



## United States Tax Alert

### PFIC guidance released

On July 10, 2019, the Treasury Department and the Internal Revenue Service (IRS) released **prospectively-applicable** proposed regulations under sections 1291, 1297, and 1298 of the Internal Revenue Code ("Code"). The regulations provide guidance with respect to a number of issues that are not specifically addressed in the current regulations and address some of the complexities that arise in the determination of the ownership of a passive foreign investment company (PFIC) and in the application of the Income Test and Asset Test in cases in which the look-through rule of section 1297(c) applies to a Tested Foreign Corporation. The proposed regulations also withdrew certain proposed regulations published in 2015 with respect to the insurance exception at section 1297(b)(2)(B) and propose new regulations with respect to the insurance exception, which was modified by the Tax Cuts and Jobs Act. The regulations specifically provide rules that:

- **Clarify application of the corporate attribution rules when a partnership indirectly holds a Tested Foreign Corporation through a corporation that is not a PFIC.**

Specifically, under the proposed regulations, for purposes of determining whether a partner, S corporation shareholder, or beneficiary in a partnership, S corporation, estate, or nongrantor trust is considered under § 1.1291-1(b)(8)(ii)(A) to own a portion of stock of a PFIC owned indirectly by the partnership, S corporation, estate, or trust through a non-PFIC foreign corporation, the partner, shareholder, or beneficiary will be considered to own 50% or more in value of the stock of the non-PFIC foreign corporation through the partnership, estate, or trust only if the partner, shareholder, or beneficiary directly or indirectly owns 50% or more of the ownership interests in the partnership, S corporation, estate, or trust.

- **Clarify the scope of the section 1297(b)(1) cross-reference to section 954(c) for purposes of defining passive income.**

As a general matter, the proposed regulations provide that for purposes of section 1297(b)(1), passive income is determined by reference to the items of income listed in section 954(c)(1), subject only to the exceptions found in section 954(c)(1), section 954(c)(2)(A) (relating to active rents and royalties), section 954(c)(2)(B) (relating to certain export financing interest), section 954(c)(2)(C) (relating to dealers), and section 954(h) (relating to entities engaged in the active conduct of a banking, financing, or similar business). In addition, the rules in section 954(c)(4) (relating to sales of certain partnership interests) and 954(c)(5) (relating to certain commodity hedging transactions) apply for PFIC purposes. However, the exceptions in section 954(c)(3) (relating to certain income received from related persons), section 954(c)(6) (relating to certain amounts received from related controlled foreign corporations), and section 954(i) (relating to entities engaged in the active conduct of an insurance business) are not taken into account for purposes of section 1297(b)(1). The proposed regulations also provide that an entity is treated as a controlled foreign corporation for purposes of applying an exception to foreign personal holding company income (FPHCI) and for purposes of determining whether a person is a related person with respect to the entity.

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

With respect to distributive share of partnership income, the proposed regulations provide that a Tested Foreign Corporation's distributive share of any item of income of a partnership is treated as income received directly by the Tested Foreign Corporation, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25% of the value of the partnership, in which case the partnership is referred to as a "Look-Through Partnership," and income elimination rules similar to those for Look-Through Subsidiaries apply. If the Tested Foreign Corporation owns less than 25% of the value of a partnership, the corporation's distributive share of any item of income of the partnership is passive income.

Finally, the proposed regulations provide that the determination of whether the payor of an item of income is a related person should be made on the date of receipt or accrual, as applicable based on the recipient's method of accounting, of the item of income. With respect to income from a related person, under the proposed regulations, for purposes of the section 1297(b)(2)(C) exception, interest is

properly allocable to income of the related person that is not passive income based on the relative portion of the related person's income for its taxable year that ends in or with the taxable year of the recipient that is not passive income (i.e., the "cream-skimming" rule of Treas. Reg. § 1.904-5(c)(2)(ii)(C) does not apply). Dividends are treated as properly allocable to income of the related person that is not passive income based on the portion of the related payor's current-year earnings and profits for the taxable year that ends in or with the taxable year of the recipient that are attributable to non-passive income. Rents and royalties are allocable to income of the related person which is not passive income to the extent the related person's deduction for the rent or royalty is allocated to non-passive income under the principles of §§ 1.861-8 through 1.861-14T.

- **Address certain computational and characterization issues that arise in applying the Asset Test.**

The proposed regulations clarify that the average percentage of a Tested Foreign Corporation's assets is determined using the average of the gross values (or adjusted bases) (i.e., not based on the passive asset percentage) at the end of each quarter of the foreign corporation's taxable year. Alternatively, the assets of a Tested Foreign Corporation can be measured for purposes of the Asset Test more frequently than quarterly (for example, weekly or monthly). The quarter or shorter interval used by a Tested Foreign Corporation is referred to as its "measuring period."

If a Tested Foreign Corporation has a short taxable year, the quarterly measuring dates for purposes of the Asset Test are the same as they would be for a full taxable year, except that the final quarterly measuring date will be the final day of the short taxable year.

The proposed regulations provide that the Asset Test should apply on the basis of value for the entire year if the corporation was publicly traded on the majority of days during the year or section 1297(e)(2) did not apply to the corporation on the majority of days of the year. Otherwise, the Asset Test should apply on the basis of adjusted basis for the entire year.

With respect to certain dual-character assets, the value (or adjusted basis) of the asset is allocated between the passive assets and non-passive assets based on the ratio of passive income produced by the asset during the taxable year to non-passive income. Special rules are provided for stock of related persons, as well as for assets that in part produce income and in part do not produce any income. Further, the proposed regulations provide that property that is subject to the dealer exception is characterized as a non-passive asset for purposes of the Asset Test, notwithstanding the dual-character asset rules.

The proposed regulations provide that for purposes of the Asset Test, a Tested Foreign Corporation that directly or indirectly owns an interest in a partnership is treated as if it held its proportionate share of the assets of a partnership, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25%, by value, of the interests in the partnership. If a Tested Foreign corporation owns less than



25% of the value of the partnership, its interest in the partnership is treated as a passive asset.

- **Clarify the treatment of income and assets of a 25-percent-owned subsidiary under section 1297(c).**

The proposed regulations provide that indirect stock ownership for purposes of section 1297(c) is determined under the principles of section 958(a) applicable for determining ownership by value, without regard to whether entities are domestic or foreign. A Tested Foreign Corporation is treated as owning a share of each asset, and receiving a proportionate share of each item of income, of such a Look-Through Subsidiary proportionate to the Tested Foreign Corporation's percentage ownership (by value) of the Look-Through Subsidiary. Ownership of a Look-Through Subsidiary is determined on each measuring date.

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

Subject to certain qualification requirements, the proposed regulations also provide that intercompany payments of dividends and interest between a Look-Through Subsidiary and the Tested Foreign Corporation, or between two Look-Through Subsidiaries, as well as stock and debt receivables, are eliminated in applying the Income Test and the Asset Test.

The proposed regulations also contain rules coordinating section 1297(c) with sections 1298(b)(7) and 1297(b)(2)(C). With respect to the potential overlap between section 1297(c) and section 1298(b)(7), the proposed regulations provide that the look-through rule of section 1297(c) does not apply to a domestic corporation, and any subsidiaries of the domestic corporation, if the stock of the domestic corporation is characterized, under section 1298(b)(7), as a non-passive asset producing non-passive income. In applying section 1297(b)(2)(C), "related person" status is tested with respect to the payor of the item of income and the Look-Through Subsidiary; the same rule applies for items of income received by a partnership and treated as received directly by a Tested Foreign Corporation.

The interaction of section 1297(c) and certain exceptions from passive income may also raise issues that require a threshold determination of whether an exception should apply at a Look-Through Subsidiary level or a Tested Foreign Corporation level. The proposed regulations provide that an

item of rent or royalty income received or accrued by a Tested Foreign Corporation (or treated as received or accrued by the Tested Foreign Corporation pursuant to section 1297(c)) that would otherwise be passive income under the general rule is not passive income for purposes of section 1297 if the item would be excluded from passive income, determined by taking into account the activities performed by the officers and employees of the Tested Foreign Corporation as well as activities performed by the officers and employees of certain Look-Through Subsidiaries and certain partnerships in which the Tested Foreign Corporation or one of the Look-Through Subsidiaries is a partner.

With respect to gain on the disposition of stock of a Look-Through Subsidiary, the proposed regulations provide that, for purposes of the Income Test, the disposition of a Look-Through Subsidiary is treated as the disposition of stock, and gain is computed accordingly. However, the amount of gain taken into account for purposes of the Income Test ("Residual Gain") is equal to the total gain recognized by the Tested Foreign Corporation on the disposition, reduced (but not below zero) by the amount (if any) by which (a) the aggregate income (if any) of the Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent stock in such other Look-Through Subsidiary is owned indirectly through the Look-Through Subsidiary) taken into account by the Tested Foreign Corporation under section 1297(c)(2) with respect to the disposed Look-Through Subsidiary stock exceeds (b) the aggregate dividends (if any) received by the Tested Foreign Corporation from the Look-Through Subsidiary with respect to the disposed stock (including dividends attributable to stock of any other Look-Through Subsidiary owned indirectly through the Look-Through Subsidiary), computed on a share-by-share basis. The Residual Gain taken into account by the Tested Foreign Corporation will be characterized as passive income or non-passive income in proportion to the passive assets and non-passive assets of the disposed-of Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent owned indirectly through the Look-Through Subsidiary) treated as held by the Tested Foreign Corporation pursuant to section 1297(c) on the date of the disposition, measured using the method (value or adjusted basis) that is used to measure the assets of the Tested Foreign Corporation for purposes of the Asset Test. Section 954(c)(4) applies with respect to the disposition of interests in a Look-Through Partnership.

- **Clarify the application of the section 1298(b)(3) change-of-business exception and propose a new rule analogous to the section 1298(b)(3) change-of-business exception that takes into consideration the assets of the Tested Foreign Corporation.**

The proposed regulations provide that for purposes of section 1298(b)(3)(B), the existence of an active trade or business and the determination of whether assets are used in an active trade or business is determined by reference to Treas. Reg. §§ 1.367(a)-2(d)(2), (3), and (5), except that officers and employees do not include the officers and employees of related entities as provided in § 1.367(a)-2(d)(3). The proposed regulations provide that income attributable to proceeds from the disposition of an active trade or business means income earned on investment of such proceeds but does not include the proceeds themselves. The proposed

regulations also expand the change-of-business exception in section 1298(b)(3) to apply if, on the measuring dates that occur during the taxable year to which the change-of-business exception is proposed to apply and after the disposition, substantially all of the passive assets of a corporation, on average, are attributable to proceeds from the disposition of one or more active trades or businesses.

- **Clarify the application of the section 1298(b)(7) qualified stock exception and provide a rule for waiving treaty benefits that would exempt a Tested Foreign Corporation from the accumulated earnings tax.**

The proposed regulations clarify that stock of the 25%-owned domestic corporation and the qualified stock generally must be owned by the Tested Foreign Corporation and the 25%-owned domestic corporation, respectively, either directly or indirectly through one or more partnerships. The regulations provide that a Tested Foreign Corporation is considered subject to the tax imposed by section 531 for purposes of section 1298(b)(7) regardless of whether the tax actually is imposed on the corporation and regardless of whether the requirements of § 1.532-1(c) are met. The proposed regulations provide that a Tested Foreign Corporation must waive any benefit under a treaty by attaching to its U.S. federal income tax return for the taxable year for which it applies section 1298(b)(7) a statement that it irrevocably waives treaty protection against the imposition of the accumulated earnings tax, effective for all prior, current, and future taxable years.

The proposed regulations also provide two anti-abuse rules to address the possibility of passive assets – particularly non-stock assets that could not themselves be eligible for the special treatment of section 1298(b)(7) – being held through a two-tiered chain of domestic subsidiaries in order to avoid the PFIC rules. The first anti-abuse rule provides that section 1298(b)(7) will not apply if the Tested Foreign Corporation would be a PFIC if the qualified stock or any income received or accrued with respect thereto were disregarded. Under the second anti-abuse rule, section 1298(b)(7) will not apply if a principal purpose for the Tested Foreign Corporation's formation or acquisition of the 25%-owned domestic corporation is to avoid classification of the Tested Foreign Corporation as a PFIC.

The proposed regulations also provide that, notwithstanding the general coordination rule between section 1297(c) and section 1298(b)(7) in Prop. Reg. § 1.1297-2(b)(2)(iii), section 1298(b)(7) does not apply for purposes of determining if a foreign corporation is a PFIC for purposes of the ownership attribution rules (i.e., providing that stock is attributed through a Tested Foreign Corporation that would be a PFIC without regard to the 50%-ownership requirement).

- **Update the insurance exception rules.**

The proposed regulations provide guidance regarding whether the income of a foreign corporation is excluded from passive income pursuant to section 1297(b)(2)(B) because the income is derived in the active conduct of an insurance business by a qualifying insurance corporation (QIC) under section 1297(f) of the Code. Generally, section 1297(f) provides that a QIC is a foreign corporation that (a) would be



subject to tax under subchapter L if it were a domestic corporation and (b) has applicable insurance liabilities that constitute more than 25% of its total assets.

**Definition of applicable insurance liabilities and total assets:**

Prop. Reg. § 1.1297-4(f)(2) defines applicable insurance liabilities as the sum of "[o]ccurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year," "unpaid expenses ... of investigating and adjusted unpaid losses" described previously, and "[t]he aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held for future, unaccrued health insurance claims and claims with respect to contracts providing coverage for mortality or morbidity risks." Prop. Reg. § 1.1297-4(f)(7) defines total assets as "the aggregate end-of-period value of the real property and personal property that the foreign corporation reports on its applicable financial statement for the last annual accounting period ending with or within the taxable year."

**Limitations on applicable insurance liabilities:** When applying the 25% test to a foreign corporation, section 1297(f)(3)(B) provides that the amount of the foreign corporation's applicable insurance liabilities cannot exceed the lesser of (1) the amount that the foreign corporation reported to its "applicable insurance regulatory body", (2) the amount required by applicable law or regulation, or (3) the amount determined under regulations prescribed by the Treasury Department and the IRS. Prop. Reg. § 1.1297-4(e) provides that the amount of applicable insurance liabilities may not exceed the lesser of (1) the amount shown on the most recent applicable financial statement, (2) the minimum amount required by applicable law or regulation of the jurisdiction of the applicable insurance regulatory body, and (3) the amount shown on the most recent financial statement made on the basis of US GAAP or IFRS if such financial statement was not prepared for financial reporting purposes. To the extent that a financial statement not prepared under GAAP or IFRS does not discount losses on an economically reasonable basis, the foreign corporation must reduce its applicable insurance liabilities to reflect discounting that would apply under either US GAAP or IFRS. The proposed regulations further provide an anti-abuse type rule whereby if a foreign corporation which prepares its financials in accordance with GAAP or IFRS ceases to do so without a non-tax business purpose, it will be treated as having no applicable insurance liabilities for purposes of the QIC test.

**Alternative facts-and-circumstances test:** Under 1297(f)(2), a company that fails to satisfy the 25% test under 1297(f)(1) may qualify under an alternative facts-and-circumstances test provided that applicable insurance liabilities constitute more than 10% of its total assets, the corporation is predominantly engaged in an insurance business, and the failure to satisfy the 25% test is due solely to runoff-related or rating-related circumstances involving such insurance business. Prop. Reg. § 1.1297-4(d)(2) provides factors to be considered as part of facts-and-circumstances determination of whether a company is predominantly engaged in an insurance business. Prop. Reg. § 1.1297-4(d)(3)-(4) provide guidance for determination of whether a company satisfies the runoff-related or rating-

related circumstances requirements. Prop. Reg. § 1.1297-4(d)(5) provides procedures that foreign corporations must follow to qualify for the alternative facts-and-circumstances test, as well as the procedures U.S. persons must undertake to make such an election.

**Definition of insurance business and investment**

**activities:** Prop. Reg. § 1.1297-5(c)(2) defines an insurance business as the business of issuing insurance and annuity contracts or reinsuring risks underwritten by other insurance companies (or both). Under the proposed regulations, an insurance business also includes the investment activities and administrative services required to support those insurance, annuity, or reinsurance contracts issued or entered into by the QIC. Prop. Reg. § 1.1297-5(h)(2) provides that investment activities are any activities that generate income from assets that a QIC holds to meet its obligations under insurance and annuity contracts issued or reinsured by the QIC.

**Definition of active conduct:** Prop. Reg. § 1.1297-

5(c)(3)(i) provides that the term "active conduct" is based on all of the facts and circumstances and that, in general, a QIC actively conducts an insurance business only if the officers and employees of the QIC carry out substantial managerial and operational activities. For this purpose, active conduct is intended to be interpreted consistently with the active conduct standard in § 1.367(a)-2(d)(5). The proposed regulation further provides that a QIC's officers and employees are considered to include the officers and employees of another related corporation if the QIC satisfies the control test set forth in Prop. Reg. § 1.1297-5(c)(3)(ii). Under Prop. Reg. § 1.1297-5(c)(4), a QIC determines the annual amount of its income that is derived in the active conduct of an insurance business (the active-conduct test) and excluded from passive income under section 1297(b)(2)(B) for purposes of section 1297(a). To make this determination, the QIC must determine its "active conduct percentage" for purposes of an **all-or-nothing income determination**. The numerator is the expenses for services of officers and employees of the QIC related to the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance contracts issued by the QIC. The denominator is the sum of the numerator and expenses paid by the QIC to a person other than a person whose services for the QIC are covered by the expenses included in the numerator. If the QIC's active-conduct percentage is greater than or equal to 50%, then **all** of the QIC's income is excluded from passive income pursuant to the exception in section 1297(b)(2)(B) for the active conduct of an insurance business. If the QIC's active conduct percentage is less than 50%, then **none** of its income is excluded from passive income.

**Treatment of income and assets of Look-Through Subsidiaries and Look-Through Partnerships held by a**

**QIC:** Prop. Reg. § 1.1297-5(f) provides that certain items of income and assets that are passive in the hands of a Look-Through Subsidiary or Look-Through Partnership may be treated as active by a QIC. Generally, if income or assets are passive in the hands of a Look-Through Subsidiary or Look-Through Partnership, the income or assets are treated as passive. However, if the Tested Foreign Corporation is a QIC (subject to certain limitations), the income and assets are



tested under section §§ 1.1297-5(c) and (e) to determine if they qualify for the section 1297(b)(2)(B) insurance exception to passive income.

**Qualifying domestic insurance corporations:** Prop. Reg. § 1.1297-5(d) and § 1.1297-5(e)(2) provide that income and assets of qualifying domestic insurance corporations are **not treated as passive**. A qualifying domestic insurance corporation is a domestic corporation that is subject to tax as an insurance company under subchapter L and is subject to U.S. federal income tax on its net income.

**No double counting:** Prop. Reg. § 1.1297-5(g) provides that nothing in Prop. Reg. §§ 1.1297-4 or 1.1297-5 permits any item to be counted more than once (for example, for determining a reserve or an applicable insurance liability for purposes of the 25% test and the 10% test).

## Applicability Dates

These regulations are proposed to apply **prospectively** – that is, to taxable years of U.S. persons that are shareholders in certain foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. However, until these regulations are finalized, taxpayers may choose to apply these proposed regulations (other than the proposed regulations under §§ 1.1297-4 and 1.1297-5) in their entirety to all open tax years as if they were final regulations provided that taxpayers consistently apply the rules of these proposed regulations. Until finalization, U.S. persons that are shareholders in certain foreign corporations may apply the rules of §§ 1.1297-4 and 1.1297-5 for taxable years beginning after December 31, 2017, provided those U.S. persons consistently apply the rules of §§ 1.1297-4 and 1.1297-5 as if they were final regulations. In addition, taxpayers may continue to rely on Notice 88-22 until these regulations are finalized.

## Contacts

If you have any questions or would like additional information on the topics covered in this alert, please email one of the following Deloitte professionals:

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