Final and proposed regulations, passive foreign investment company (PFIC) rules

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Introduction

Final regulations (T.D. 9936) (the "2021 final regulations") and proposed regulations (REG-111950-20) (the "2021 proposed regulations") concerning passive foreign investment company ("PFIC") rules are published in the Federal Register on January 15, 2021.

The 2021 proposed regulations also contain rules related to qualified business asset investment ("QBAI") announced in Notice 2020-69, 2020-39 I.R.B. 604.

Read the text of the **2021 final regulations** [PDF 496 KB] (64 pages) and the **2021 proposed regulations** [PDF 348 KB] (29 pages).

The Internal Revenue Service ("IRS") and the Department of the Treasury (collectively, "Treasury") on December 4, 2020, released an unofficial advance copy of these final regulations and proposed regulations.

This report provides initial impressions and observations about the regulations.

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Background

Generally, a PFIC is a foreign corporation (a "tested 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"), which was modified 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" or "TCJA"). Another exception is income derived by a bank in the active conduct of a banking business ("active banking exception"). Guidance on the active banking exception is provided in Notice 89-81, 1989-2 C.B. 399, and in proposed regulations published in the Federal Register on April 28, 1995 (INTL-0065-93) (the "1995 proposed regulations").

The 2021 final regulations finalize proposed regulations (REG-105474-18) (the "2019 proposed regulations") concerning PFICs. The 2019 proposed regulations addressed many lingering issues concerning the general rules for PFICs and provided rules under section 1297(b)(2)(B), as revised, and section 1297(f), as added by the TCJA to address insurance companies. For a more detailed discussion of the 2019 proposed regulations, read a **KPMG report** [PDF 465 KB].

The 2021 final regulations largely adopt the framework of the 2019 proposed regulations with certain changes responsive to comments, some of which are expanded upon in the 2021 proposed regulations. The 2021 final regulations also finalize without change the rule in separate proposed regulations (REG-104223-18) published in the Federal Register on October 2, 2019, which addressed the application of the Asset Test to tested foreign corporations that are controlled foreign corporations ("CFCs") as a result of the repeal of section 958(b)(4). For a more detailed discussion of these proposed regulations, read a **KPMG report** [PDF 1.25 MB].

The 2021 final regulations also withdraw certain portions of Notice 88-22, 1988-1 C.B. 489, which provided guidance on the application of the Income Test and Asset Test. The 2021 proposed regulations would revise certain rules described in Notice 88-22 and would finalize the remaining rules that are not withdrawn in the 2021 final regulations.

In addition, the 2021 proposed regulations would modify certain rules in the 2021 final regulations concerning the elimination of intercompany dividends, the treatment of gain on the disposition of stock of a look-through subsidiary rule, the domestic subsidiary stock rule, the QIC determination, and the determination of whether a QIC is engaged in the active conduct of an insurance business. They also

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propose new rules that would address the use of financial statements and the treatment of working capital for purposes of the Asset Test.

The 2021 proposed regulations also include rules determining qualified business asset investment for purposes of the foreign-derived intangible income ("FDII") deduction under section 250 and the global intangible low-taxed income ("GILTI") rules under section 951A. The 2021 proposed regulations implement Notice 2020-69, which provides that the technical amendment to section 168(g) made by the Coronavirus Aid, Relief, and Economic Security ("CARES") Act (Pub. L. No. 116-136) applies to determine the adjusted basis of property under section 951A(d)(3) as if it originally had been included in TCJA and, thus, enacted on December 22, 2017.

General rules

Attribution for determination of ownership

The 2021 final regulations modify rules in the 2019 proposed regulations addressing attribution of PFIC stock through pass-through entities and non-PFIC foreign corporations. The statutory attribution rules generally treat stock owned by a partnership, estate, or trust as owned proportionately by its partners or beneficiaries, regardless of their level of ownership. However, a U.S. person that owns a non-PFIC corporation is treated as owning stock owned by the non-PFIC only if the U.S. person owns at least 50% of the value of the non-PFIC. The 2019 proposed regulations were intended to resolve inconsistency between the application of the rules under a "top-down" approach, under which a U.S. person's ownership was analyzed by considering its ownership successively down a chain of entities that includes both a pass-through entity and a non-PFIC corporation, and the inverse "bottom-up" approach (i.e., considering ownership successively up the chain) by adopting the former. Under the taxpayer-favorable approach of the 2019 proposed regulations, a U.S. person would have been considered to own stock of a non-PFIC corporation through a partnership only if it owned at least 50% of the partnership.

However, in response to a comment that the proposed rule would inappropriately prevent attribution to a partner that indirectly through multiple chains did own at least 50% of the non-PFIC corporation, the 2021 final regulations adopt a more general rule that does not require at least 50% ownership of the partnership. Under the new rule, the "top-down" approach is implemented by providing that a person is treated as actually owning its proportionate share of stock owned by an entity directly held by the person for further attribution. The 2021 final regulations include an example of the issue highlighted by the comment and illustrating the aggregation of ownership through multiple chains, including a chain involving a pass-through entity, to result in attribution of PFIC stock.

The 2019 proposed regulations requested comments as to whether a top-down approach to attribution also should be adopted for purely corporate chains of ownership. Although the preamble to the 2021 final regulations indicates that the only comment received argued that the rules should not be so extended, Treasury decided that consistent treatment with ownership through pass-through entities was appropriate. Accordingly, the 2021 final regulations do not modify attribution only for chains of ownership including pass-through entities, but rather generally modify the attribution rules for all chains of ownership. The preamble to the 2021 final regulations includes an example in which the pure top-down approach of the final rule results in a U.S. person being treated as owning more PFIC stock than it would have under either a bottom-up approach or the "top-down" approach in the 2019 proposed regulations.

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KPMG observation

Although the new approach of the 2021 final regulations is sensible as it relates to chains of ownership involving pass-through entities that have historically raised questions about the attribution rules, the immediate extension to other chains of ownerships is a surprise. Taxpayers will need to revisit their structures to understand whether the "top-down" approach of the 2021 final regulations is as unequivocally beneficial as that of the 2019 proposed regulations or whether it may have some negative consequences.

In response to a request for comments concerning attribution through nongrantor trusts, Treasury acknowledged the need for guidance but referred taxpayers to prior statements concerning the application of reasonable methods until such guidance is provided. Treasury also rejected a request to extend the rule addressing the overlap of PFIC status and CFC status ("CFC/PFIC overlap rule") to apply to all U.S. shareholders of all CFCs, including those under special rules for related party insurance income. Treasury indicated that the CFC/PFIC overlap rule is outside of the scope of the 2021 final regulations.

"Income Test"

The 2021 final regulations generally adopt the rules of the 2019 proposed regulations concerning gross income and the incorporation of the FPHCI rules for purposes of identifying passive income for the Income Test, although they more granularly identify the FPHCI provisions for which a tested foreign corporation is treated as a CFC when applying the Income Test. They do not adopt comment suggestions that income effectively connected with a U.S. trade or business should be excluded from passive income by reason of the exclusion in section 952(b). Furthermore, the 2021 final regulations confirm that section 954(i)'s exception from FPHCI for certain insurance income may not be taken into account in determining passive income, despite comments arguing for reversal of that position, partially based on arguments that the 2019 proposed regulations' incorporation of the active financing exception of section 954(h) ("active financing exception"), which, as discussed below, was substantially modified in the 2021 final regulations, should be extended to provide parallel treatment of qualified insurance income.

Active banking and financing rules

2021 final regulations

Significantly, the 2021 final regulations eliminate the proposed rule treating the active financing exception as applying for purposes of determining passive income generally. Treasury explains in the preamble to the 2021 final regulations that, in its view, allowing the active financing exception to operate via the general definition of passive income would be duplicative of the active banking exception in section 1297(b)(2)(A), contrary to the legislative history. Accordingly, Treasury is proposing a different and more limited, approach under which taxpayers may look to specific rules within the section 954(h) active financing exception in determining whether they meet the active banking exception (see next paragraph).

2021 proposed regulations

In light of the fact that final rules under section 1297(b)(2)(A) have never been issued, the 2021 proposed regulations contain rules that are based on elements of the active financing exception rules, and taxpayers are permitted to rely on the proposed rules or the previously proposed rules concerning the active banking exception in Notice 89-81 or the 1995 proposed regulations.

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KPMG observation

It had long been uncertain whether the PFIC definition of passive income incorporated the active financing exception or the insurance exception section 954(i). As evidenced by comments indicating that the active financing exception rule should be retained for PFIC purposes even when active banking guidance was finalized, the incorporation of the active financing exception in the 2019 proposed regulations was generally welcomed by taxpayers, both because of concerns about relying on proposed active banking guidance that was more than 20 years old and because the active financing exception may apply more broadly than such guidance. The new rules indicate that while Treasury was sympathetic to taxpayers' first set of concerns, it ultimately decided that a broader exception for financing income should not be blessed even for a temporary interval.

Regarding the active banking exception, the 2021 proposed regulations would treat as non-passive any income that would be excluded from FPHCI under the active financing exception if a tested foreign corporation were a CFC, provided that the tested foreign corporation is a foreign bank engaged in the active conduct of a banking business and the income is derived in the conduct of that banking business. The definition of foreign bank for this purpose would include the same foreign licensing and deposit-taking requirements as the 1995 proposed regulations, unless the 2021 proposed regulations provided a different rule. For example, instead of satisfying the additional lending activity requirement in the 1995 proposed regulations, the 2021 proposed regulations provide that a tested foreign corporation would need to carry out any of the activities listed in section 954(h)(4) as constituting a lending or finance business with respect to unrelated customers. Treasury explains in the preamble to the 2021 proposed regulations that the selective adoption of the section 954(h) rules is intended to ensure that certain service providers, such as payment service providers and money transmitters, are not treated as banks. Furthermore, by referring only to the active conduct of a banking business test in section 954(h) (specifically section 954(h)(2)(B)(ii)), and not including the lending and finance business test in section 954(h)(2)(B)(i), Treasury has proposed to narrow the cases in which taxpayers may rely on section 954(h) to meet the section 1297(b)(2)(A) exception to passive income, in comparison to the general cross-reference to the active financing exception in the 2019 proposed regulations.

The 2021 proposed regulations would incorporate the section 954(h) application of the exception to qualified business units of a bank. Moreover, because the 2021 proposed regulations would also treat related persons as CFCs to the extent relevant, activities of same country related persons could also be taken into account for purposes of determining whether income qualifies for the exception. However, Treasury rejected a comment to provide for broader attribution of activities among related persons and instead noted that the rules in Notice 89-81 or the 1995 proposed regulations concerning qualified bank affiliates may continue to be relied upon as an alternative to the 2021 proposed regulations. Treasury also rejected a comment suggesting that income from U.S. customers received by a domestic look-through subsidiary (as discussed in more detail below) should be able to qualify for the exception notwithstanding section 954(h)(3)(A)(ii)(I).

KPMG observation

The narrowing of the scope of the incorporation of the active financing exception into the active banking exception would not allow non-bank finance companies to qualify for the active banking exception. If finalized, this may impact private equity and other non-bank industries with finance groups that have relied on the 2019 proposed regulations to apply the active financing exception to treat income as non-passive for PFIC purposes for tax years ending on or before December 31, 2020. For tax years ending after 2020 and until the 2021 proposed regulations are finalized, as

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noted above, taxpayers who may previously have been comfortable that the active financing exception rules were automatically incorporated by the statutory definition of passive income could potentially continue to apply such rules until the 2021 proposed regulations are finalized. However, both the discussion in the preamble to the 2019 proposed regulations suggesting that Congress did not intend for all exceptions to FPHCI to apply for PFIC purposes and the preamble discussion in the 2021 proposed regulations specifically addressing the active financing exception arguably change the landscape when pondering the current viability of prior positions. It is unclear why, if Treasury thought it was appropriate to not require application of the much more limited rules in the 2021 proposed regulations until they are finalized, it felt the need to limit its blessing for the application of the active financing exception to years before 2021 instead of allowing the exception to be applied until fully reversed by the 2021 proposed regulations.

KPMG observation

Given that both Notice 89-81 and the 1995 proposed regulations would allow banking income of a domestic bank subsidiary of a tested foreign corporation to be treated as non-passive, it is unclear why Treasury declined to incorporate a similar rule in the 2021 proposed regulations. More generally, it is unclear why Treasury felt it was necessary to issue a third set of proposed rules concerning active banking income rather simply leaving taxpayers to rely on the existing proposed guidance. This is particularly surprising given that such guidance seems intended to survive beyond finalization of the rules in the 2021 proposed regulations, given Treasury's endorsement of that guidance to treat as non-passive banking income that is earned by various members of a group even if only some of such members would qualify as banks.

Netting of gains

The 2019 proposed regulations would have provided that in the case of gains from property transactions, gains from transactions in commodities, foreign currency gains, and income from notional principal contracts, only the excess of gains over losses or the net income in a category would be treated as passive income, despite the fact that the Income Test is generally based on gross income. In response to comments, the 2021 final regulations expand on the netting concept by allowing a tested foreign corporation to net its directly received items in a category and those of a look-through subsidiary or look-through partnership (as discussed in more detail below) that it is treated as receiving directly under section 1297(c).

KPMG observation

The expansion of the netting rule in the 2021 final regulations is a taxpayer-favorable change consistent with other changes in the regulations intended to more fully reflect the treatment of a tested foreign corporation and look-through entities as a combined economic unit. However, Treasury did not broaden it to the same extent that it did the rules for attribution of activities (discussed below), as a subsidiary foreign corporation still may not net its items with those of a brother-sister corporation for purposes of determining the subsidiary's PFIC status, even though both may have their items netted by a parent corporation for purposes of determining the parent's PFIC status.

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Related-person exceptions

The 2021 final regulations include some modifications and clarifications to the rules in the 2019 proposed regulations concerning the exception under section 1297(b)(2)(C) for interest, dividend, rents, and royalties received or accrued from a related person and allocable to non-passive income ("related-person exception"). The determination of whether an amount is received or accrued from a related person is made on the date of receipt or accrual.

KPMG observation

The 2021 final regulations clarify that in the absence of an exception, dividends from a non-look-through subsidiary and a distributive share of income from a non-look-through partnership would be passive income, and that the rules eliminating distributions from look-through subsidiaries and look-through partnerships are applied before applying the related-person exceptions to any non-eliminated amounts. The clarifications are not described as responding to comments, and it is unclear what concerns may have motivated such clarifications.

In response to comments, the 2021 final regulations revise the rules to provide that interest income from a related person is allocated based on the payor's gross income for the tax year that ends with or within the recipient's tax year. If the payor does not have gross income for the tax year, it may be allocated either under the principles of Reg. §§ 1.861-9 through 1.861-13T, applied in a reasonable and consistent manner taking into account the general operation of the PFIC rules and the purpose of the related-person exception or, alternatively, at the election of the tested foreign corporation, entirely to passive income.

Under the 2019 proposed regulations, all dividends from a related person would have been allocated based on the payor's current earnings and profits ("E&P"). In response to comments, the 2021 final regulations more closely tailor the allocation of a dividend to the E&P out of which such E&P is paid by largely following the principles of Reg. § 1.316-2(a) for determining the bucket of E&P to which the dividend is attributable and incorporating the principles of Reg. § 1.243-4(a)(6) in the case of an E&P deficit. Accordingly, dividends are first treated as coming out of current year E&P and then out of accumulated E&P. Dividends paid out of accumulated E&P may be characterized based on the character of E&P (1) for the years to which they are allocated (which is the two immediately preceding tax years, done by year in reverse chronological order), (2) ratably for the entire period during which the related person was related to the recipient (the "related party period"), or (3) if shorter than the related party period, ratably for the three-year period immediately preceding the related person's tax year that ends with or within the current tax year of the recipient.

KPMG observation

The preamble to the 2021 final regulations indicates that some of the modifications are intended to be responsive to comments indicating that foreign corporations may not maintain E&P in accordance with U.S. federal income tax principles. However, given that all of the rules in the 2021 final regulations are nevertheless based on E&P, it is not clear how the modifications are responsive to such concerns. Nevertheless, the modifications do seem like appropriate measures to more closely align the characterization of dividends with the characterization of the payor's E&P out of which they are paid, and the alternative methods for accumulated E&P should be welcome to taxpayers weighing precision with administrability.

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"Asset Test"

As mentioned above, 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 are held for the production of passive income is at least 50%. The 2021 final regulations adopt many of the rules in the 2019 proposed regulations related to the Asset Test without change, including rules concerning dealer property and dual-character assets. Consistent with the clarification to the Income Test rules described above, they also provide that stock other than stock of look-through subsidiaries and related persons, and partnership interests other than interests in look-through partnerships or related persons are passive.

KPMG observation

Although not emphasized in the preamble discussion of the rules, the 2021 final regulations slightly modify the dual-character asset rules to bifurcate all assets based on their use during a measuring period, rather than the year as a whole. As a result, in the case of a dual-use asset for which one of the uses generates income during part of a year but not the entire year, the asset may be characterized differently under the 2021 final regulations than under the 2019 proposed regulations.

Methodology and basis of measurement

For purposes of the Asset Test, assets may be measured based on either their fair market value or adjusted bases, depending on the particular status of the tested foreign corporation. As set forth in the 2021 final regulations, for purposes of applying the Asset Test, publicly traded tested foreign corporations must use fair market value, and non-publicly traded tested foreign corporations that are CFCs must use adjusted basis. The 2021 final regulations finalize without change the rule in the separate proposed regulation published in 2019, which provides that foreign corporations that are CFCs only by reason of the repeal of section 958(b)(4) are not required to use adjusted basis for purposes of the Asset Test.

The Asset Test generally applies to all tested foreign corporations that are neither publicly traded corporations nor CFCs based on fair market value unless an election is in effect to use adjusted basis, although special rules apply when a tested foreign corporation owns look-through subsidiaries. The 2021 final regulations also finalize the procedural rules under which tested foreign corporations that are not publicly traded and not CFCs can elect to apply the Asset Test on adjusted basis. While retaining the elections provided in the 2019 proposed regulations to measure assets on the basis of adjusted basis, the 2021 final regulations modify the rule to allow the elections to be made either by the tested foreign corporation or by an owner.

KPMG observation

As with the election for the allocation of interest income from a related person to passive income, no procedure is provided for a tested foreign corporation election to measure assets on the basis of adjusted basis. However, unlike for interest income allocation, where it might be inferred that the election can be made simply through use of the taxpayer-unfavorable method without any additional filing, it seems unlikely that a presumably taxpayer-favorable election would require a filing when undertaken by an owner but not when undertaken by the tested foreign corporation itself.

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The 2021 final regulations revise the rule in the 2019 proposed regulations that would have addressed the Asset Test when a tested foreign corporation is publicly traded for less than an entire year. Under the final rules, a tested foreign corporation that is regularly traded on appropriate exchanges (exchanges described in section 1297(e)(3)) in more than de minimis quantities for at least 20 trading days during a tax year must apply the Asset Test based on fair market value for the entire year. A CFC that does not satisfy that test must apply the Asset Test based on adjusted basis for the quarters in which it is a CFC. A tested foreign corporation that is neither publicly traded nor a CFC must use fair market value for the entire year unless the adjusted basis election is made. However, if a non-publicly traded foreign corporation is a CFC for only a portion of the year, it uses adjusted basis for the quarters for which it is a CFC on the measuring date while using fair market value as the default measurement for the remainder of the year.

KPMG observation

Treasury observes in the preamble to the 2021 final regulations that fair market value measurement of assets is generally preferred. Presumably that informs what appears to have made a calculated decision to put a thumb on the scale in favor of fair market value measurement by treating a foreign corporation as publicly traded, and thus required to use fair market value despite CFC status, for an entire year based on only 20 days of trading.

KPMG observation

The 2021 final regulations reintroduce the possibility that a foreign corporation could measure its assets under more than one method during a year, an outcome that the preamble to the 2019 proposed regulations indicated was to be avoided due to possible distortions in light of the weighted average approach to the Asset Test adopted by both the 2019 proposed regulations and the 2021 final regulations. Treasury does not explain its reversal of position in the preamble to the 2021 final regulations.

The 2021 final regulations generally retain the rules in the 2019 proposed regulations that generally apply the Asset Test based on quarterly measuring periods but allow for an election to use a shorter period, such as a weekly or monthly measurement period. The election continues to be made solely by an owner.

Basis of measurement for subsidiaries

A tested foreign corporation that owns directly or indirectly at least 25% of the value of a subsidiary ("look-through subsidiary") takes into account its share of the assets of the look-through subsidiary in applying the Asset Test. The 2021 final regulations provide guidance on the application of the Asset Test when a tested foreign corporation owns a look-through subsidiary. A tested foreign corporation that is publicly traded applies the Asset Test to the assets of its look-through subsidiary based on fair market value, unless the look-through subsidiary is a CFC (without regard to the repeal of section 958(b)(4)), in which case it uses adjusted basis for the look-through subsidiary's assets. A tested foreign corporation that is a non-publicly traded CFC applies the Asset Test to the assets of its look-through subsidiary based on adjusted basis, unless the look-through subsidiary is publicly traded, in which case it uses fair market value. A tested foreign corporation that owns a look-through subsidiary that is neither publicly traded nor a CFC must apply the Asset Test to the assets of the look-through subsidiary using the same method that applies to the tested foreign corporation. In addition, the Asset Test (if applicable) must be applied to the look-through subsidiary using the same method that applies to the tested foreign corporation.

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Furthermore, the rule requiring the use of a parent foreign corporation's method is extended even to subsidiaries that are not look-through subsidiaries of the parent foreign corporation. Additional rules provide guidance on the appropriate method to use if there are multiple parent foreign corporations.

KPMG observation

Under the 2021 final regulations, a tested foreign corporation that is a publicly traded corporation that has a look-through subsidiary that is a CFC (without regard to the repeal of section 958(b)(4)) that is not publicly traded cannot apply the Asset Test using fair market value for all of its assets because it must use adjusted basis for the CFC look-through subsidiary's assets that it is treated as owning directly. This rule could add additional complexity in applying the Asset Test and could impact the PFIC status of the tested foreign corporation, for example if the look-through subsidiary has non-passive assets in which it does not have basis, such as self-created intangibles.

KPMG observation

Additional guidance concerning the measurement of look-through subsidiaries' assets may be welcomed by taxpayers, and it seems appropriate to require, to the extent possible in the face of statutory constraints, consistency in the measurement of the assets of a tested foreign corporation and its look-through subsidiaries for purposes of determining the tested foreign corporation's PFIC status. However, it is unclear why Treasury felt the need to extend such consistency to the measurement of assets of a subsidiary for purposes of determining its PFIC status, even if it is not a look-through subsidiary with respect to a parent foreign corporation. Such constraints seem inconsistent with the electivity provided in section 1297 for measuring the assets of a corporation for purposes of determining its own PFIC status.

Use of financial statements

There currently is no guidance on determining the fair market value of assets for purposes of applying the Asset Test. The 2021 proposed regulations generally would allow the fair market value of assets for Asset Test purposes to be determined based on the amounts reported on financial accounting statements if the statements were provided at least annually. In addition, the proposed rules would allow the fair market value of an asset to be determined based on readily accessible information that provides a more reasonable estimate of the fair market value of an asset if the value of the asset reported on the financial accounting statement is not reasonable. As described in the preamble to the 2021 proposed regulations, this proposed rule is meant to allow, for example, self-created intangible assets that are not reflected on financial statements to be taken into account in appropriate circumstances. The preamble notes that whether information provides a "more reasonable estimate" of the value of an asset than the value reported on the financial statements is based on facts and circumstances.

Related-person stock

The 2021 final regulations clarify the rules for determining whether stock of a related person is passive or non-passive for Asset Test purposes. As generally described above, although dividends generally are passive income under the FPHCI rules, dividends received from a related person can be excluded from passive income under an exception in the PFIC rules. The related party stock therefore can be characterized as non-passive to the extent the dividends are non-passive because the Asset Test characterizes assets based on the income that the asset produces or is held to produce. The 2021 final

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regulations adopt the rule in the 2019 proposed regulations addressing the characterization of related party stock in years in which no dividends are received with respect to the stock. In that case, if dividends in respect of the related party stock have been received in either of the two immediately preceding years, then the stock is characterized based on the relative portion of the aggregate dividends over the two-year period that are passive or non-passive. Despite comments that requested that stock be characterized based on dividends received over a longer period or on dividends that could be paid with respect to the stock, the 2021 final regulations confirm that if dividends are not received in the current year or either of the two immediately preceding years, then the stock is treated as a passive asset. As described in the preamble to the 2021 final regulations, the rule is premised on a view that stock that has not recently generated dividends is held to produce gains rather than dividends and accordingly should be characterized as passive because gain on the disposition of stock generally is passive income.

Rules in Notice 88-22

The preamble to the 2021 final regulations notes that comments argued that Notice 88-22's treatment of working capital as passive was inappropriate and that working capital should be characterized similarly to dual-character assets based on the character of the income generated in a tested foreign corporation's business. Although Treasury rejected the suggestion, the 2021 proposed regulations contain a limited working capital exception. The proposed rule would treat as a non-passive asset an amount of functional currency held in a non-interest bearing financial account that is held for the present needs of an active trade or business and is no greater than the amount necessary to cover operating expenses incurred in the ordinary course of the trade or business that are reasonably expected to be paid within 90 days.

The preamble to the 2021 proposed regulations also indicates that the other rules in Notice 88-22 not addressed in the 2021 final regulations or the 2021 proposed regulations will be included in final regulations, including rules related to depreciable property used in a trade or business, trade or service receivables, intangible property, tax-exempt assets, and goodwill. Comments are requested as to whether any modifications to the rules as set forth in Notice 88-22 should be made. Treasury specifically notes awareness of disagreement with the rule characterizing goodwill based on the income generated by the specific income-producing activity to which it relates and preemptively rejects the idea that goodwill should always be treated as entirely non-passive but indicates openness to alternatives to the approach of Notice 88-22.

The rules in Notice 88-22 addressed in the 2021 final regulations concerning the determination of the average value of assets, the characterization of assets, and dealer property, as well as the rules concerning the income test and look-through subsidiaries are obsoleted. The 2021 proposed regulations indicate that the remaining rules in the notice are expected to be obsoleted upon issuance of final regulations reflecting such rules.

KPMG observation

Given that the Notice 88-22 rules are not actually contained in the regulatory text of the 2021 proposed regulations, it is unclear whether it is intended that they would have the same applicability dates as the remainder of the 2021 proposed regulations, tax years beginning after finalization, or would have the applicability date reflected in Notice 88-22, tax years beginning after December 31, 1986. To the extent modified from their form in Notice 88-22, such rules would presumably not be retroactive, consistent with the statement in the notice.

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Stapled entities

The 2021 final regulations retain the rules in the 2019 proposed regulations that would have treated certain stapled entities as a single corporation for PFIC determination purposes, with certain modifications. In response to comments, the final rule was modified to treat stapled entities as a single entity for all purposes of the PFIC regime, but only with respect to a U.S. person that owns stock in each of the stapled entities. As described in the preamble to the 2021 final regulations, Treasury declined to adopt recommendations that would have further limited the application of the stapled stock rule.

KPMG observation

The 2021 final regulations do not expand the specific treatments for which stapled entity single entity treatment applies beyond those included in the 2019 proposed regulations relating to PFIC determination. Furthermore, the preamble does not elaborate on the consequences of treating stapled entities as a single corporation for purposes other than PFIC determination. If the deemed single entity is a PFIC, it is unclear, for example, how the excess distribution rules might apply if the entities were stapled for only a portion of a U.S. person's holding period with respect to one of the stapled entities. Moreover, if a qualified electing fund election could be made with respect to the deemed single entity, it is unclear whether the single entity treatment would allow E&P deficits in one stapled entity to offset positive E&P in the other for purposes of determining inclusions pursuant to the election. It is also conceivable that one of the stapled entities could be publicly traded while the other was not, raising the question of the impact of the rule on the ability of a U.S. person to make a mark-to-market election under section 1296.

Partnership rules

Despite a significant volume of comments suggesting that aggregate treatment ought to apply to all partnerships owned directly or indirectly by a tested foreign corporation, regardless of the level of ownership, the 2021 final regulations generally retain the approach of the 2019 proposed regulations. Under the final rules, the definition of a "look-through partnership" generally is limited to partnerships in which the tested foreign corporation directly or indirectly owns at least 25% by value. The 2021 final regulations add a new rule that treats a less than 25% owned partnership as a look-through partnership in limited situations. If a tested foreign corporation would not be a PFIC under both the Asset Test and Income Test if the determination were made without regard to any interests in less than 25%-owned partnerships, then the less than 25%-owned partnerships are treated as look-through partnerships. An election may be made to exclude less than 25%-owned partnerships from look-through partnership status in these cases. According to the preamble, the election is provided to address situations in which shareholders are unable to obtain information on the assets and income of a less than 25% partnership interest. No rules are provided for making the election.

KPMG observation

The import of the limited treatment of less than 25%-owned partnerships as look-through partnerships is that they cannot help a tested foreign corporation avoid PFIC status. Instead, the treatment of the partnerships as look-through partnerships only prevents such partnerships from causing an otherwise sufficiently active tested foreign corporation to be treated as a PFIC.

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The 2021 final regulations generally retain the rule in the 2019 proposed regulations that treats a distributive share of partnership income from a non-look-through partnership as passive income, and the corresponding partnership interest as a passive asset, subject to a special rule for related partnerships. The 2021 final regulations add a helpful rule providing that a tested foreign corporation includes its distributive share of the separate items of passive or non-passive income from a partnership that is a related person (under section 954(d)) and not a look-through partnership. Accordingly, an interest in such a partnership can be treated as a dual-character asset characterized in accordance with the tested foreign corporation's distributive shares of income.

KPMG observation

Regarding the special rule for a tested foreign corporation's distributive share of income of a related non-look through partnership, the preamble states that such distributive share is treated as passive or non-passive in whole or part based on the activities of the partnership. This language used in the preamble tracks the regulatory language used for determining a TFC's proportionate share of income of a look-through partnership, which specifies that the exceptions to passive income in section 1297(b)(2) and the relevant exceptions to FPHCI in section 954(c) that are based on whether the income is derived in the active conduct of a business (or whether the entity is engaged in the active conduct of a business) apply taking into account only the activities of the partnership, subject to certain exceptions. Treasury intends for the same principles to apply to distributive shares of income of a related non-look through partnership.

Look-through 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 (the "look-through rule").

The 2021 final regulations generally adopt the look-through rules contained in the 2019 proposed regulations, incorporating the rules relating to look-through partnerships therein. Under the final rules, like the proposed rules, a tested foreign corporation is treated as receiving directly its proportionate share of income of a look-through subsidiary or look-through partnership (collectively, "look-through entity") for the year, or if information is available for individual measuring periods, for a measuring period for which it is a look-through entity. Similarly, a tested foreign corporation is treated as owning directly its proportionate share of the assets of a look-through entity for a measuring period. Consistent with discussion in the preamble to the 2019 proposed regulations, as well as the rules in both the 2019 proposed regulations and the 2021 final regulations applying the related-person exception at the look-through entity level, the 2021 final regulations explicitly provide that income and assets of a look-through entity are generally characterized at the level of the look-through entity based solely on its activities, subject to the recharacterization and activity attribution rules discussed below.

Elimination of intercompany income and assets

Stock, partnership interests, and distributions

2021 final regulations

The 2021 final regulations finalize rules that eliminate stock of and certain dividends from look-through subsidiaries in applying the Asset Test and Income Test to a tested foreign corporation. In addition, the

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2021 final regulations make clear that interests in and the distributive share of income of look-through partnerships are eliminated for Asset Test and Income Test purposes, consistent with treating the partnership's income and assets as received and owned directly by the tested foreign corporation.

KPMG observation

Significantly, the 2021 final regulations replace the rule that would have extended elimination treatment with respect to look-through subsidiaries to look-through partnerships with one that does not reference elimination of distributions from look-through partnerships. Accordingly, it appears that the 2021 final regulations could result in the double counting of look-through partnership income by requiring a tested foreign corporation to take amounts into account once when income is received by a look-through partnership and once when a partnership makes a distribution. However, except for gain as a result of a distribution in excess of basis, a partnership distribution may not constitute income, and to the extent it exceeds the partner's basis in the partnership, such that it is treated as income, inclusion would seem to be consistent with the inclusion of dividends under the rules.

Comments requested removal of the rule in the 2019 proposed regulations limiting dividends from a look-through subsidiary and distributions from a look-through partnership that can be eliminated to those attributable to amounts previously taken into account by the tested foreign corporation for Income Test purposes under the look-through rules. Treasury rejected the comments on the basis that the limitation was necessary for proper interaction with the rules for dispositions of look-through subsidiaries (discussed below) and added a reference to the rules for related-person dividends for purposes of determining the income to which distributions are considered attributable.

2021 proposed regulations

Although the limitation on dividends by a look-through subsidiary that may be eliminated was retained in the 2021 final regulations, it would be eliminated under the 2021 proposed regulations, which also would include corresponding adjustments to the rules applicable to a disposition of a look through subsidiary, as discussed below.

Other income and assets

In response to comments, the 2021 final regulations expand the elimination rules beyond intercompany obligations and interest to include leases and licenses between a tested foreign corporation and a look-through subsidiary or two look-through subsidiaries as well as the corresponding rents and royalties derived from the intercompany leases and licenses. The principles of the rules that eliminate these intercompany obligations, leases, and licenses and corresponding income items apply for purposes of eliminating obligations, leases, and licenses between a tested foreign corporation and a look-through partnership or two look-through partnerships and the corresponding income items.

The 2021 final regulations provide rules for determining the amount of debt, leases, or licenses between look-through subsidiaries of a tested foreign corporation that is eliminated in applying the Asset Test, which are revised from the rule in the 2019 proposed regulations that would have applied to obligations between look-through subsidiaries. Similarly, the 2021 final regulations provide rules on excluding the amount of the corresponding interest, rents, and royalties eliminated from the tested foreign corporation's income for purposes of applying the Income Test. The amount of eliminated income is based on the tested foreign corporation's ownership (by value) in each look-through subsidiary. As a result of the revisions, as illustrated by modifications to the examples contained in the 2021 final

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regulations, a smaller amount of such intercompany items may be eliminated pursuant to the revised rules.

The 2021 final regulations also specifically provide that for property subject to an intercompany lease or license, activities of qualified affiliates (defined below) of the owner of the property are taken into account in determining whether income derived from the property is passive or non-passive. Activities of the owner of the property are not taken into account for this purpose.

Interaction of look-through rule with domestic subsidiary stock rule

Comments suggested elimination of the rule in the 2019 proposed regulations providing that the look-through rules did not apply to stock of a look-through subsidiary that is treated as non-passive under the domestic subsidiary stock rule of section 1298(b)(7) ("domestic subsidiary stock rule"). Treasury rejected the comments and finalized the rule without substantial change, defending the application of the domestic subsidiary stock rule as trumping the look-through rule on the basis of greater specificity.

KPMG observation

Interestingly, although look-through treatment would not apply with respect to a domestic corporation with respect to cases in which the domestic subsidiary stock rule would apply, the rules do not actually negate the domestic corporation's look-through subsidiary status. Accordingly, because the rules eliminating intercompany income and assets are based on look-through subsidiary status, rather than actual look-through treatment, they would appear to still apply with respect to such a domestic corporation. Although it was likely not intended, in the case of a domestic subsidiary whose stock was treated as non-passive pursuant to the domestic subsidiary stock rule, and whose assets are not taken into account by a tested foreign corporation, a debt receivable from such subsidiary owned by the tested foreign corporation (interest payments on which could reduce the amount of U.S. tax to which the subsidiary's income is subject) apparently could be eliminated pursuant to the elimination rules. Thus, for example, if a tested foreign corporation with a wholly-owned second-tier domestic subsidiary had a $40 debt receivable from the subsidiary along with $60 of stock of the subsidiary, the tested foreign corporation would take into account only the $60 of stock, treated as non-passive, and not the subsidiary's assets or its $40 receivable. This would be advantageous if the subsidiary's income were wholly passive, such that the receivable would also be characterized as passive, although not if the subsidiary's income would cause the receivable to be treated as non-passive.

Activity attribution

The 2019 proposed regulations would have provided limited rules allowing activities of look-through subsidiaries and look-through partnerships to be attributed to a tested foreign corporation for purposes of determining whether rents or royalties (and corresponding assets) received (and owned) by the tested foreign corporation could be treated as non-passive under the FPHCI active rent or royalty exception. In response to comments, the 2021 final regulations extend the activity attribution rules to apply to other FPHCI exceptions that are based on the active conduct of a trade or business, including exceptions related to commodities income, income from foreign currency transactions, export financing, and dealer income.

Under the activity attribution rule in the 2019 proposed regulations, a tested foreign corporation would have taken into account the activities performed only by those look-through subsidiaries or look-through partnerships with respect to which the tested foreign corporation owns (directly or indirectly) more than

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50% by value, and not the activities of other affiliates (e.g., a brother-sister company). In response to comments, the 2021 final regulations expand the activity attribution rule to attribute activities among members of an affiliated group (each a "qualified affiliate"), determined by applying a more than 50% threshold and by including partnerships and U.S. affiliates in which corporate members of the affiliated group satisfy such ownership requirements. Thus, the activities of a commonly controlled brother-sister corporation of the tested foreign corporation can be considered in determining whether the relevant activity-based FPHCI exception is satisfied. However, the 2021 final regulations further require the parent of the affiliated group to be foreign (a foreign corporation or partnership) in order to apply the activity attribution rule. Accordingly, if the parent of an affiliated group that includes the tested foreign corporation is a U.S. corporation, the activity attribution rule does not apply to allow the activities of the U.S. parent or brother-sister corporations of the tested foreign corporation owned by the U.S. parent to be taken into account.

KPMG observation

The approach in the 2019 proposed regulations of limiting activity attribution to a tested foreign corporation may have been sufficient in many cases to prevent a U.S. person from being treated as a shareholder of a PFIC, given that its application to a parent tested foreign corporation would have generally applied to treat any U.S. person that owned less than 50% of its stock as not owning the stock of any look-through subsidiaries that were PFICs. However, the continuing treatment of a look-through subsidiary's assets as passive could have resulted in negative ramifications upon a disposition of stock of the look-through subsidiary, gain from which now could potentially be characterized as non-passive as a result of the 2021 final regulations' extension of activity attribution to such a look-through subsidiary. Accordingly, the expansion of the scope of the activity attribution rule to generally all members of an affiliated group is a welcome change. 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 these assets or activities are located in such a manner as to take advantage of the expanded activity attribution rules.

Disposition of look-through subsidiary or look-through partnership

2021 final regulations

The 2021 final regulations finalize without substantive change the rules in the 2019 proposed regulations concerning the disposition of stock of a look-through subsidiary. Under the final rules, a disposition of a look-through subsidiary is treated as a disposition of stock, and gain is computed accordingly, with certain adjustments for "unremitted earnings." The adjusted gain amount is treated as passive or non-passive in proportion to the passive and non-passive assets of the look-through subsidiary (and any indirectly owned look-through subsidiaries) on the date of disposition.

In addition, the 2021 final regulations generally extend similar look-through treatment and rules to determine the amount and character of gain on the disposition of interests in look-through partnerships. However, under an exception, look-through treatment does not apply to the disposition of a partnership interest that is subject to the rules of section 954(c)(4), which generally apply to the sale of a partnership interest by a partner that owns at least 25% of the partnership. In that case, the 2021 final regulations determine the amount of gain on the disposition of the look-through partnership under section 954(c)(4), which generally treats the sale of a partnership interest as a sale of the assets attributable to the partnership interest.

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KPMG observation

The 2021 final regulations retain the rule of the 2019 proposed regulations measuring the assets of a look-through subsidiary for purposes of characterizing the gain on its disposition on the same basis on which the tested foreign corporation's assets are measured. Such rule seems odd, however, in light of the new rules in the 2021 final regulations that might apply a different method for measuring the look-through subsidiary's assets during the interval in which it is held by the tested foreign corporation. It is unclear whether Treasury considered and affirmatively created the incongruity.

2021 proposed regulations

As noted above, the 2021 proposed regulations would revise the rules that apply to a disposition of a look-through subsidiary in connection with revisions to the rules for eliminating dividends from look-through subsidiaries. Instead of preventing distributions from look-through subsidiaries not attributable to income previously included by a tested foreign corporation from being eliminated, the 2021 proposed regulations would instead, for purposes of determining gain on the disposition of a look-through subsidiary, reduce the tested foreign corporation's basis in the stock of the look-through subsidiary by the amount of such distributions. The amount of unremitted earnings that reduces the tested foreign corporation's gain on a disposition would not take into account the distributions so accounted for.

KPMG observation

The basis reduction rule contained in the 2021 proposed regulations does not require reduction of basis below zero nor otherwise account for eliminated dividends in excess of basis. Accordingly, the elimination of dividends that are not attributable to income of a look-through subsidiary included by a tested foreign corporation could, in certain circumstances, result in the types of distortions that the motivated Treasury to retain the limitation on dividend elimination in the 2021 final regulations. However, given that the basis reductions correspond to distributions of E&P accumulated before the look-through subsidiary became a look-through subsidiary, such distortions would be a result of pre-acquisition E&P in excess of the tested foreign corporation's basis in the subsidiary, which is not likely to be common.

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 2021 final regulations generally adopt without substantive change the rules in the 2019 proposed regulations concerning the change of business exception, including its taxpayer-favorable expansion from the statutory rule to allow the exception to apply if "substantially all" of the passive assets of the tested foreign corporation are attributable to the proceeds from a disposition, as an alternative to the exception applying based on income. In addition, the final rules treat a disposition of a look-through subsidiary or a look-through partnership as a disposition of its assets for purposes of the change of business exception.

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KPMG observation

Although the 2019 proposed regulations had studiously avoided weighing in on what could be considered substantially all, revisions to the examples illustrating the change of business exception now conclude that certain percentages do (91%) or do not (24%) constitute substantially all, while curiously not concluding on another (89%).

Domestic subsidiary stock rule

Under the domestic subsidiary stock rule, if 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), and conditions related to the accumulated earnings tax ("AET") are met, 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.

2021 final regulations

The 2021 final regulations adopt without change the rules from the 2019 proposed regulations relating to the mechanics and procedural rules of the domestic subsidiary stock rule, including relating to the AET.

In response to comments, significant changes are made in the 2021 final regulations and would be made in the 2021 proposed regulations relating to the anti-abuse rules in the 2019 proposed regulations. The 2021 final regulations eliminate the rule disregarding the domestic subsidiary stock rule for purposes of determining the status of a foreign corporation as a PFIC for purposes of allowing attribution of PFIC stock owned through such corporation to any shareholder regardless of ownership. They also eliminate the rule preventing the application of the domestic subsidiary stock rule if the tested foreign corporation would be a PFIC if the stock in the second-tier domestic corporation were disregarded.

However, the 2021 final regulations retain the "principal purpose" anti-abuse rule from the 2019 proposed regulations and expand it to provide that the domestic subsidiary stock rule does not apply if a principal purpose for the formation of, acquisition of, or holding of stock of the 25% owned domestic corporation or the second-tier domestic corporation, or for the capitalization or other funding of the second-tier domestic corporation, is to hold passive assets through the second-tier domestic corporation to avoid classification of the tested foreign corporation as a PFIC. However, the 2021 final regulations no longer deem a principal purpose to exist if a corporation is not engaged in an active trade or business in the United States.

KPMG observation

Although elimination of the "bright-line" anti-abuse rule in the 2019 proposed regulations is sure to be welcome news for taxpayers, it may be offset by the expansion of the principal purpose rule, which may prevent even the use of a pre-existing two-tier domestic holding company structure to avoid PFIC status. For example, private letter rulings mentioned in the comments and the preamble to the 2021 final regulations suggested that contribution of proceeds from an IPO to the second-tier corporation in such a structure in order to prevent such passive assets from affecting PFIC status would be appropriate. That is no longer as clear in light of the application of the anti-abuse rule in the case of funding of the second-tier corporation. The changes to the domestic subsidiary

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stock rules certainly do not represent an abandonment of Treasury's concern concerning tax planning in reliance on the domestic subsidiary stock rule.

KPMG observation

The anti-abuse rule in the 2021 final regulations does not include any transition rules or allow grandfathering of existing structures that qualified for the domestic subsidiary stock rule prior to the applicability date of the 2021 final regulations. Taxpayers that currently are applying the domestic subsidiary stock rule should revisit their structures to determine whether they still qualify for the rule taking into account the anti-abuse rule in the 2021 final regulations.

2021 proposed regulations

Despite the elimination of the deemed principal purpose in the 2021 final regulations, the requirement of an active U.S. trade or business is effectively incorporated into the safe harbors included in the 2021 proposed regulations in light of the expansion of the general rule to cover tax-motivated insertion of the second-tier domestic corporation as well as funding thereof.

Under the 2021 proposed regulations, the anti-abuse rule would not apply if the value of the assets of the second-tier domestic corporation used or held for use in an active trade or business within the United States is more than 80% of the fair market value of its gross assets. A look-through rule applies for purposes of the determination of assets. In response to comments that taxpayers should be permitted to rely on the domestic subsidiary stock rule to plan around the limitations of the start-up and change of business exceptions, the 2021 proposed regulations also would provide that the anti-abuse rule will not apply if the second-tier domestic corporation engages in an active U.S. trade or business within 36 months of formation or disposition of a previous active U.S. trade or business.

KPMG observation

While these safe harbors would be helpful additions to the anti-abuse rule, it is not clear when the 80%-of-fair-market-value test is to be applied. Should it be applied only in the year that the principal purpose transaction (e.g., formation, capitalization, or funding of either domestic corporation) occurs, or is it an annual test? Because the principal purpose rule applies to the "holding of stock", this might suggest an annual test is contemplated, but that is not clear.

Elections

KPMG observation

The general rules in the 2021 final regulations contain four elections, which do not have consistent election mechanics. The election to use an alternative measuring period for the asset test is made by a U.S. person (including a partnership) that is lowest on the chain of ownership of the tested foreign corporation. The election to measure a tested foreign corporation's assets based on adjusted basis (rather than fair market value) for asset test purposes is made either by the U.S. person lowest on the chain of ownership or the tested foreign corporation. On the other hand, the

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election to allocate interest entirely to passive income for purposes of the related party exception is made only by the tested foreign corporation. Finally, no guidance is provided on the appropriate person to make the election to not apply the "active partner" test in determining whether a partnership is a look through partnership. Moreover, the election related to QIC treatment (described below) is made by "[a] United States person." Elections in the PFIC rules generally are made by U.S. shareholders of the tested foreign corporation, which is reasonable both because U.S. persons would be impacted by the election and because a tested foreign corporation may be unlikely to be attuned to U.S. tax consequences.

Treasury does not explain why the related party exception election is to be made only by a tested foreign corporation, unlike other elections contained in the 2021 final regulations and other guidance. In addition, the 2021 final regulations do not contain any procedures for a tested foreign corporation to make either of its two elections.

Applicability dates and reliance

2021 final regulations

The 2021 final regulations generally apply to tax years of shareholders that begin on or after January 14, 2021. Moreover, a shareholder generally can choose to apply rules in the 2021 final regulations (other than the rules relating to insurance, discussed below) for any open tax year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation the shareholder satisfies certain consistency requirements for that year and all subsequent years. The consistency requirements generally require the shareholder to apply either most of the rules in the 2021 final regulations or a certain subset of the rules to the particular tested foreign corporation.

In addition, as noted above, for tax years ending on or before December 31, 2020, Treasury explicitly provides that taxpayers can rely on the rule in the 2019 proposed regulations that permitted the application of the active financing exception in determining PFIC status.

As described in the preamble, Treasury rejected requests to extend the application of the 2021 final regulations to closed tax years and acknowledged that U.S. persons could be subject to the PFIC results with respect to a foreign corporation under the "once a PFIC, always a PFIC" rule if the foreign corporation was a PFIC in a closed year, even if it would not be a PFIC under the 2021 final regulations for all open years. In that case, the shareholder would need to request permission to make a late purging election on Form 8621-A in order to avoid PFIC taxation under the "once a PFIC, always a PFIC" rules.

The rule in the 2021 final regulations relating to determining CFC status for purposes of the Asset Test without regard downward attribution from foreign entities applies to tax years of shareholders ending on or after October 1, 2019. For tax years ending before October 1, 2019, a shareholder can apply the final rule to the last tax year of a foreign corporation beginning before January 1, 2018, and each subsequent tax year of the foreign corporation, provided that the shareholder and all U.S. persons related (under section 267 or section 707) to the shareholder consistently apply the rule to all foreign corporations.

2021 proposed regulations

The 2021 proposed regulations are proposed to apply to tax years of U.S. shareholders of foreign corporations that begin on or after the date the final regulations are filed in the Federal Register.

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Shareholders can apply one or more of the rules in the 2021 proposed regulations for any open year before the final regulations apply without regard to whether the rules are applied consistently, provided that once applied, the rule must be applied to each subsequent tax year until the final regulations are applicable.

KPMG observation

Shareholders can continue to apply the rules in Notice 88-22 that were not withdrawn in the 2021 final regulations.

Insurance rules

2021 final regulations

Section 1297(f) provides that a qualifying insurance company or QIC is a foreign corporation that (1) would be subject to tax under subchapter L if it were a domestic corporation, and (2) either (A) has applicable insurance liabilities ("AIL") constituting more than 25% of its total assets on its applicable financial statement ("ADS") (the 25% test), or (B) meets an elective alternative facts and circumstances test which lowers the AIL ratio to 10% (alternative facts and circumstances test).

The 2021 final regulations modify when a foreign corporation satisfies the alternative facts and circumstances test. Despite industry comments, the 2021 final regulations continue to limit the alternative facts and circumstances test in the case of run-off related circumstances to cases when the company is in the process of terminating its pre-existing, active conduct of an insurance business under the supervision of its regulators or under a court receivership proceeding. In addition, the 2021 final regulations retain the requirement that the insurance company make claims payments during the annual reporting period.

The 2021 final regulations clarify when the failure to satisfy the 25% test is due to ratings related circumstances. Surprisingly, the final regulations generally limit the rating related circumstances exception to either when the foreign corporation exclusively provides mortgage insurance or, generally, if more than half of the foreign corporation's net written premiums for the annual reporting period are from insurance coverage against the risk of loss from a catastrophic loss event. In addition, the 2021 final regulations also provide that a financial guaranty insurance company that fails the 25% test is deemed to satisfy the rating-related circumstances.

The 2021 proposed regulations and the 2021 final regulations also expand the scope of the qualifying domestic insurance company exception. The income and assets of a qualifying domestic insurance company ("QDIC") are non-passive for purposes of determining whether a non-U.S. corporation is treated as a PFIC. A QDIC is defined as a domestic corporation that is subject to tax as an insurance company under subchapter L, is subject to Federal income tax on its net income and is a look-through subsidiary of a tested foreign corporation. The 2021 final regulations deleted the previously proposed rule that provided that the QDIC rule did not apply for purposes of section 1298(a)(2) and determining if a U.S. person directly owns stock in a lower tier PFIC. In the preamble to the 2021 proposed regulations, Treasury expressed concern that a QDIC could be over-capitalized relative to the assets necessary to support its insurance and annuity obligations. Consequently, the 2021 proposed regulations provide that the amount of a QDIC's otherwise passive income and assets that may be treated as non-passive is subject to a maximum based on an applicable percentage of the QDIC's total insurance liabilities. These

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limitations are similar to the proposed limitations for ordinary and necessary investment income for an insurance company under proposed section 1.904-4(e)(2)(ii)(B).

KPMG observation

Industry comment letters emphasized that insurance run-off related businesses are not necessarily a prelude to liquidation or termination, but rather an industry accepted practice to shift core business segments or maximize capital. The limitation of this alternative test to companies in liquidation and under receivership effectively limits this aspect of the alternative facts and circumstances test to a narrow group of companies. Similarly, Treasury limits the rating related circumstances to certain mortgage insurance companies, catastrophic loss companies, and financial guaranty companies. Each of these companies has a strong position to support its basis for meeting the rating related prong; however, the bright line test adopted by Treasury eliminates the possibility that other insurers potentially satisfy this test. In practice, the alternative facts and circumstances test will likely be limited to those companies with the enumerated lines of business.

2021 proposed regulations

The 2021 proposed regulations clarify the rules to determine the tested foreign company's applicable financial statement by detailing a priority ranking of types of financial statements. The determination of what qualifies as the applicable financial statement is integral to the determination of whether a tested foreign company satisfies the qualified insurance company requirements. Proposed 1.1297-4(f) provides ordering rules for how to prioritize between multiple financial statements prepared at the same level of priority.

Applicable insurance liabilities

The preambles to the 2021 final regulations and the 2021 proposed regulations clarify what types of liabilities are considered applicable insurance liabilities. Treasury received comment letters requesting that applicable insurance liabilities include unearned premiums and insurance claims paid during the year. However, Treasury determined that inclusion of these liabilities is inconsistent with the statutory language of section 1297(f).

The 2021 proposed regulations also clarify that insurance liabilities should be reduced by the amount of any reinsurance recoverable relating to those liabilities. In addition, if a tested foreign corporation's applicable financial statement is prepared on a consolidated basis, liabilities of the tested foreign corporation must be reduced by an amount equal to the assets relating to those liabilities that may be recoverable through reinsurance from another entity including in the consolidated financial statement, regardless of whether the reinsurance transaction is eliminated in the preparation of the consolidated financial statement. Consistent with these proposed adjustments for reinsurance recoverables, the 2021 proposed regulations provide for an optional asset adjustment to reduce total assets by the reduction in insurance liabilities due to a reinsurance recoverable. The preamble to the 2021 proposed regulations also requests comments on the appropriate rules for "modco" reinsurance arrangements whereby the reserves are attributed to the ceding company and not the assuming company.

Active conduct test

Treasury determined that the active conduct test as detailed in the 2019 proposed regulations should be amended to provide more flexibility in determining whether a QIC is engaged in the active conduct of an

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insurance business. Under the 2021 proposed regulations, a QIC is engaged in the active conduct of an insurance business if it satisfies either the factual requirements test under proposed section 1.1297-5(c) or the active conduct percentage test under proposed section 1.1297-5(d).

The 2021 proposed regulations preclude certain categories of insurance companies from meeting the active conduct test. Specifically, the active conduct requirement is not satisfied if the insurance business is a securitization vehicle or part of insurance linked securities funds that invest in securitization vehicles. Treasury believes that these securitization vehicles are designed to provide passive investment return tied to insurance risk rather than in the participation in the earnings of an active business. In addition, a foreign corporation that has no employees or only a nominal number of employees and relies exclusively or almost exclusively upon independent contractors to perform its core functions cannot satisfy the active conduct requirement.

Under the facts and circumstances test, the active QIC requirement is satisfied if the QIC's officers and employees carry out substantial managerial and operational activities on a regular and continuous basis with respect to all of its core functions and perform virtually all of the active decision making functions relevant to underwriting. Core functions generally include underwriting, investment, contract and claim management and sales activity. To meet the active decision making requirement for underwriting, the officers and employees of the QIC must carry out virtually all of the activities related to the QIC's decision to assume an insurance risk and must conduct virtually all of the decision-making with respect to the execution of an insurance contract on a contract-by-contract basis.

The active conduct percentage test provides an alternative means to meet the active QIC requirement. Under this test, the ratio of the QIC's costs performed by its officers and employees (or by officers and employees of certain related companies) for core insurance functions must equal at least 50% of the total costs for core functions. Costs associated with investment activities are excluded from the numerator and denominator of this fraction. Also, if any core functions are outsourced to an unrelated entity, the QIC's officers and employees much conduct robust oversight with respect to the outsourced activities.

For purposes of the factual requirements test and the active conduct percentage test, the officers and employees of certain related entities are considered the QIC's officers and employees. To be considered a related entity for this purpose, the related entity must satisfy three requirements. First, the related entity must be a qualified affiliate of the QIC within the meaning of section 1.1297-2(e)(2) except that, in addition, the required stock ownership by total voting power test in section 1504(a)(2)(A) applies with the percentage reduced from "at least 80 percent" to "more than 50 percent." By referencing Treas. Reg. 1.1297-2(e)(2), the common parent of the group must be a foreign corporation or foreign partnership, and a corporation or a partnership is included in the affiliated group only if it is a look-through subsidiary or look-through partnership of the common parent. Second, the QIC must exercise regular oversight and supervision over the related entity's services. Third, the QIC must satisfy certain arm's length payment requirements.

KPMG observation

The 2021 proposed regulations provide a welcome clarification of Treasury's interpretation of what qualifies as an "active" insurance company. The facts and circumstances test provides a basis for companies to establish procedures so that their activities satisfy this active requirement. In addition, the 2021 proposed regulations provide an alternative, based on facts and circumstances, to the strict 50% requirement that was included in the 2019 proposed regulations. Many foreign insurance companies, however, rely extensively on unrelated third-party service providers to perform many insurance related activities. These entities may want to modify their current

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practices to satisfy one of these tests for active insurance companies.

QBAI rules for FDII and GILTI

Treasury also proposed regulations on determining QBAI for purposes of the FDII deduction under section 250 and the GILTI rules under section 951A. QBAI is relevant for both GILTI and FDII purposes because GILTI and FDII generally are calculated by taking into account a deemed tangible income return ("DTIR"), which generally is 10% of certain business assets of a domestic corporation (for FDII) or a CFC (for GILTI). QBAI generally increases DTIR, which effectively can reduce a U.S. shareholder's GILTI inclusion or a domestic corporation's FDII deduction.

For purposes of GILTI and FDII, the statute provides that the adjusted basis of property for QBAI is determined under section 168(g) (the "alternative depreciation system" or "ADS"), without regard to any law enacted after December 22, 2017. GILTI final regulations (T.D. 9866) and FDII final regulations (T.D. 9901), as well as FDII proposed regulations (REG-104464-18) provide that a statute enacted after December 22, 2017 has effect for QBAI purposes only if the after-enacted statute specifically amends the QBAI definition for purposes of section 951A (or, for FDII purposes, if it amends the QBAI definition for purposes of section 250 or section 951A(d)).

On March 27, 2020, the CARES Act amended section 168(g) to treat qualified improvement property ("QIP") as 20-year property for ADS purposes. The CARES Act provides that the amendment "shall take effect as if included in [the TCJA], which was enacted on December 22, 2017." Prior to the CARES Act and as of December 22, 2017, the ADS rules provided a 40-year recovery period for nonresidential real property, including QIP placed in service after December 31, 2017.

On September 1, 2020, Treasury released Notice 2020-69, announcing that Treasury intended to issue regulations addressing the treatment of QIP under the ADS depreciation provisions in section 168(g) for purposes of calculating QBAI for FDII and GILTI purposes. For a more detailed discussion of the notice, read the **KPMG report**. The 2021 proposed regulations would provide that the technical amendment to section 168(g) made by the CARES Act applies to determine the adjusted basis of property under section 951A(d)(3) as if it originally had been included in TCJA and, thus, enacted on December 22, 2017. Consequently, for purposes of calculating QBAI for FDII and GILTI purposes, the adjusted basis of QIP would be determined by using a 20-year (rather than a 40-year) recovery period under the ADS.

KPMG observation

As a general matter, the shorter recovery period in the 2021 proposed regulations would result in an increased annual depreciation amount when applying ADS, and, thus, potentially more QBAI for the tax year. For GILTI purposes, this revision would be favorable because an increase in QBAI can reduce the amount of the GILTI inclusion at the U.S. shareholder level. However, for FDII purposes, the revision would be unfavorable because QBAI generally reduces the amount of the FDII deduction.

The 2021 proposed regulations relating to QBAI would apply retroactively to tax years beginning after December 31, 2017. The preamble states that taxpayers may rely on the QBAI rules in the 2021 proposed regulations for any tax years beginning after December 31, 2017, provided that the QBAI rules are applied consistently for purposes of GILTI and FDII to the tax year and all subsequent tax years. For FDII purposes, the preamble also states that the QBAI rule can be applied regardless of whether the

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corporation applies the FDII proposed regulations published in 2019, the FDII final regulations issued in 2020, or the statute for a tax year. Treasury requested comments on whether a transition rule should be provided to allow a corrective adjustment in the first tax year ending after the date that final regulations containing the QBAI rules in the 2021 proposed regulations are published in the Federal Register. The contemplated transition rule would apply to taxpayers that took positions inconsistent with the QBAI rules in the 2021 proposed regulations on a return filed before September 1, 2020 (the date that Notice 2020-69 was released) and that do not file an amended return for the year.

Comment period and hearing

Comments or requests for a public hearing on the 2021 proposed regulations must be submitted by April 14, 2021.

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