in order to exclude a foreign insurance company's income from the definition of passive income for purposes of determining PFIC status, it must be "derived in the active conduct of an insurance business by a QIC". The new law also introduced new section 1297(f) to provide the definition of a QIC. Section 1297(f) set forth a new requirement that the entity's "applicable insurance liabilities" are more than 25% of the entity's total assets (the "25% test"). A special rule applies which reduces the threshold to 10% of total assets (the "10% test") where the foreign insurance company is in run-off or if the company failed to meet the 25% test because of rating-related circumstances. Section 1297(f) also retained an element of former 1297(b)(2)(B) which requires that the foreign insurance company would be taxed as an insurance company under Subchapter L were it a domestic corporation.

Requirements for a foreign insurance company to be treated as a QIC

The proposed rules require that in order for a foreign insurance company to be treated as a QIC, it must (1) be an insurance company as defined in section 816(a) that would be taxed under Subchapter L if it were a domestic company, and (2) meet the 25% test (or the 10% test if applicable). In order to meet the requirements of Subchapter L, more than half of an entity's business during the tax year must be the issuance of insurance contracts or annuities and/or the reinsurance of such contracts. *See* section 816(a). In order to be a QIC, a foreign insurance company must have "applicable insurance liabilities" that exceed 25% (or 10% if the 10% test applies) of its "total assets."

"Applicable insurance liabilities" are defined to include losses that have occurred for which the foreign corporation has become liable but has not yet paid, before the end of the last annual reporting period ending with or within the tax year, including unpaid claims for death benefits, annuity contracts, and health insurance benefits, unpaid expenses of investigating and adjusted unpaid losses and, in the case of life, health and annuity business, reserves, i.e., amounts actually paid during the year are not included in determining applicable insurance liabilities.

Applicable insurance liabilities are determined based on the company's "applicable financial statement," but the amount of the applicable insurance liabilities is capped at the lesser of (1) the amount shown in the applicable financial statement, (2) the minimum amount of applicable insurance liabilities required by the applicable law or regulation of the jurisdiction of the applicable regulatory body; or (3) the amount shown on the most recent financial statements determined under U.S. GAAP or IFRS, even if the financial statement was not prepared for financial reporting purposes.

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In the case of an applicable financial statement that is not prepared under U.S. GAAP or IFRS, if the statement does not discount losses on an economically reasonable basis, the foreign corporation must reduce its applicable insurance liabilities to reflect an appropriate discount rate, i.e., a discount rate that would apply under U.S. GAAP or IFRS.

The proposed rules provide that an insurance business is the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, as well as the investment activities and administrative services that are required to support, or are substantially related to, the insurance, annuity, or reinsurance contracts issued or entered into by the QIC. At least 50% of the entity's business must be insurance business for the entity to qualify as a QIC.

In determining if the foreign entity is actively conducting an insurance business, the officers and employees of the foreign insurance company must carry out substantial managerial and operational activities. A QIC's officers and employees may include the officers and employees of certain companies related to the owner of the QIC. This requirement is more generous than the rule stated in proposed regulations issued under the previous version of section 1297(b)(2)(B) in 2015, but third party administrators cannot be used to do the majority of managerial and operational activities.

Eligibility for the 10% test of companies in runoff and companies subject to rating-related circumstances

If a corporation fails to be a QIC solely due to failing the 25% test described above, it may elect to qualify as a QIC under a reduced 10% test provided that the failure is due to either rating-related or run-off related circumstances.

"Rating-related circumstances" occur when a rating agency requires a foreign corporation to maintain a level of capital to achieve a minimum credit rating for the foreign corporation to be "classified as secure to write new insurance business for the current year." The preamble states that the proposed rule is "intended to apply to the highest minimum credit rating required to be classified as secure to write new insurance business for any line of insurance business."

A company will not be considered in runoff unless it has adopted a plan of liquidation or termination of operations.

In order for a company to qualify for the 10% test, section 1297(f)(2)(B)(i) requires that the company be "predominantly engaged in an insurance business". The proposed rules make clear that the "predominantly engaged" requirement is over and above the general requirement that a QIC be engaged in the active conduct of an insurance business. The proposed rules state that whether a company is "predominantly engaged in an insurance business" is a facts and circumstances test, and the proposed rules provides a list of four facts and circumstances to consider in determining whether a foreign corporation is predominantly engaged in an insurance business, as well as three examples of facts indicating a foreign corporation is not predominantly engaged in an insurance business.

Look-Through Rules

In applying the Look-Through Rules in the insurance context, the proposed rules operate as follows: income and assets that are passive in the hands of a look-through subsidiary or look-through partnership may be treated as active by a direct or indirect parent that is a QIC. Under this provision, the tested

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foreign corporation is treated as if it directly holds its proportionate share of the assets and as if it directly receives its proportionate share of the income of the look-through subsidiary or look-through partnership. If the tested foreign corporation is a QIC, the income and assets are tested under the proposed rules to determine if they qualify for the section 1297(b)(2)(B) insurance exception to passive income.

However, in order for the income and the assets of a look-through subsidiary or partnership to be tested in the hands of the QIC, the look-through subsidiary or partnership must have its assets and liabilities included in the applicable financial statement of the foreign corporation for purposes of the 25% test and the 10% test.

Qualifying domestic insurance corporations

The proposed rules provide that income of a qualifying domestic insurance corporation is not treated as passive income, and assets of a qualifying domestic insurance corporation are not treated as passive assets. A qualifying domestic insurance corporation is a domestic corporation that is subject to tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Code and is subject to Federal income tax on its net income.

This rule is intended to address situations where a tested foreign corporation owns a domestic insurance corporation through a structure to which section 1298(b)(7) does not apply.

KPMG observations

The proposed rules would impose a significant burden on any foreign insurance company that seeks to avoid PFIC status. Even those companies whose applicable insurance liabilities exceed the 25% threshold may find it difficult to maintain the kind of documentation that would be needed to demonstrate that the 25% test is met.

It will be disappointing to taxpayers and their advisors that two features that were requested in comments on section 1297(f) were not incorporated in the proposed rules. The first is that only unpaid liabilities and reserves are taken into account for determining applicable insurance liabilities; amounts actually paid are not taken into account. This means for example that a company that comfortably met the 25% test on December 30 might find itself falling short if a large amount of claims are paid on December 31. There is also no coherent reason why a taxpayer should be treated differently depending on whether claims are paid on December 31 or January 1.

A second disappointing feature of the proposed rules is that they make no accommodation for insurance companies that, by the nature of their business, hold low reserves and a large amount of assets, such as companies that provide catastrophe cover or terrorism insurance. In fact, quoting legislative history, the preamble expresses the view that companies with "a small number of insured risks with low likelihood but large potential costs" looks less, not more, like an insurance company.

The rule set forth in the Code under section 1297(f)(3)(B) limits the amounts that may be treated as applicable insurance liabilities to those amounts reported to the applicable insurance regulatory body in the applicable financial statement. Prior to the issuance of the proposed rules, tax advisors devoted most of their attention to thinking about how to identify the "applicable financial statement". However, the proposed rules add an additional layer of complexity by further limiting the applicable insurance liabilities (even if less than those shown on the applicable financial

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statement) to the lesser of (1) the "minimum amount" required under law or regulation by the insurance regulator, and (2) the most recent U.S. GAAP or IFRS financial statement even if the financial statement is not an "applicable financial statement" because it was not prepared for financial reporting purposes (a term which is not even defined in the proposed rules).

The difficulties associated with establishing a foreign insurance company's status as a qualifying insurance corporation are exacerbated by certain ambiguities in the proposed rules. For example, limiting the amount of the applicable insurance liabilities to the "minimum amount" required by the regulator would seem to suggest that the cap is not the amount actually required or permitted by the regulator. This interpretation is supported by the preamble to the regulations, which states that it is appropriate to cap applicable insurance liabilities at the lesser amount "even if the foreign corporation's regulator would accept a higher liability amount for regulatory purposes." The proposed rules apparently give no weight at all to the foreign insurance company's actual liabilities shown on the financial statement even where a regulator requires the company to hold assets commensurate with those actual required liabilities. Furthermore, the proposed rules do not provide meaningful guidance on how the minimum amount should be determined.

Even more daunting are the obstacles to companies qualifying for the 10% test as a run-off company or because of rating-related circumstances. In the case of a run-off company, the company will not be permitted to apply the 10% test unless the company has a plan of liquidation or termination, which is not currently typical for companies in run-off.

The rule for determining whether a company is entitled to apply the 10% test because of rating-related circumstances is rife with ambiguity. The higher level of surplus must be "required" by the rating agency – however numerous factors go into determining a company's credit rating. Hopefully the final regulations will better define the minimum rating requirement.

The rules make clear that the election of the 10% test is made by the shareholder, based on information provided by the corporation. This election bears some resemblance to the process required for a U.S. shareholder of a PFIC to make a QEF election, where the PFIC is required to provide information to the shareholder sufficient to allow the shareholder to prepare its tax return. Unlike the QEF election, however, the election of the 10% test will be invalid if the shareholder knew or had reason to know that the statement made by the foreign corporation regarding eligibility for the 10% test was incorrect. This "knew or had reason to know" test perhaps makes sense in the context of a closely held company with a small number of shareholders that would have access to information, but would be difficult, or impossible, to apply in the case of widely-held companies. The difficulties that shareholders have faced in obtaining the information necessary to make a comparatively simple QEF election do not bode well for the shareholder who wishes to elect the 10% test. The final regulations should provide further guidance on the circumstances under which a shareholder would be deemed to know or have reason to know that a statement from the foreign corporation is untrue.

The proposed rules provide no guidance regarding how a taxpayer is to identify the applicable financial statement where the foreign insurance company does not have a stand-alone financial statement, e.g., where there is only a consolidated financial statement. In the absence of guidance, the implication is that a foreign insurance company that cannot identify any stand-alone financial statement has no applicable insurance liabilities. However, because the application of the look-through rule to a foreign insurance company and a look-through subsidiary requires that the insurance company and the subsidiary be included within the same applicable financial statement, the implication is that the available financial statement will drive the analysis of whether the foreign insurance company is a QIC, as opposed to permitting taxpayers that seek to treat a foreign

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insurance company as a QIC to use whatever financial statements are available, whether stand-alone or not, to determine whether the 25% test or 10% test is met. Also problematic in relation to the requirement that a look-through subsidiary be included in the applicable financial statement is that many regulators around the world require stand-alone financial statements for the regulated entity with subsidiaries accounted for on the equity method and not consolidated. It's not clear whether the assets of an equity method investee meet the requirement of being included in the applicable financial statements. Again, hopefully this issue will be addressed in the final regulations.

Applicability dates and reliance

The proposed rules are proposed to apply to tax years of shareholders beginning on or after the date the final regulations are published. Prior to finalization, taxpayers may rely on the proposed rules, provided they consistently apply all of the proposed rules. The proposed rules on insurance can be relied on for tax years beginning after December 31, 2017, while the other proposed rules can be relied on for all open tax years of the taxpayer.

Additionally, the preamble states that taxpayers may continue to rely on Notice 88-22 until the proposed rules are finalized.

Comment period and hearing

The preamble to the proposed rules includes a number of specific requests for comments. Any comments or requests for a public hearing must be received by September 9, 2019.

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