KPMG

KPMG report: Regulations addressing tax treatment of U.S. partnerships and S corporations that own stock of CFCs and PFICs

January 28, 2022

Introduction

The U.S. Treasury Department and IRS (collectively, "Treasury") on January 25, 2022, published **final regulations** [PDF 287 KB] (T.D. 9960) (the "2022 Final Regulations") related to the treatment of domestic partnerships and S corporations that own stock of controlled foreign corporations ("CFCs") for purposes of determining amounts included in the gross income of their partners and shareholders with respect to the CFCs. The regulations finalize a portion of the proposed regulations published on June 21, 2019 (REG-101828-19) (the "2019 Proposed Regulations").

In addition to the 2022 Final Regulations, Treasury also issued **proposed regulations** [PDF 487 KB] (REG-118250-20) (the "2022 Proposed Regulations") that would provide guidance regarding the treatment of domestic partnerships and S corporations that own stock of passive foreign investment companies ("PFICs") and their domestic partners and shareholders, including for purposes of making qualified electing fund ("QEF") and mark-to-market ("MTM") elections under the PFIC rules and the application of the CFC overlap rule.

The 2022 Proposed Regulations also:

- Would provide guidance related to partnerships and S corporations for purposes of determining controlling domestic shareholders of certain foreign corporations, related person insurance income ("RPII") under section 953(c), and the election under Treas. Reg. § 1.1411-10(g) related to the net investment income tax

- Include rules described in Notice 2020-69 (2020-39 I.R.B. 604, September 1, 2020), which allow an S corporation to be treated as an entity for purposes of CFC inclusions for certain years when certain conditions are satisfied

- Include rules described in Notice 2019-46 (2019-37 I.R.B. 69, September 9, 2019), which allow domestic partnerships and S corporations to apply a hybrid aggregate-entity approach for determining GILTI inclusions under proposed regulations published in October 2018 (REG-104390-18) (the "2018 Proposed Regulations") for tax years that ended before June 22, 2019, if certain conditions are satisfied.

Finally, proposed Treas. Reg. § 1.953-3(b)(1) and (5) that was published on April 17, 1991 (56 FR 15540) is withdrawn in the 2022 Proposed Regulation.

This report provides initial impressions and observations about these final and proposed rules.

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Background

United States Shareholders ("U.S. shareholders") of CFCs include in income subpart F inclusions, section 956 inclusions, and global intangible low-taxed income ("GILTI") inclusions (collectively, "CFC inclusions"). For this purpose, a U.S. shareholder generally is a U.S. person that owns under section 958 at least 10% of the value or voting power of a foreign corporation, and a CFC generally is a foreign corporation in which more than 50% of the value or voting power is owned by U.S. shareholders. Special rules for determining U.S. shareholder and CFC status apply for certain captive insurance companies. A U.S. shareholder generally determines its CFC inclusions based on the amount of the CFC that it owns under section 958(a).

Final regulations issued on June 21, 2019 (T.D. 9866) (the "GILTI Final Regulations") adopt an aggregate approach to domestic partnerships for purposes of determining the persons that must take into account a GILTI inclusion with respect to CFC stock held by a domestic partnership and any provision that applies by reference to the GILTI inclusion (such as rules on previously taxed earnings and profits ("PTEP") and basis). The GILTI Final Regulations did not follow the hybrid treatment of domestic partnerships included in the 2018 Proposed Regulations. The rules in subpart F, including GILTI, for partnerships apply equally to S corporations and their shareholders because S corporations are treated as partnerships and S corporation shareholders are treated as partners for purposes of subpart F (sections 951 through 965).

Final regulations

The 2022 Final Regulations finalize the 2019 Proposed Regulations concerning the treatment of domestic partnerships for CFC inclusion purposes without significant changes.

The 2022 Final Regulations extend the aggregate approach adopted in the GILTI Final Regulations to subpart F inclusions and section 956 inclusions with respect to CFCs owned by a domestic partnership. For these purposes, a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a). Instead, a domestic partnership is treated in the same manner as a foreign partnership for purposes of determining the persons that own stock of a CFC under section 958(a). The effect of this rule is that a domestic partnership cannot have subpart F or section 956 inclusions. Rather, partners in a domestic partnership are treated as owning proportionately the stock of a CFC owned by the partnership, and a partner that is a U.S. shareholder with respect to the CFC determines its pro rata share of the subpart F inclusion and section 956 inclusion. As noted above, these rules also apply to S corporations and their shareholders because S corporations are treated as

partnerships and S corporation shareholders are treated as partners for subpart F purposes.

The 2022 Final Regulations continue to treat domestic partnerships as entities for purposes of determining whether a foreign corporation is a CFC, determining whether a U.S. person is a U.S. shareholder of a CFC, applying section 1248, defining "U.S. property" for purposes of section 956, including for purposes of pledges and guarantees, and determining whether a U.S. shareholder is a controlling domestic shareholder of a CFC for purposes of making certain elections with respect to a CFC. The treatment of domestic partnerships for determining whether a U.S. shareholder is a controlling domestic shareholder of a CFC would be revised in the 2022 Proposed Regulations (see discussion below).

KPMG observation

The 2019 Proposed Regulations did not address whether a domestic partnership is treated as a U.S. person for purposes of determining whether a CFC holds U.S. property that could result in a section 956 inclusion. The 2022 Final Regulations helpfully clarify that a domestic partnership is treated as an entity for U.S. property determinations. As a result, for example, a loan from a CFC to a related domestic partnership would be U.S. property for section 956 purposes.

Treasury received several comments addressing section 1248, including with respect to dispositions by domestic partnerships of CFC stock, dispositions of interests in domestic partnerships that hold CFC stock, and the interaction between sections 1248 and 751. In the preamble to the 2022 Final Regulations, Treasury states that these issues are beyond the scope of the final regulations. Nonetheless, as noted above, the 2022 Final Regulations expressly clarify that the aggregate approach to partnerships discussed above does not apply for purposes of section 1248.

KPMG observation

The 2019 Proposed Regulations did not include rules addressing section 1248, but the preamble to the regulations noted that the aggregate treatment of domestic partnerships for GILTI inclusion purposes did not impact the treatment of domestic partnerships as entities for purposes of section 1248. Consistent with the statement in the preamble to the 2019 Proposed Regulations, the 2022 Final Regulations clarify that domestic partnerships are treated as entities for purposes of section 1248.

Applicability dates

The 2022 Final Regulations apply to tax years of foreign corporations that begin on or after January 25, 2022, and to tax years of U.S. persons in which or with which such tax years of foreign corporations end.

A domestic partnership also may apply the 2022 Final Regulations to prior tax years of a foreign corporation beginning after December 31, 2017, provided that the partnership, its partners that are U.S. shareholders, and related domestic partnerships and their U.S. shareholder partners consistently apply the final rules to all foreign corporations owned by the domestic partnership within the meaning of section 958(a). Treasury noted in the preamble that partnerships can choose to apply the aggregate approach (subject to the consistency requirement) for a prior eligible year on an amended return or by initiating an administrative adjustment request.

KPMG observation

In the case of widely held partnerships, it may be difficult, if not impossible, to get all partners to agree to apply the rules to pre-finalized years. Treasury acknowledges this issue in the preamble but rejected requests to eliminate the consistency requirement, noting that such requirement is important to the administration of the regulations.

KPMG observation

The 2022 Final Regulations do not address whether domestic partnerships and their U.S. shareholder partners who choose to apply the 2022 Final Regulations to prior tax years of a foreign corporation beginning after December 31, 2017 must apply the 2022 Final Regulations to all such prior tax years consistently or can choose to apply the 2022 Final Regulations to only certain prior years. Arguably, because Treasury did not include this type of consistency rule, taxpayers may choose to apply the 2022 Final Regulations to only certain prior years.

KPMG observation

If a partnership chooses to adjust a previously filed Form 1065, a partnership subject to the centralized partnership audit rules of the Bipartisan Budget Act of 2015 ("BBA Partnership") must use an AAR. Section 6031(b) prohibits BBA Partnerships from amending after the due date of the return, unless specifically provided by the Secretary. The IRS previously has allowed BBA Partnerships to use amended returns in order to take advantage of certain legislation (e.g., Revenue Procedure 2021-29, 2021-28, and 2020-23). Query if the IRS might consider future relief given the administratively complex nature of AARs.

Proposed regulations

The 2022 Proposed Regulations would provide guidance on the treatment of domestic partnership and S corporations for purposes of certain PFIC and subpart F rules, including special rules applicable to S corporations that were addressed in Notice 2020-69 and special rules applicable to domestic partnerships and S corporations in Notice 2019-46. The 2022 Proposed Regulations also would provide guidance on the RPII rules. Finally, the 2022 Proposed Regulations would remove the ability for domestic partnerships and S corporations to make an election under Treas. Reg. § 1.1411-10(g), which applies for net investment income tax purposes.

PFIC rules

Background

Generally, a PFIC is a foreign corporation that has at least 75% passive income or an average percentage of assets that produce passive income of at least 50% for a tax year. A domestic shareholder is subject to the excess distribution regime of section 1291 if it does not make a QEF or MTM election, or if it makes a QEF or MTM election after the first year of its holding period (with respect to QEFs, an

"unpedigreed QEF"). A shareholder that makes a QEF election includes in income its share of the PFIC's annual earnings and profits. A shareholder of PFIC stock that is "marketable stock" may make an MTM election to annually include in income an MTM inclusion or deduction, generally based on the fair market value of the PFIC.

A PFIC shareholder that makes a QEF election after the first year of its holding period may make an election to "purge" the "PFIC taint" by subjecting the amount of gain on a deemed disposition of the PFIC stock to the excess distribution rules. If the unpedigreed QEF also is a CFC, the PFIC shareholder may elect to include its share of the foreign corporation's accumulated earnings and profits ("E&P") as a dividend subject to the excess distribution rules. Similar purging elections are available for shareholders of former PFICs and for shareholders who are not subject to the PFIC rules with respect to a foreign corporation under the CFC overlap rule but who (in both cases) remain subject to the PFIC rules under the "once a PFIC always a PFIC" rule.

A domestic partnership is not subject to the excess distribution rules; instead, the domestic partners of the partnership are subject to section 1291. Nonetheless, under current law, a domestic partnership that owns PFIC stock may make QEF and MTM elections and includes QEF and MTM inclusions in income. In that case, the partners take into account their share of the partnership's QEF and MTM inclusions under the partnership rules. S corporations and their shareholders are treated similarly to domestic partnerships and their domestic partners for purposes of the excess distribution, QEF, MTM, and purging election rules.

In general, if a foreign corporation is both a CFC and a PFIC, a U.S. shareholder is not subject to the PFIC rules with respect to the corporation (the "CFC Overlap Rule").

Proposed rules

Aggregate approach to elections and filings

The 2022 Proposed Regulations generally would extend the aggregate approach in section 1291 and in subpart F for CFC inclusions to other areas of the PFIC regime, including QEF and MTM elections, purging elections, and the obligation to file Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*. Specifically, domestic partnerships and S corporations would no longer be able to make QEF or MTM elections and would not have QEF inclusions or MTM inclusions or deductions. Instead, each domestic partner or S corporation shareholder would be able to make its own QEF and MTM election and determine its own QEF inclusions and MTM inclusions and deductions as if it directly held its share of the PFIC stock held by the partnership or S corporation. Each domestic partner or S corporation shareholder similarly would make its own purging election and file its own Form 8621. The 2022 Proposed Regulations would require the partner to notify the partnership, and the shareholder to notify the S corporation, of a QEF or MTM election no later than 30 days after filing the return on which the election is made. There are no formal notification requirements; a partner or shareholder would be able to notify the partnership or S corporation using any reasonable method.

The 2022 Proposed Regulations also would make changes to the MTM rules, including the rules for basis adjustments when the PFIC MTM stock is indirectly held through a pass-through entity. Under the proposed rules, a domestic partnership would have basis adjustments in its PFIC stock for chapter 1 purposes based on its partner's MTM inclusions and deductions.

Transition rules in the 2022 Proposed Regulations would allow QEF and MTM elections made by domestic partnerships and S corporations that are effective for tax years of PFICs ending on or before the date the final regulations are published in the Federal Register (a "preexisting election") to continue

to apply. Thus, partners and S corporation shareholders would not be required to make new QEF or MTM elections if the partnership or S corporation had made a preexisting election. Nonetheless, the partnership or S corporation would not have a QEF inclusion or MTM inclusion or deduction for the PFICs. Instead, the partners and S corporation shareholders would determine their QEF inclusions or MTM inclusion or deductions under the rules in the 2022 Proposed Regulations.

KPMG observation

Under the 2022 Proposed Regulations, a partner would determine its QEF inclusion as if it directly held its share of the PFIC stock held by the domestic partnership. Currently, a domestic partnership allocates its QEF inclusion to its partners under the partnership rules. The 2022 Proposed Regulations do not provide rules for determining the partner's share of the QEF stock held by the partnership. Where the partners have the same percentage interest in profits, loss, and capital, the determination of their share of the QEF stock may be straightforward. However, most partnerships today are not simple "straight up" partnerships. If stock ownership is based on entitlement to partnership capital, that share may vary under the partnership agreement based on profit/value thresholds that take into account all partnership assets, not just the value of the QEF stock. A partnership may not have such value determinations on a year-to-year basis. Another potential way to determine a partner's share of QEF stock is to use the relative value of its partnership interest. Such a determination necessarily also includes a valuation, and in addition calls into question other considerations such as where discounts are factored in.

Finally, income inclusions based on a partner's pro-rata share of stock (however determined) are likely to vary from the partner's distributive share of income inclusions at the partnership level in all but a "straight up" partnership. Most partnership agreements today reflect economic agreements that result in interests in the partnership that vary based on net income or net loss levels in the partnership. It is very likely allocations consistent with these economic positions will differ from an allocation based on relative share of stock using value, as the latter may be determined based on appreciation that has not been recognized in taxable income of the partnership.

KPMG observation

In discussing the proposed rules that would require a partner to notify the partnership if it made a QEF election, Treasury states in the preamble to the 2022 Proposed Regulations that the notification would assist with "tracking basis" in the QEF stock. The reference to tracking basis is unclear but possibly refers to the Treas. Reg. § 1.1291-9(f) principle-based adjustments referenced in proposed Treas. Reg. § 1.1293-1(c)(3)(i). The application of these rules is uncertain but infer that a QEF inclusion at the partner level may result in a basis adjustment by the partnership to the QEF stock (in addition to adjustments to the basis of the partner's interest in the partnership). If so, it is unclear whether any such adjustment to the basis of QEF stock would constitute common basis, or basis unique to the shareholder, similar to the treatment of a section 743(b) adjustment.

In addition, the placement of the reference to Treas. Reg. § 1.1291-(f) principle-based adjustments in a subparagraph addressing QEF stock transferred to a pass-through entity raises questions about its application in other contexts in which basis is relevant. More generally, the reference raises a question as to whether Treasury is considering providing specific rules allowing domestic partnerships basis adjustments based on partner-level inclusions in connection with the aggregate approach of partnerships. In such a case, presumably the basis adjustments would also apply to foreign partnerships.

A domestic partner that wants to make a QEF election with respect to a PFIC owned by a partnership will need to obtain information from the partnership that partnerships typically are not required to provide under current law. Treasury notes in the preamble that the Schedule K-2, "Partners' Distributive Share Items – International" and Schedule K-3, "Partner's Share of Income, Deductions, Credits, etc – International" are expected to facilitate a partner's ability to make a QEF election. Presumably, the partnership would be required to provide the relevant information on the Schedules K-2 and K-3 in the future if the 2022 Proposed Regulations are finalized in their current form. Treasury acknowledges that there could be practical issues with partners receiving information to make a timely QEF election when partners and partnerships have certain non-conforming tax years but indicates that the burden will be on the partner to "make arrangements with the partnership" to obtain the relevant information in a timely fashion.

Additionally, in response to comments received regarding the administrability of partner-level QEF elections, Treasury requests comments on whether the final regulations should allow a domestic partnership or S corporation to make a QEF election on behalf of its partners or S corporation shareholders. The preamble provides a detailed list of items that comments should address, including: the legal mechanism by which the domestic partnership or S corporation would make a QEF election on behalf of its partners and shareholders, whether that delegation should be based on the partnership agreement or S corporation organizational documents or some other instrument, whether a QEF election made by the domestic partnership or S corporation should be binding on all partners or shareholders, and certain the timing, filing, and notification requirements of such an election.

KPMG observation

The detailed request for comments seems to indicate that Treasury may be concerned about the authority for a partnership to make an election for an item of income that is not a partnership item. Currently, domestic partnerships that make QEF and MTM elections arguably are making the election with respect to an item of partnership income: the QEF or MTM inclusion. Under the 2022 Proposed Regulation, the partnership would no longer have an item of income to which the election would relate.

Consistent with the aggregate approach, domestic partnerships and S corporations would no longer be required to file Form 8621. Instead, domestic partnerships and S corporations that own PFICs would provide information to their partners and shareholders to allow the partners and shareholders to complete Form 8621 for the PFIC.

KPMG observation

In general, a domestic partnership with a pedigreed QEF election or a MTM election for a PFIC does not need to complete Part VII (Information to Complete Form 8621) of the Schedules K-2 and K-3, which is used to report PFIC information to partners, if the partnership files Form 8621 for the PFIC. As noted above, Treasury suggests in the preamble to the 2022 Proposed Regulations that domestic partnership could be required to provide QEF and MTM information to their partners on the Schedules K2 and K3 in connection with the aggregate approach in the 2022 Proposed Regulations. On balance, the increase in the domestic partnership's administrative burden of completing the PFIC information on Schedules K2 and K3, including tracking whether and which elections are made by its partners, and potentially assisting the partners in determining their pro

rata share of stock annually most certainly should outweigh the reduction in their burden caused by no longer having to file Form 8621. In particular, the administrative burden on widely held partnerships would be expected to significantly increase.

CFC overlap rule

The CFC Overlap Rule generally provides that a foreign corporation that is both a CFC and a PFIC is not treated as a PFIC with respect to a shareholder during the "qualified portion" of the shareholder's holding period in the stock—i.e., the period during which the corporation was a CFC and the shareholder was a U.S. shareholder. This rule generally is intended to eliminate the simultaneous application of both the PFIC and subpart F regimes to the same U.S. shareholder with respect to the same foreign corporation. Under the GILTI Final Regulations and the 2022 Final Regulations, domestic partnerships and S corporations generally do not have CFC inclusions. Rather, any CFC inclusions are determined by the partners and S corporation shareholders that are U.S. shareholders; partners and S corporation shareholders that are not U.S. shareholders do not have any CFC inclusions under these regulations. Consistent with the aggregate approach to CFC Inclusions, the 2022 Proposed Regulations would "confirm" that for purposes of the CFC Overlap Rule, the qualified portion of a domestic partner's or S corporation shareholder's holding period in CFC/PFIC stock does not include any period where that partner or shareholder was not a U.S. shareholder with respect to the CFC/PFIC. The effect of this rule is that partners that are not U.S. shareholders would be subject to the PFIC rules with respect to the CFC/PFIC.

Treasury acknowledges in the preamble that the application of this rule could lead to inappropriate results under the entity approach that applied to CFC inclusions prior to the 2022 Final Regulations and GILTI Final Regulations because smaller U.S. partners that are not themselves U.S. shareholders would be subject to the PFIC rules even though they include in income their share of any of the partnership's CFC inclusions. The 2022 Proposed Regulations include a transition rule that would mitigate this result by allowing indirect PFIC shareholders who owned stock of a foreign corporation through a domestic partnership or S corporation but are not U.S. shareholders to qualify for the CFC Overlap Rule during periods when the shareholder was subject to current inclusions under subpart F or GILTI with respect to the corporation—e.g., where a partner or shareholder included a share of a domestic partnership's or S corporation's inclusions under Notice 2020-60 or Notice 2019-46. The transition rule would not apply to any year in which the domestic partnership or S corporation applied the aggregate approach in determining subpart F inclusions and section 956 inclusions under the 2019 Proposed Regulations or 2022 Final Regulations. The transition rule would apply to tax years of shareholders beginning before the publication of final regulations in the Federal Register, or for tax years of S corporation shareholders where the S corporation elects entity treatment under the 2022 Proposed Regulations.

KPMG observation

The preamble discussion might suggest that Treasury views the CFC Overlap Rule as currently not applying to a partner of a domestic partnership that is a U.S. shareholder of the CFC/PFIC if the partner itself is not a U.S. shareholder of the CFC/PFIC. Nonetheless, the relief afforded by the transition rule also might suggest that Treasury is not interested in applying the PFIC rules to these partners for years in which the partnership applied the subpart F rules under an entity approach. Arguably, the proposed rules may be intended to address a situation in which a domestic partnership early adopted the 2019 Proposed Regulations (or after the 2022 Final Regulations are applicable to the partnership). In that situation, the domestic partnership might argue that it is a "U.S. shareholder" for CFC Overlap Rule purposes because a partnership is treated as an entity for U.S. shareholder determinations, and further argue that all its partners are protected by the CFC

Overlap Rule as a result of its U.S. shareholder status even though the partnership itself does not have CFC inclusions. This position would be contrary to the rule in the 2022 Proposed Regulation.

KPMG observation

Although the transition rule applies retroactively, the preamble and regulatory text do not address whether taxpayers can early adopt the proposed transition rule prior to its finalization.

The PFIC rules are proposed to apply to tax years of shareholders beginning on or after the date the final regulations are published in the Federal Register.

Subpart F rules

Section 964, including controlling domestic shareholder

As mentioned above, the 2022 Final Regulations provide that a domestic partnership is treated as an entity for purposes of determining whether a U.S. shareholder is a controlling domestic shareholder as defined in Treas. Reg. § 1.964-1(c)(5). In general, controlling domestic shareholders take certain actions on behalf of certain foreign corporations, including CFCs, for example, by making certain elections and adopting and changing methods of accounting.

The 2022 Proposed Regulations would revise the 2022 Final Regulations to take an aggregate approach to domestic partnerships for purposes of Treas. Reg. § 1.964-1(c), which includes controlling domestic shareholder determinations. As a result, for example, domestic partnerships would no longer make elections on behalf of CFCs, such as the high-tax exclusion election. The aggregate approach also would result in the notice requirements in Treas. Reg. § 1.964-1(c) applying with respect to domestic partners of a domestic partnership. Nonetheless, the 2022 Proposed Regulations would allow the notice requirement to be deemed satisfied by providing notice to the domestic partnership itself. These proposed revisions also would apply with respect to S corporations and their shareholders. In addition, the 2022 Proposed Regulations would revise the notice requirements to require notice to be provided to any U.S. person that is a Category 4 filer of a Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations", which is a U.S. person that owns more than 50% of the vote or value of the foreign corporation based on the constructive ownership rules of section 6038(e).

These rules are proposed to apply to tax years of foreign corporations after the date the final regulations are published in the Federal Register, and to tax years of United States shareholders in which or with which such tax years end.

KPMG observation

Extending the aggregate approach for controlling domestic shareholder purposes could impose additional administrative burden on partners of certain partnerships who may need to coordinate in order to act in concert as controlling domestic shareholders when no single partner is a controlling domestic shareholder. Such coordination, further, is likely going to involve the partnership as the partners may not know who the other relevant partners are and may not have the necessary information to contact and coordinate with them.

Elective entity treatment for S corporations

Notice 2020-69, 2020-39 I.R.B. 604, released on September 1, 2020, announced that Treasury intended to issue regulations under section 958 to ease the transition of S corporations with accumulated earning and profits ("AE&P"), from the historic entity treatment (and the hybrid treatment under the 2019 Proposed Regulations) to the aggregate treatment required under the GILTI Final Regulations (the "S corporation transition approach").

The 2022 Proposed Regulations would fully adopt the S corporation transition approach, as described in the Notice, and extend the treatment to potential subpart F and section 956 inclusions, in addition to GILTI inclusions. Under the approach in the proposed rules, an S corporation would be subject to entity treatment with respect to a tax year if:

- An election is made;
- The corporation has elected S corporation status before June 22, 2019;
- The S corporation would be treated as owning, within the meaning of section 958(a), stock of a CFC on June 22, 2019, if entity treatment applied;
- The S corporation has "transition AE&P" on September 1, 2020, or on the first day of any subsequent tax year; and
- The S corporation maintains records to support the determination of the transition AE&P amount.

Under this elective entity treatment, an S corporation that owns stock of a foreign corporation would be treated as owning, within the meaning of section 958(a), a foreign corporation, such that the S corporation would have CFC inclusions. The effect of the election would be to treat an applicable CFC inclusion as an item of income of the S corporation itself, increasing the S corporation's accumulated adjustment account ("AAA"), and consequently, decreasing the potential for a taxable distribution out of the S corporation's AE&P.

For this purpose, the term transition AE&P would mean, with respect to an S corporation and its shareholders, the amount of AE&P of the S corporation calculated as of September 1, 2020, reduced solely by subsequent distributions out of AE&P after September 1, 2020. Generally, under the 2022 Proposed Regulations, an electing S corporation would be treated as an entity under the S corporation transition approach until the first tax year for which it has no transition AE&P on the first day of that year, at which point the S corporation would be treated as an aggregate of its shareholders for that year and each successive year.

The rule is proposed to apply to tax years of S corporations that end on or after September 1, 2020. Taxpayers can choose to apply the rule to tax years of S corporations ending on or after June 22, 2019, provided that the S corporation and its shareholders consistently apply the rules with respect to all CFCs whose stock the S corporation owns within the meaning of section 958(a).

GILTI: Hybrid approach/Notice 2019-46

The 2022 Proposed Regulations include the rules described in Notice 2019-46, which generally allowed domestic partnerships and S corporations to choose to be treated as entities for GILTI inclusion purposes for tax years ending before June 22, 2019, if certain requirements were satisfied. The notification requirements described in Notice 2019-46 that must be satisfied for entity treatment to apply are included in the 2022 Proposed Regulations without substantial change. For example, as described in Notice 2019-46, the partnership or S corporation would have had to provide the required notification to its partners or shareholders no later than the due date (with extensions) for the partnership or S corporation's last tax year that ended before June 22, 2019, for entity treatment to apply for the year. The 2022 Proposed Regulations include the requirement in the Notice for the partnership or S

corporation to report annually to its partners or shareholders the partner's or shareholder's share of the E&P that relates to the GILTI inclusion that the partnership or S corporation reported out to its partner or shareholder for the year in which the partnership or S corporation chose entity treatment.

This rule is proposed to apply to tax years of foreign corporations ending before June 22, 2019, and to tax years of U.S. shareholders in which or with which such tax years end.

Related person insurance income ("RPII") provisions

Treasury also proposed that aggregate treatment for partnerships apply for purposes of determining RPII under section 953. The 2022 Proposed Regulations generally would allocate the RPII in proportion to the partnership's allocation of the related party premium income to U.S. partners. This proposed change appears to be in response to the NY State Bar Association comments. See NYSBA Report No. 1423, September 18, 2019. The NYSBA noted that, if the insured is an operating domestic partnership that is a shareholder in the CFC, under current rules, the partnership would be a U.S. shareholder, so that the income of the CFC from a policy with the partnership as the insured would be RPII. Under the 2022 Proposed Regulations, for purposes of computing the RPII, generally there would not be any RPII to the extent that the partners are not U.S. persons. Treasury included this change in the 2022 Proposed Regulations to allow the opportunity for additional public comment on this change.

KPMG observation

The proposed regulation is consistent with the underlying policy for RPII under section 953. Absent the partnership, a non-U.S. person would not generate RPII. Similarly, if an insurance policy is owned by a foreign partnership, RPII should only be generated to the extent of the U.S. partners.

Section 953(c)(8)(A) provides that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of section 953(c) including regulations preventing the avoidance of this subsection using cross insurance arrangements. Treasury included an anti-abuse rule in the 1991 section 953 proposed regulations. In the 2022 Proposed Regulations, Treasury updated and reproposed its anti-abuse rule against cross-insurance arrangements. This anti-abuse rule aims to stop companies from using an unrelated third-party insurer to circumvent the related party insurance rules. Under the proposed rule, RPII would include an arrangement where a foreign company issues insurance to an unrelated party and, as part of the arrangement, another person issues insurance to a related insured of the foreign company. The rule is proposed to be effective for tax years for foreign corporations ending on or January 24, 2022 and to the associated tax years of U.S. persons.

KPMG observation

The fact that the proposed regulation addressing cross insurance arrangements is generally proposed to be effective for tax years ending on or after January 24, 2022, may impact transactions that have already occurred during the current tax year. Taxpayers who have engaged in transactions that fall within this rule will want to evaluate the provision's impact and potentially restructure the arrangement.

Net investment income tax*: Treas. Reg. § 1.1411-10(g)* election

In general, individuals, estates, and trusts are subject to tax under section 1411 based on their net investment income. For this purpose, distributions of PTEP attributable to CFC inclusions or QEF

inclusions generally are included in net investment income, and CFC inclusions and QEF inclusions are excluded from net investment income. In addition, special basis adjustment rules apply in determining gain or loss on the disposition of CFCs and QEFs for net investment income purposes. The effect of this general rule is that taxpayers subject to section 1411 must separately track PTEP and basis adjustments in order to determine their net investment income. Nonetheless, if an election under Treas. Reg. § 1.1411-10(g) is in effect, CFC inclusions and QEF inclusions are included in net investment income rather than the PTEP distributions, and no special rules applying in determining gain and loss on dispositions of CFCs and QEFs. Thus, the election reduces administrative burden because it eliminates the need to separately track PTEP and certain basis adjustments for section 1411 purposes. An election can be made either by a domestic partnership or S corporation or its partners or shareholders for CFCs and QEFs held by the domestic partnership or S corporation.

Consistent with the move to an aggregate treatment of partnerships and S corporations for Subpart F and PFIC purposes, the 2022 Proposed Regulations would provide that the election under Treas. Reg. § 1.1411-10(g) could be made only by individuals, trusts, and estates. Thus, domestic partnerships and S corporations would no longer be able to make the election.

This rule is proposed to apply to tax years that begin on or after the date the final regulations are published in the Federal Register.

KPMG observation

As described in the preamble to the section 1411 final regulations (T.D. 9644), the ability for partnerships to make the Treas. Reg. § 1.1411-10(g) election was added to the final regulations in response to a comment on the proposed regulation that pointed out the administrative burden that could be imposed on partnerships if they were not otherwise allowed to make the election. The 2022 Proposed Regulations would remove the ability for partnerships to make the election and, thus, could impose on partnerships this additional administrative burden as well as additional administrative burden on any partner that does not make the election. For example, a domestic partnership that owns CFCs or QEFs would have to track whether each of its partners made a section Treas. Reg. § 1.1411-10(g) election and provide certain information regarding PTEP distributions by a CFC or QEF where no election is made. In addition, any partner that does not make the election would need to separately track its PTEP and basis adjustments in order to determine the amount of PTEP and gain or loss on the disposition of the CFC or QEF for section 1411 purposes.

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