

DEPARTMENT OF THE TREASURY**Internal Revenue Service****26 CFR Part 1**

[TD 9936]

RIN 1545-BO59

Guidance on Passive Foreign Investment Companies**AGENCY:** Internal Revenue Service (IRS), Treasury.**ACTION:** Final regulations.

SUMMARY: This document contains final regulations regarding the determination of whether a foreign corporation is treated as a passive foreign investment company (“PFIC”) for purposes of the Internal Revenue Code (“Code”), and the application and scope of certain rules that determine whether a United States person that indirectly holds stock in a PFIC is treated as a shareholder of the PFIC. The regulations affect United States persons with direct or indirect ownership interests in certain foreign corporations.

DATES:

Effective date: These regulations are effective on January 14, 2021.

Applicability dates: For dates of applicability see §§ 1.1291-1(j), 1.1297-1(g), 1.1297-2(h), 1.1297-4(g), 1.1297-6(f), 1.1298-2(g), and 1.1298-4(f).

FOR FURTHER INFORMATION CONTACT:

Concerning the regulations §§ 1.1291-0 and 1.1291-1, 1.1297-0 through 1.1297-2, 1.1298-0, 1.1298-2, and 1.1298-4, Christina G. Daniels at (202) 317-6934; concerning the regulations §§ 1.1297-4 and 1.1297-6, Josephine Firehock at (202) 317-4932 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:**Background**

On July 11, 2019, the Department of the Treasury (“Treasury Department”) and the IRS published proposed regulations (REG-105474-18) under sections 1291, 1297, and 1298 in the **Federal Register** (84 FR 33120) (the “proposed regulations” or “2019 proposed regulations”). All written comments received in response to the proposed regulations are available at www.regulations.gov or upon request. A public hearing on the proposed regulations was scheduled for December 9, 2019, but it was not held because there were no requests to speak. Terms used but not defined in this preamble have the meaning provided in these final regulations.

In addition, on October 2, 2019, the Treasury Department and the IRS published proposed regulations (REG-

104223-18) relating to the repeal of section 958(b)(4) by the Tax Cuts and Jobs Act, Public Law 115-97, 131 Stat. 2054 (2017) (the “Act”) in the **Federal Register** (84 FR 52398) (the “section 958 proposed regulations”). As in effect before its repeal, section 958(b)(4) provided that section 318(a)(3)(A), (B), and (C) (providing for downward attribution) was not to be applied so as to consider a United States person (as defined in section 7701(a)(30)) as owning stock owned by a person who is not a United States person (a “foreign person”). After the Act repealed section 958(b)(4), stock of a foreign corporation owned by a foreign person could be attributed to a United States person under section 318(a)(3) for various purposes, including for purposes of determining whether the foreign corporation is a controlled foreign corporation within the meaning of section 957 (“CFC”). The section 958 proposed regulations generally made modifications to ensure that the operation of certain rules outside of subpart F of part III of subchapter N of chapter 1 of subtitle A of the Code (“subpart F”) are consistent with their application before the Act’s repeal of section 958(b)(4). A public hearing on these regulations was not held because there were no requests to speak. This rulemaking finalizes the portion of the section 958 proposed regulations under section 1297 regarding the treatment of foreign corporations for purposes of section 1297(e).¹ See Part III.D.1 of the Summary of Comments and Explanation of Revisions section.

A notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register** (REG-111950-20) (the “2020 NPRM”) provides additional guidance on the treatment of income and assets of a foreign corporation for purposes of the PFIC rules and on the exception from passive income under section 1297(b)(2)(B) (“PFIC insurance exception”).

Summary of Comments and Explanation of Revisions**I. Overview**

The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions section discusses those revisions as well as comments received in response to the solicitation of comments in the notice of proposed rulemaking. Comments outside the scope of this rulemaking are generally

not addressed but may be considered in connection with the potential issuance of future guidance.

II. Comments and Revisions to Proposed § 1.1291-1—Taxation of U.S. Persons That Are Shareholders of Section 1291 Funds

Section 1298(a) provides attribution rules that apply to the extent the effect is to treat stock of a PFIC as owned by a United States person. These rules apply when a United States person directly or indirectly owns an interest in a PFIC, a partnership, an estate or a trust, or when a United States person directly or indirectly owns 50 percent or more in value of the stock of a corporation that is not a PFIC. In such cases, the attribution rules of section 1298(a) may apply to treat the United States person as owning shares of a PFIC owned directly or indirectly by such an entity. Stock considered to be owned by a person by reason of any of the foregoing rules is treated as actually owned by that person for purposes of the further application of those rules (the “successive application rule”). Except as provided in regulations, the attribution rules do not apply to treat stock owned or treated as owned by a United States person as owned by any other person. The current rules in § 1.1291-1(b)(8) are consistent with these statutory provisions.

A. Attribution of Ownership Through a Partnership, S Corporation, Estate or Trust

Proposed § 1.1291-1(b)(8)(iii) provided that an owner of an interest in a partnership, S corporation, estate or trust (a “pass-through entity”) would be treated as owning stock owned by the pass-through entity only if the pass-through owner owns 50 percent or more of the pass-through entity. Examples in the proposed regulations illustrated the operation of this rule in cases where a United States person owns 50 percent, in one case, or 40 percent, in another case, of a foreign partnership. The preamble to the proposed regulations indicated that the proposed rule was intended to ensure that the attribution rules apply consistently whether a United States person owns stock of a non-PFIC foreign corporation indirectly through a partnership or directly.

The only comment received on this proposed rule agreed with the results of the first example but recommended that a different approach be taken with respect to attribution through partnerships. The comment responded to the statement in the preamble that the proposed regulations would have results consistent with an aggregate approach to

¹ The other portions of the section 958 proposed regulations were finalized at 85 FR 59428.

partnerships by noting that in certain circumstances the proposed rule would deviate from a true aggregation approach. It posited an example in which application of the rule in the proposed regulations would prevent a United States person from being treated as owning stock of a PFIC owned by a non-PFIC corporation, even though the United States person directly and indirectly owned, in the aggregate, more than 50 percent of the stock of the non-PFIC corporation and argued that this result was inappropriate. Accordingly, the comment suggested that the final regulations, instead of adopting the rule included in the proposed regulations, adopt a rule that uses an aggregation approach to attribution through partnerships.

The Treasury Department and the IRS agree with the comment that the rule in the proposed regulations could have inappropriate results, and that a partner in a partnership should be treated as indirectly owning the same number of shares of a non-PFIC corporation owned by the partnership as if the partner held those shares directly. Accordingly, the final regulations do not adopt the rules in the proposed regulations to amend the rules of § 1.1291-1(b)(8)(iii), relating to pass-through entities (partnerships, S corporations, estates and nongrantor trusts).

B. Application of “top-down” Approach

The preamble to the proposed regulations indicated that proposed § 1.1291-1(b)(8)(iii) was intended to apply the attribution rules to a tiered ownership structure involving a pass-through entity on a “top-down” basis, by starting with a United States person and determining what stock is considered owned at each successive lower tier on a proportionate basis. The preamble requested comments as to whether the “top-down” approach should be extended to attribution through corporations.

The only comment received on the issue indicated that the “top-down” approach should not be so extended, on the grounds that the successive application rule of section 1298(a)(5) requires a “bottom-up” approach (that is, applying the attribution rules to a tiered ownership structure by starting with the lowest-tier entity and determining which persons are treated as owning stock of that entity at each successive higher tier on a proportionate basis) for corporate structures. The comment acknowledged that this would result in inconsistency in attribution of ownership between stock of a PFIC held through a partnership (which, in many cases, may be a foreign corporate entity

treated as a partnership for U.S. federal income tax purposes as the result of a check-the-box election) and stock of a PFIC held through a corporation.

The Treasury Department and the IRS have determined that the same approach should apply to attribution through a pass-through entity, a PFIC or a 50 percent-owned non-PFIC corporation. In each case, the statutory language provides that an owner of an interest in such an entity is treated as owning its proportionate share of stock owned by the entity. The same approach to attribution therefore should apply regardless of which entity a United States person holds an interest in.

The successive application rule of section 1298(a)(5) can be applied either under a “top-down” or “bottom-up” approach. While both approaches to attribution may treat a United States person as owning an amount of stock of a PFIC that is less than that person’s economic interest in the PFIC, a “top-down” approach takes into account both the direct and indirect ownership of stock of a corporation by the same person while the bottom-up approach may not do so. For example, assume that U.S. individual A owns 49 percent of the partnership interests in a partnership that owns 95 percent of the stock of a tested foreign corporation. The tested foreign corporation is not a PFIC but owns all of the single class of stock of a PFIC. Individual A also owns the remaining 5 percent of the tested foreign corporation’s stock directly. Under a “top-down” approach, individual A is deemed to hold 46.55 percent of the tested foreign corporation’s stock through the partnership and owns 5 percent of the tested foreign corporation’s stock directly. Therefore, individual A is treated as owning 51.55 percent of the tested foreign corporation’s stock and 51.55 percent of the PFIC stock. Under a “bottom-up” approach, the tested foreign corporation owns all of the PFIC stock; the partnership owns 95 percent of the tested foreign corporation’s stock and therefore is treated as owning 95 percent of the PFIC stock; and individual A is treated as owning 49 percent of what the partnership owns, or 46.55 percent of the PFIC stock. In this example, the “top-down” approach treats individual A as owning its economic share of the PFIC’s stock, while the “bottom-up” approach may not take into account the PFIC stock that is owned through the 5 percent of the tested foreign corporation’s stock that individual A owns directly. Accordingly, the final regulations apply a “top-down” approach to the

attribution of ownership through all tiered ownership structures.

The final regulations also include a new rule addressing the application of the successive application rule to tiered ownership structures. The new rule specifically provides for a top-down approach to attribution of ownership. See § 1.1291-1(b)(8)(iv). The examples in the existing and proposed regulations have been revised to clarify how the top-down approach applies to those examples. See § 1.1291-1(b)(8)(v). A new example is added to illustrate the operation of the successive application rule in a fact pattern in which a United States person owns stock of a foreign corporation both directly and indirectly through a partnership. See § 1.1291-1(b)(8)(v)(D).

C. Ownership Attribution Through Nongrantor Trusts

A comment requested that the final regulations provide additional guidance on attributing PFIC stock held by a nongrantor trust to the beneficiaries of the trust, suggesting that determining ownership by U.S. beneficiaries of PFIC stock held directly or indirectly by a nongrantor trust warrants more specificity than determining ownership in PFIC stock held directly or indirectly by other pass-through entities.

Section 1298(a)(3) and § 1.1291-1(b)(8)(iii)(C) provide that each beneficiary is considered to own a proportionate amount of stock held by a foreign or domestic estate or nongrantor trust. Section 1.1291-1(b)(8)(i) provides that the determination of a person’s indirect ownership is made on the basis of all the facts and circumstances of each case and that the substance rather than the form of the ownership is controlling, taking into account the purposes of sections 1291 through 1298.

On December 31, 2013, the Treasury Department and the IRS published final and temporary regulations under several Code sections including section 1291 (78 FR 79602, as corrected at 79 FR 26836) (“2013 temporary and final regulations”). The preamble to those regulations provided that pending further guidance, beneficiaries of estates and nongrantor trusts that hold PFIC stock subject to the section 1291 regime should use a reasonable method to determine their ownership interests in the PFIC. The preamble to those regulations also provided that section 1291 and the principles of subchapter J must be applied in a reasonable manner with respect to estates and trusts, and beneficiaries thereof, to preserve or trigger the tax and interest charge rules under section 1291. Accordingly, the

preamble provided that the estate or trust, or the beneficiary thereof, must take excess distributions into account under section 1291 in a reasonable manner, consistent with the general operating rules of subchapter J and that it would be unreasonable for the shareholders of the section 1291 fund to take the position that neither the beneficiaries nor the estate or trust are subject to the tax and interest charge rules under section 1291.

The Treasury Department and the IRS remain aware of the need for guidance regarding both the ownership attribution rules and the interaction of the rules in subchapter J with the PFIC rules. The Treasury Department and the IRS are also aware that in some cases, the application of the PFIC attribution rules may impose tax on U.S. beneficiaries of foreign trusts that never receive the related distributions. The Treasury Department and the IRS believe that further guidance with respect to the identification of indirect shareholders in such circumstances requires coordination of the PFIC rules with the rules of subchapter J, which is beyond the scope of this regulation project. Pending the issuance of further guidance, taxpayers should continue to apply these rules in a reasonable manner as expressed in the preamble to the 2013 temporary and final regulations.

III. Comments and Revisions to Proposed § 1.1297-1—Definition of Passive Foreign Investment Company

Proposed § 1.1297-1 provided general rules and definitions under section 1297 including general rules concerning the application of the income test of section 1297(a)(1) (“Income Test”) and the asset test of section 1297(a)(2) (“Asset Test”), clarification on the scope of the section 1297(b)(1) cross-reference to section 954(c) for purposes of defining passive income, and general rules that address certain computational and characterization issues that arise in applying the Asset Test.

A. Definition of Passive Income

1. In General

Section 1297(b)(1) defines passive income, for purposes of the PFIC rules, as income of a kind that would be foreign personal holding company income (“FPHCI”) under section 954(c), and proposed § 1.1297-1(c)(1)(i) provided accordingly that passive income means income of a kind that would be FPHCI under section 954(c)(1). A comment suggested that the cross-reference to section 954(c)(1) should incorporate only those

provisions of section 954(c) (and the regulations thereunder) that were in effect in 1986 when section 1297 was enacted and not, for example, section 954(c)(1)(H), relating to income from personal services contracts, or recent revisions to the regulatory rules for active rents and royalties under section 954(c)(2)(C). The Treasury Department and the IRS disagree, and believe that, in view of the original purpose of referencing section 954(c), section 1297 incorporates the law in respect of the referenced provisions—both statutory and regulatory—when it is applied. *Compare* section 951A(d)(3).² Therefore, the final regulations do not adopt this comment.

2. PFIC/CFC Overlap Rule and RPII Income

Section 1297(d) provides that, for PFIC purposes, a corporation shall not be treated as a PFIC with respect to a shareholder during the qualified portion of such shareholder’s holding period with respect to stock in such corporation during which time the corporation is a CFC (“PFIC/CFC overlap rule”). The qualified portion of a shareholder’s holding period generally is the period during which the shareholder is a United States shareholder (“U.S. shareholder”), as defined in section 951(b). Section 951(b) defines a U.S. shareholder, for purposes of the Code, as a U.S. person that owns 10 percent or more of the voting power or value of a foreign corporation. Section 957(a) provides that, for purposes of the Code, a CFC means any foreign corporation more than 50 percent owned (by vote or value, taking into account section 958(b) constructive ownership rules) by U.S. shareholders on any day during the taxable year of the foreign corporation.

In certain circumstances, the subpart F insurance rules lower the CFC ownership threshold requirements used to determine CFC status and eliminate the 10 percent vote or value test for determining U.S. shareholder status that are otherwise applicable for purposes of the Code. Under section 957(b), a special definition of a CFC applies and lowers the more than 50 percent ownership rule to a more than 25 percent ownership rule for taking into account section 953(a) insurance income, but only if the foreign corporation’s gross amount of premiums or other consideration in respect of reinsurance or the issuing of insurance

² As enacted, section 951A(d) contains two paragraphs designated as paragraph (3). The section 951A(d)(3) referenced in this preamble relates to the paragraph on determination of the adjusted basis in property for purposes of calculating QBAL.

or annuity contracts not described in section 953(e)(2) exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks. Also, under section 953(c)(1)(B), for purposes of taking into account related party insurance income (“RPII”) as defined in section 953(c)(2), the CFC ownership requirement is reduced to a “25 percent or more” requirement. In addition, for purposes of determining RPII, the 10 percent of vote or value test for determining U.S. shareholder status is eliminated. *See* section 953(c)(1)(A). Instead, for RPII purposes, a U.S. shareholder means any U.S. person that directly or indirectly owns any of the stock of the foreign corporation at any time during the foreign corporation’s taxable year. *See* section 953(c)(1)(A). Constructive ownership under section 958(b) is not taken into account for this purpose.

A comment requested that the proposed regulations be modified to provide an exception to the PFIC rules for all U.S. shareholders (meaning without regard to the 10 percent vote or value test in section 951(b)) of all CFCs (including those that satisfy the 25 percent threshold applicable solely for the subpart F purposes described above). The final regulations do not adopt this comment. Consideration of the scope of the PFIC/CFC overlap rule, including the interaction with the RPII rules, is beyond the scope of this rulemaking. The Treasury Department and the IRS continue to study the interaction of these provisions and if necessary, will provide guidance in the future.

B. Exceptions From Passive Income

1. Application of Active Banking and Active Insurance Exceptions

Proposed § 1.1297-1(c)(1)(i)(A) provided that section 954(h), which excludes from FPHCI income derived by a CFC in the active conduct of a banking or financing business from customers outside of the United States, applied for purposes of determining PFIC status. The proposed regulations also provided that section 954(i), which excludes from FPHCI certain income derived in the active conduct of an insurance business, did not apply for purposes of determining PFIC status. *See* proposed § 1.1297-1(c)(1)(i)(B). Several comments approved of the application of section 954(h) to the determination of whether income is treated as passive for purposes of section 1297. One comment noted that, in the case of tested foreign corporations with look-through subsidiaries that are domestic corporations, section 954(h)(3)(A)(ii)(I)

would result in the section 954(h) exception being inapplicable to active financing income earned by these subsidiaries from transactions with local customers, even though it would otherwise be of a type that would not be passive. The comment suggested that section 954(h) should be applied in the PFIC context by treating income as qualified banking or financing income even if the income is derived from transactions with customers in the United States. Several comments recommended that the section 954(h) exception continue to apply in the PFIC context in the event that final regulations implementing the active banking exception in section 1297(b)(2)(A) are adopted. Comments also requested that the final regulations apply the section 954(i) insurance exception for purposes of determining PFIC status of an insurance company in a parallel manner as section 954(h).

In response to these comments, the Treasury Department and the IRS have further studied sections 954 and 1297 and their legislative history. As described in more detail in the remainder of this Part III.B.1 of this Summary of Comments and Explanation of Revisions section, the Treasury Department and the IRS have determined that sections 954(h) and (i) do not apply for purposes of section 1297(b) absent regulations and that the appropriate statutory authority for any such regulations is section 1297(b)(2) rather than section 1297(b)(1). The Treasury Department and the IRS have further concluded that section 954(i) does not apply for purposes of section 1297(b)(2)(B), and that certain principles of section 954(h) should be applied for purposes of section 1297(b)(2)(A) but that a different approach is warranted with respect to section 954(h) than the approach taken in the proposed regulations. Accordingly, the 2020 NPRM proposes rules that would treat qualifying income of certain taxpayers that satisfy the requirements of section 954(h) as income derived in the active conduct of a banking business within the meaning of section 1297(b)(2). See proposed § 1.1297–1(c)(2).

As previously discussed, section 1297(b)(1) provides that, except as otherwise provided in section 1297(b)(2), passive income means any income of a kind that would be FPHCI as defined in section 954(c). The definitions of the categories of FPHCI listed in section 954(c) describe types of gross income, for example interest, dividends, gains from the sale of property and foreign currency gains, as well as exceptions to those definitions.

While these definitions and exceptions in some places refer to CFCs, the definitions and exceptions themselves do not require that a foreign corporation be a CFC. By contrast, although sections 954(h) and (i) apply “for purposes of section 954(c)(1),” those provisions explicitly require that a foreign corporation be a CFC to qualify for an exception to FPHCI. Section 954(h) applies only to eligible CFCs, as defined in section 954(h)(2), and section 954(i) applies only to qualifying insurance company CFCs, as defined in section 953(e)(3). Accordingly, sections 954(h) and (i) do not apply for purposes of section 1297(b)(1) unless a tested foreign corporation is treated pursuant to regulations as a CFC for that purpose or otherwise qualifies as a CFC. See proposed § 1.1297–1(c)(1)(i)(D) of the 2019 proposed regulations (treating a tested foreign corporation as a CFC for purposes of applying section 954(h)).

The Treasury Department and the IRS have further determined that any regulations treating sections 954(h) and (i) as applicable for purposes of section 1297(b) should be issued under section 1297(b)(2) and not under section 1297(b)(1). As originally enacted, section 1297(b)(1) provided a rule of general application, and section 1297(b)(2) provided a limited set of exceptions to section 1297(b)(1). While the list of exceptions in section 1297(b)(2) has changed from time to time, that statutory scheme remains intact today. Section 1297(b)(2) provides exceptions for income derived in the active conduct of a banking or insurance business, subject to various conditions. If section 954(h) or (i) were treated as applicable for purposes of section 1297(b)(1), section 1297(b)(2)(A) and (B) would provide duplicative exceptions for banking or insurance income, respectively. Moreover, interpreting section 1297(b)(1) in this manner would have the effect of narrowing the scope of the exceptions provided by section 1297(b)(2), because the income of some foreign banks or insurance companies would already be treated as non-passive under section 1297(b)(1). No explicit action by Congress authorizes the narrowing of section 1297(b)(2) in this manner. The legislative history of the enactment of section 954(h) (as a temporary rule relating to both banking and insurance income) in 1997 and the enactment of sections 954(h) and (i) in 1998 are void of any indication that Congress intended such an interpretation of section 1297(b)(1).³

³ See H.R. Rep. No. 220, 105th Cong. 1st Sess. 623–28 (July 30, 1997) (discussing adoption of section 1297(d) CFC overlap rule and section 1296

The legislative history provides further evidence that section 954(h) was not intended to apply for purposes of section 1297(b)(1); the conference report states that “the conferees intend that a corporation will be considered to be engaged in the active conduct of a banking . . . business if the corporation would be treated as so engaged under the regulations proposed under” section 1297(b)(2).⁴ Incorporating this standard into section 1297(b)(1) would limit the scope of section 1297(b)(2). Accordingly, given the specialized nature of these exceptions within the subpart F regime, the Treasury Department and the IRS have determined that it is inappropriate to apply them in defining the types of income that are “of a kind” described in section 954(c) (that is, FPHCI) for purposes of section 1297(b)(1).

In addition, as explained in the preamble to the 2019 proposed regulations, the Treasury Department and the IRS have determined that because the recent changes to section 1297(b)(2)(B) require that income eligible for the exception be earned by a qualifying insurance corporation, section 954(i) should not apply in addition to the newly modified exception in section 1297(b)(2)(B). See 84 FR 33120, at 33123. Therefore, the final regulations do not adopt the comments requesting that the section 954(i) exception apply for purposes of determining PFIC status. As a result, section 954(i) remains listed in § 1.1297–1(c)(1)(i)(B) as one of the exceptions in section 954 that is not applied in the PFIC context.

Section 954(h) has been removed from the list of exceptions that are applied to PFICs with respect to section 1297(b)(1). See § 1.1297–1(c)(1)(i)(A). Despite the conclusion that it is inappropriate to incorporate section 954(h) as an exception to the definition of passive income under section 1297(b)(1), the Treasury Department and the IRS have considered whether principles of section 954(h) could apply in the context of the rules of section 1297(b)(2)(A). Section 1297(b)(2)(A) provides that passive income does not include any income derived in the

mark-to-market rule; no discussion of contemporaneous adoption of section 954(h)); *id.* at 639–45 (discussing adoption of active financing income (section 954(h)) rule; no suggestion that rules apply for PFIC purposes).

⁴ *Id.* at 642; see also H.R. Rep. No. 105–825, at 1555 (Oct. 19, 1998) (Conf. Rep.) (“[I]n this regard, a corporation is considered to be engaged in the active conduct of a banking or securities business if the corporation would be treated as so engaged under the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997)”).

active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in regulations, by any other corporation). Pursuant to this grant of regulatory authority, the 2020 NPRM proposes an active banking exception that incorporates certain principles of section 954(h) in defining other corporations that are eligible to apply this exception in addition to U.S. licensed banks. See proposed § 1.1297–1(c)(2). The preamble to the 2020 NPRM discusses comments that address issues relating to the potential application of section 954(h) in the PFIC context.

2. Treatment of Gains From Certain Transactions

Proposed § 1.1297–1(c)(1)(ii) provided that for purposes of the Income Test, categories 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. However, under the proposed regulations, the net amount of income in each category of FPHCI was calculated separately for each relevant corporation, such that net gains or losses of a look-through subsidiary may not be netted against net losses or gains of another look-through subsidiary or of a tested foreign corporation. See proposed § 1.1297–1(c)(1)(ii).

One comment recommended that the final regulations not adopt the separate entity approach in proposed § 1.1297–1(c)(1)(ii) and, instead, permit a tested foreign corporation to net its gains and losses with those of its directly or indirectly owned look-through subsidiaries and its directly or indirectly owned partnerships. The comment noted that the separate entity approach could result in an overstatement of FPHCI of an integrated business that is conducted through multiple subsidiaries.

The Treasury Department and the IRS have determined that the integrated treatment proposed by the comment with respect to look-through subsidiaries and look-through partnerships is consistent with the statutory language treating the owner of a look-through subsidiary as receiving directly its proportionate share of the income of the subsidiary, and with the policies underlying section 1297(c). Accordingly, § 1.1297–1(c)(1)(ii) provides that the net gains or income for a category of FPHCI that is determined by netting gains against losses are determined at the level of a tested foreign corporation taking into account individual items of the tested foreign corporation and its look-through subsidiaries and look-through

partnerships. Because these regulations do not adopt an overall look-through approach with respect to all partnerships, netting is not provided with respect to gains and losses derived from partnerships that are not look-through partnerships. For example, netting does not apply to gains and losses that are part of a tested foreign corporation's distributive share from a partnership that is a related person within the meaning of section 954(d)(3) but not a look-through partnership.

3. Treatment of Effectively Connected Income and Income Attributable to U.S. Permanent Establishments

Section 952(b) excludes from subpart F income the U.S. source income of a CFC that is effectively connected with the conduct by such CFC of a trade or business in the United States (“effectively connected income”). Comments noted that the proposed regulations did not address the treatment of effectively connected income, or the assets held to produce such income, of a foreign corporation or the treatment of income that is attributable to a U.S. permanent establishment, or the assets held to produce such income. The comments noted that section 952(b) can exclude from subpart F income amounts that are FPHCI in order to prevent such amounts from being double-taxed, once directly to the foreign corporation, and a second time to United States shareholders of the foreign corporation, and stated that the PFIC rules should not discriminate against income earned through a U.S. branch rather than through a domestic subsidiary that may qualify for the special rules of section 1298(b)(7). These comments suggested that the final regulations either characterize such income, and the assets held to produce such income, as non-passive or not include such income for purposes of the Income and Asset Tests.

As noted in Part III.B.1 of this Summary of Comments and Explanation of Revisions, the determination of whether amounts should be taken into account for purposes of the Income Test or the Asset Test is based on whether income would be FPHCI under section 954(c), not whether the income is treated as subpart F income. The PFIC rules address whether income is passive, which is a different question from whether it should be treated as subpart F income. Section 1298(b)(7) does not provide non-passive treatment for all income of domestic subsidiaries, but rather only for income of domestic subsidiaries that meet specified requirements, indicating that Congress did not consider it appropriate to

exclude all income of domestic subsidiaries that are subject to U.S. net income taxation from passive income treatment. As a corollary, the limited scope of section 1298(b)(7) implies that a broad exception for effectively connected income is not warranted. Furthermore, section 1293(g)(1)(B)(ii) provides authority to exclude effectively connected income of a PFIC that is subject to U.S. net income taxation from inclusion in the hands of a shareholder of the PFIC that has made a qualified electing fund election, indicating that effectively connected income is otherwise treated as income of a tested foreign corporation for PFIC purposes.

The Treasury Department and the IRS have determined that an exclusion of effectively connected income (and income attributable to a U.S. permanent establishment) from passive income would be inconsistent with the statutory definition of passive income in section 1297(b)(1), with the limited application of section 1298(b)(7) and with the exclusion provided by section 1293(g)(1)(B)(ii), and that the treatment of effectively connected income (and income attributable to a U.S. permanent establishment) is contemplated and appropriately addressed by the existing PFIC rules. Consequently, the final regulations do not adopt the suggestions in these comments.

C. Income Subject to the Related Person Look-Through Rule

Section 1297(b)(2)(C) characterizes dividends, interest, rents, and royalties received or accrued from a related person as non-passive income to the extent those amounts are properly allocable to income of such related person that is not passive. Proposed § 1.1297–1(c)(3) provided additional guidance on the application of the section 1297(b)(2)(C) related person exception for dividends, interest, rents, and royalties. In response to comments, changes have been made to these regulations and additional guidance has been provided.

Under the final regulations, for purposes of the Asset Test and Income Test, corporations and partnerships owned in whole or part by a tested foreign corporation are generally classified into one or more of three categories. Lower-tier entities generally are treated as one or more of (i) a look-through subsidiary or look-through partnership (a “look-through entity”), (ii) a related person or (iii) an entity that is neither a look-through entity nor a related person. The rules for look-through entities are discussed in Part IV of this Summary of Comments and Explanation of Revisions. Dividends

and the distributive share of income from a lower-tier entity that is neither a look-through entity nor a related person generally are treated as passive income, regardless of whether the income of the lower-tier entity is active or passive in its hands. See § 1.1297-1(c)(3).

Similarly, ownership interests in such entities are treated as passive assets. See § 1.1297-1(d)(4).

For purposes of section 1297(b)(2)(C), the term *related person* has the meaning provided by section 954(d)(3). See section 1297(b)(2) and § 1.1297-1(f)(8). Because the ownership threshold required for an entity to be treated as a related person is higher than the ownership threshold required for an entity to be treated as a look-through entity, there may be many entities that qualify as both or solely as look-through entities. However, because section 954(d)(3) has broader attribution rules than the rules that apply for purposes of determining look-through entity classification, there may be entities that are treated as related persons with respect to a tested foreign corporation but not as look-through entities with respect to that tested foreign corporation.

For purposes of section 1297(b)(2)(C), interest, dividends, rents or royalties actually received or accrued by a tested foreign corporation are considered received or accrued from a related person only if the payor of the interest, dividend, rent or royalty is a related person with respect to the tested foreign corporation. In the case of income received or accrued from a look-through entity, the rules that eliminate intercompany income described in Part IV.D of this Summary of Comments and Explanation of Revisions apply before the rules applicable to income received or accrued from a related person. See § 1.1297-1(c)(4)(ii). Consequently, the rules of § 1.1297-1(c)(4) apply to dividends, interest, rents, and royalties received or accrued from a look-through entity only if those amounts are treated as regarded after application of the intercompany income rules. These rules also apply to income from a related person that is received or accrued by a look-through entity. The determination of whether income received or accrued by a look-through entity is treated as received from a related person is made at the level of the look-through entity, both for purposes of determining whether the look-through entity is a PFIC, if relevant, and for purposes of determining whether an upper-tier tested foreign corporation is a PFIC. See § 1.1297-2(d).

If a partnership is a related person (that is not a look-through entity) with

respect to a tested foreign corporation or look-through entity, and therefore subject to these rules, the tested foreign corporation's or look-through entity's distributive share of income from the partnership is treated as passive or non-passive in whole or part based on the activities of the partnership, and the partnership interest is correspondingly treated as passive or non-passive in whole or part. See § 1.1297-1(c)(4)(vii), (d)(3)(i), and (d)(4). An asset that gives rise to income that is treated as in part passive and in part non-passive pursuant to these rules is subject to the rules that apply to dual-character assets. See § 1.1297-1(d)(3)(i).

1. Treatment of Interest

The proposed regulations provided that, 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. See proposed § 1.1297-1(c)(3)(i). Comments generally supported the pro rata approach taken in the proposed regulations. One comment noted that the final regulations should clarify that the allocation is based on the ratio of gross non-passive income to gross total income. Another comment that supported the pro rata approach in the proposed regulations recommended that the final regulations address situations in which the related person does not have income during the taxable year of the payment. In such a case, this comment suggested that the final regulations apply the principles of § 1.861-9T, which provides rules for allocating and apportioning interest expense, to determine whether the interest payments are allocated to passive or non-passive income of the related person. The comment also requested that the approach using the principles of § 1.861-9T to allocate interest when the related person does not have gross income be made available as an alternative method at the election of the tested foreign corporation.

As suggested by the first comment, the final regulations clarify that the ratio for allocating interest to income is based on gross income. See § 1.1297-1(c)(4)(iii). Similar clarifications are made for the rule for rents and royalties. See § 1.1297-1(c)(4)(v). The Treasury Department and the IRS have determined that the pro rata approach provided in the proposed regulations is the most straightforward and consistent

with the purposes of the section 1297(b)(2)(C) exception if the related person has gross income in the taxable year, and accordingly, the final regulations do not provide a generally applicable election to apply the principles of § 1.861-9T in lieu of the general rule. See § 1.1297-1(c)(4)(iii).

It is anticipated that it will rarely be the case that a related person will not have gross income, because gross income for most taxpayers is determined without taking expenses into account. However, in the case of taxpayers that determine gross income after taking operating expenses into account, it is possible that a taxpayer will not have gross income for a taxable year. In such a case, the Treasury Department and the IRS agree that the principles of § 1.861-9T may properly apply for a year in which the related person does not have gross income, because § 1.861-9T is a general rule—the default rule in the absence of a more specific rule—relating to the allocation of interest expense. Alternatively, because section 1297(b)(2)(C) characterizes interest received or accrued from a related person as non-passive income to the extent it is properly allocable to non-passive income of the related person, it may also be appropriate for interest received or accrued by the tested foreign corporation to be allocated entirely to passive income in such a case, and that treatment may be simpler for a tested foreign corporation to determine. Accordingly, the final regulations provide that for a year in which the related person does not have gross income, a tested foreign corporation may use the principles of § 1.861-9 through -13T, applied in a reasonable and consistent manner taking into account the general operation of the PFIC rules and the purpose of section 1297(b)(2)(C) in order to allocate interest received or accrued from the related person between passive and non-passive income. Alternatively, at a tested foreign corporation's election, it may treat the interest income entirely as passive income.

2. Treatment of Dividends

The proposed regulations provided that, for purposes of the section 1297(b)(2)(C) exception, 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 earnings and profits ("E&P") for the taxable year that ends in or with the taxable year of the recipient that is attributable to non-passive income. See proposed § 1.1297-1(c)(3)(ii).

A comment observed that foreign corporations often do not maintain E&P based on U.S. tax principles. The comment recommended that dividends be treated as allocated between passive and non-passive amounts based on the ratio of passive to non-passive gross income.

Two comments requested that proposed § 1.1297-1(c)(3)(ii) be modified to allocate dividend income based on both current and accumulated E&P of the related payor to which the dividend income is attributable, in accordance with the principles of section 316. A third comment observed that there are administrative benefits to characterizing dividends by reference to current E&P, because it may be easier to obtain relevant information for current E&P and because the nature of a company's activities may change. This comment further requested that dividends be determined by reference to gross income over a reasonable look-back period such as three to five years, rather than by reference to E&P under section 316 principles, in order to reflect the economic reality of the corporation's activities and to avoid undue emphasis on the timing of the dividends. The comment suggested as an alternative that this method might apply only if the related payor does not maintain E&P using U.S. tax principles, while if the related party does maintain E&P based on U.S. tax principles, then, to the extent of current E&P, dividends would be characterized based on the portion of the related payor's current-year E&P that is attributable to non-passive income, and the remaining amount would be characterized based on the relative portion of accumulated E&P that is attributable to non-passive income. The comment suggested that the ratio for accumulated E&P could be based on accumulated E&P for the period in which the related payor was a related person under section 954(d)(3).

Another comment suggested that the difficulty in obtaining information necessary to determine the character of accumulated E&P with respect to foreign corporations could be addressed by allowing taxpayers to use reasonable methods to determine the character of accumulated E&P and proposed that characterizing the accumulated E&P based on the current year's E&P be considered a reasonable method.

The Treasury Department and the IRS agree that dividends from related parties should be allocated between passive and non-passive E&P based on the principles of section 316, which apply generally for purposes of the U.S. international tax rules. Accordingly, the final regulations adopt the

recommendation to characterize dividends in accordance with first current and then accumulated E&P of the related payor to which the dividend income is attributable. *See* § 1.1297-1(c)(4)(iv)(A). In order to address concerns that foreign corporations that are not CFCs may not maintain E&P based on U.S. tax principles, taxpayers are permitted to allocate E&P in proportion to the ratio of passive gross income to non-passive gross income for the relevant period. *See* § 1.1297-1(c)(4)(iv)(B).

The Treasury Department and the IRS also agree with the premise of all of the comments that if dividends are paid out of E&P other than current E&P, either because there is no current E&P or because the amount of the dividends exceeds the current E&P, it would be appropriate to take into account the character of the income supporting the dividend. The final regulations provide that dividends paid out of accumulated E&P are allocated between passive and non-passive E&P under the same rules that apply with respect to dividends paid out of current E&P. *See* § 1.1297-1(c)(4)(iv)(C).

The Treasury Department and the IRS understand that it may be difficult for shareholders to determine the character of accumulated E&P with respect to foreign corporations, particularly for E&P from pre-acquisition periods. The suggestion of referring to a look-back period of several years is consistent with the rule for characterizing stock, discussed in Part III.D.4 of this Summary of Comments and Explanation of Revisions, which is intended to effectively treat stock as, in whole or part, held for the production of non-passive income if dividends received with respect to it within a three-year period constitute non-passive income due to the application of section 1297(b)(2)(C). Accordingly, the final regulations permit taxpayers to use the default approach, consistent with general U.S. federal income tax principles, of allocating dividends paid out of accumulated E&P based on the ratio of passive to non-passive E&P for each prior year (beginning with the most recently accumulated), or to use one of two administratively simpler alternatives. *See id.* The first alternative is to allocate dividends paid out of accumulated E&P based on the ratio of passive to non-passive E&P that is attributable to E&P accumulated in the years in which the payor was related to the recipient. If the payor has been related to the recipient for more than three years, a second alternative is available, which is to allocate dividends paid out of accumulated E&P based on

the ratio of passive to non-passive E&P that is attributable to E&P accumulated during a look-back period of the three years before the current taxable year. *See id.*

D. Asset Test

1. Section 958 Proposed Regulations

Shareholders of a foreign corporation that became a CFC as a result of the repeal of section 958(b)(4) would have to apply the Asset Test based on the adjusted basis of the foreign corporation's assets under section 1297(e). The section 958 proposed regulations modified the definition of a CFC for purposes of section 1297(e) to disregard downward attribution from foreign persons. *See* proposed § 1.1297-1(d)(1)(iii)(A). No comments were received with respect to this rule in the section 958 proposed regulations. Accordingly, the rule is finalized without modification. *See* § 1.1297-1(d)(1)(v)(B)(2).

2. Determination of Average Amount of Assets Based on Value or Adjusted Basis

Section 1297(e) provides that the assets of a tested foreign corporation are to be measured based on (i) value, pursuant to section 1297(e)(1), if it is a publicly traded corporation for the taxable year, or if section 1297(e)(2) does not apply to it for the taxable year; or (ii) adjusted basis, pursuant to section 1297(e)(2), if it is a CFC or elects the application of section 1297(e)(2). These statutory provisions create a hierarchy for determining the method for measuring the assets of a tested foreign corporation, as follows: (a) First by value, if the tested foreign corporation is a publicly traded corporation for the taxable year; (b) second by adjusted basis, if the tested foreign corporation is not a publicly traded corporation and is a CFC; and (c) third by value, or at the election of the tested foreign corporation, by adjusted basis, in other cases. The Treasury Department and the IRS understand that taxpayers typically prefer to use value to measure assets of a tested foreign corporation.

The proposed regulations provided that, for purposes of the Asset Test, companies that were publicly traded for only part of the year were required to measure assets on the basis of value for the entire year if the corporation was publicly traded on the majority of days during the year or if section 1297(e)(2) did not apply to the corporation on the majority of days of the year. If the tested foreign corporation was not publicly traded on the majority of days during the year, the tested foreign corporation was required to use adjusted basis to

measure assets if it was a CFC or if an election to use adjusted basis was made under section 1297(e)(2)(B). See proposed § 1.1297–1(d)(1)(v). The majority of days rule in the proposed regulations would have required a tested foreign corporation that was a CFC and whose shares were publicly traded for less than the majority of days during the year to use adjusted basis to measure its assets for that taxable year because the corporation would not have been treated as a publicly traded corporation. The requirement to use adjusted basis might apply, for example, to a foreign corporation treated as a CFC that issues publicly traded shares in an initial public offering in the second half of the year.

A comment requested that the proposed regulations be modified to provide that the Asset Test be applied based on value if shares of the tested foreign corporation were publicly traded at any time during the taxable year. The comment asserted that the use of value more appropriately reflects the purposes of the PFIC rules in general, and that the statute requires only non-publicly traded CFCs to use basis for purposes of the Asset Test and otherwise allows a tested foreign corporation to apply the Asset Test based on value. The comment also noted that, due to the repeal of section 958(b)(4), there may be more tested foreign corporations that are CFCs. In such cases, less-than-10-percent shareholders of those tested foreign corporations would be required to use basis rather than value in determining PFIC status. The comment requested relief from this result. The comment further noted that publicly traded corporations required to use basis would not be able to take into account goodwill and other self-created business intangibles for purposes of the Asset Test because such items often do not have tax basis.

The Treasury Department and the IRS agree with the concerns expressed by the comment regarding the effects of the repeal of section 958(b)(4). As discussed in Part III.D.1 of this Summary of Comments and Explanation of Revisions, this rulemaking finalizes the portion of the section 958 proposed regulations concerning the definition of the term CFC for purposes of the Asset Test, which accordingly allows use of the value method of measuring assets to the extent permissible under the statute. See § 1.1297–1(d)(1)(v)(B)(2) (treating foreign corporations that are CFCs solely due to the repeal of section 958(b)(4) as not CFCs for purposes of section 1297(e)). The Treasury Department and the IRS believe that this change may alleviate much of the concern expressed

about the proposed rule because the change makes it less likely that a tested foreign corporation will be treated as a CFC that is required to use adjusted basis to measure its assets.

The Treasury Department and the IRS also agree that section 1297(e) favors the use of value as a method to measure assets and that the use of value aligns with the objective of the PFIC rules. As a result, the final regulations expand the definition of publicly traded corporation for purposes of section 1297(e) to include more circumstances in which a tested foreign corporation is treated as a publicly traded foreign corporation. See § 1.1297–1(f)(7). However, the Treasury Department and the IRS believe that it would be inappropriate to require a corporation to use value for purposes of the Asset Test if it was publicly traded for a de minimis period during its taxable year. Accordingly, the final regulations provide that a publicly traded corporation, which is defined as a corporation that has been publicly traded in more than de minimis amounts for at least twenty trading days (approximately one month) during a taxable year, is required to apply the Asset Test based on value. See § 1.1297–1(d)(1)(v)(A) and (f)(7). Pursuant to section 1297(e), a tested foreign corporation that does not qualify as a publicly traded foreign corporation may use value to measure assets as long as it is not a non-publicly traded CFC, but it is not required to do so.

The comment also requested clarification on the application of section 1297(e) in the case of tiers of tested foreign corporations. The comment recommended the final regulations provide that, for purposes of applying the Asset Test, a publicly traded tested foreign corporation should measure all of its assets—including the assets of its non-publicly traded look-through subsidiaries—based on value. The Treasury Department and the IRS generally agree with the premise of this comment, except in cases where section 1297(e) requires a different treatment for the assets of subsidiaries (as discussed in the next paragraph). For the avoidance of doubt, the final regulations include cross-references to § 1.1297–2(b)(2)(i) (which provides the rule that a tested foreign corporation is deemed to directly own the assets of the look-through subsidiary) in the final section 1297(e) rules. See § 1.1297–1(d)(1)(i) and (d)(1)(v)(A).

The comment also observed that, unlike the typical situation where a publicly traded tested foreign corporation would measure all of its assets (including the assets of its non-publicly traded look-through

subsidiaries) based on value in accordance with section 1297(e)(1)(A), it is questionable whether a CFC that is a non-publicly traded subsidiary of a publicly traded parent corporation could also use value, rather than basis, for purposes of testing its own PFIC status. The comment noted that such a subsidiary might be a CFC as a result of the repeal of section 958(b)(4). As discussed in Part III.D.1 of this Summary of Comments and Explanation of Revisions, § 1.1297–1(d)(1)(v)(B)(2), which provides that foreign corporations that are CFCs solely due to the repeal of section 958(b)(4) are not treated as such for purposes of section 1297(e), mitigates this concern. Further, if a lower-tier tested foreign corporation is a CFC that is not publicly traded, section 1297(e)(2)(A) requires that adjusted basis be used as the method for measuring its assets. Therefore, the final regulations clarify that a lower-tier tested foreign corporation that is a non-publicly traded CFC must use adjusted basis and not value to measure its assets, regardless of whether it is owned by a publicly traded foreign corporation.

In order to clarify the application of the statutory hierarchy for measuring a tested foreign corporation's assets more generally, including with respect to lower-tier tested foreign corporations, § 1.1297–1(d)(1)(v) has been revised. The regulation provides a hierarchy that generally applies to every tested foreign corporation, regardless of whether it is an upper-tier or lower-tier tested foreign corporation. Pursuant to section 1297(e) and this hierarchy, (i) a publicly traded foreign corporation (as defined in § 1.1297–1(f)(7)) must use value to measure its assets, (ii) a non-publicly traded CFC must use basis to measure its assets, unless the CFC becomes a publicly traded foreign corporation (as defined in § 1.1297–1(f)(7)) during a taxable year, and (iii) any other tested foreign corporation would use value to measure its assets unless an election is made to use adjusted basis, except if it is a lower-tier subsidiary in which case additional rules apply. See § 1.1297–1(d)(1)(v)(A), (B), and (C)(1). Section 1.1297–1(d)(1)(iii) clarifies that the election to use adjusted basis may be made by the tested foreign corporation or its shareholders.

Revised § 1.1297–1(d)(1)(v) provides specific rules for measuring the assets of lower-tier subsidiaries, which in the usual case are expected to be look-through subsidiaries. These rules follow the same hierarchy described in the prior paragraph, except that the method used to measure the assets of a lower-tier subsidiary may be determined either by the status of the lower-tier subsidiary

if it is a publicly traded foreign corporation or a non-publicly traded CFC, or by the status of a tested foreign corporation that directly or indirectly owns all or part of the shares of the lower-tier subsidiary (a parent foreign corporation), if the parent foreign corporation has one of those statuses. See § 1.1297-1(d)(1)(v)(C)(2).

As a general matter, the method used by a parent foreign corporation to measure its assets also must be used to measure the assets of a lower-tier foreign corporation owned in whole or part by that parent foreign corporation. This rule applies both for purposes of determining whether the parent foreign corporation is a PFIC and for purposes of determining whether the lower-tier foreign corporation is a PFIC. If a tested foreign corporation indirectly owns a lower-tier subsidiary through one or more other foreign corporations, the status of the parent foreign corporation in that chain of corporations that has the highest status in the hierarchy described above governs. See § 1.1297-1(d)(1)(v)(C)(2)(iii).

This general consistency rule does not apply, however, if the lower-tier foreign corporation has a status for which section 1297(e) mandates a method for measuring assets (that is, it is a publicly traded foreign corporation or non-publicly traded CFC). In such a case, the statutorily mandated method applies to measure the lower-tier foreign corporation's assets, both for purposes of determining whether the parent foreign corporation is a PFIC and for purposes of determining whether the lower-tier foreign corporation is a PFIC. For example, if a tested foreign corporation is a publicly traded foreign corporation, then both its assets and the assets of its lower-tier subsidiaries must be measured on the basis of value, unless a lower-tier subsidiary is a non-publicly traded CFC, in which case the assets of that subsidiary must be measured using adjusted basis. Similarly, if a tested foreign corporation is a non-publicly traded CFC, then both its assets and the assets of its lower-tier subsidiaries must be measured using adjusted basis, unless a lower-tier subsidiary is a publicly traded foreign corporation, in which case the assets of that subsidiary must be measured using value. See § 1.1297-1(d)(1)(v)(C)(2)(i) and (ii). If a lower-tier tested foreign corporation does not have a status for which section 1297(e) mandates a method for measuring assets, and it is a subsidiary of more than one parent foreign corporation, then U.S. shareholders of the two different parent corporations may be required to use different methods to measure the assets

of the lower-tier foreign corporation based on the method used for each respective parent foreign corporation.

See the last sentence of § 1.1297-1(d)(1)(v)(C)(2)(iii) and § 1.1297-1(d)(1)(v)(E)(3) (Example 3).

The Treasury Department and the IRS recognize that section 1297(e)(1) requires in many cases that a valuation must be performed for assets of an operating company for which no publicly available valuation is available, apart from information provided in financial statements prepared under widely-used financial reporting standards, and that ascertaining such a valuation creates a compliance burden. The Treasury Department and the IRS are studying whether to provide rules permitting taxpayers to rely on financial statement information in appropriate cases, and the final regulations reserve on this issue. See § 1.1297-1(d)(1)(v)(D). The 2020 NPRM proposes a rule to address this issue and solicits comments on the proposed rule. See proposed § 1.1297-1(d)(1)(v)(D).

3. Treatment of Working Capital for Purposes of Asset Test

The proposed regulations did not address the treatment of working capital for purposes of the Asset Test. Notice 88-22, 1988-1 C.B. 489 ("Notice 88-22") provides that cash and other current assets readily convertible into cash, including assets that may be characterized as the working capital of an active business, are treated as passive assets for purposes of the Asset Test. Notice 88-22 indicated that passive treatment is warranted because working capital produces passive income (interest income).

A comment on the proposed regulations asserted that the approach taken in Notice 88-22 with respect to working capital undermines the purpose of the PFIC regime to distinguish between investments in passive assets and investments in active businesses. The comment requested that the final regulations adopt an approach, similar to the treatment of dual-character assets, pursuant to which working capital would be bifurcated between passive and non-passive assets in proportion to the relative amount of gross income that is passive or non-passive.

The Treasury Department and the IRS continue to study the appropriate treatment of working capital, and the final regulations reserve on this issue. See § 1.1297-1(d)(2). The 2020 NPRM proposes a limited exception to the treatment of working capital to take into account the short-term cash needs of operating companies. See proposed § 1.1297-1(d)(2).

4. Assets That Produce Income Subject to the Related Person Look-Through Rule

The proposed regulations defined the term passive asset, consistent with section 1297(a), as an asset that produces passive income, or which is held for the production of passive income, taking into account the rules in proposed § 1.1297-1(c), which defined passive income, and proposed § 1.1297-1(d), which provided rules for the application of the Asset Test. See proposed § 1.1297-1(f)(6). The proposed regulations also provided that an asset that produces both passive income and non-passive income during a taxable year is treated as two assets, one of which is passive and one of which is non-passive, with the value (or adjusted basis) of the asset being allocated between the passive asset and non-passive asset in proportion to the relative amounts of passive and non-passive income produced by the asset during the taxable year. See proposed § 1.1297-1(d)(2)(i).

A number of comments expressed concern that the proposed regulations did not provide a general rule to characterize assets—in particular shares of stock—that give rise to income subject to the related person look-through rule of section 1297(b)(2)(C), discussed in Part III.C of this Summary of Comments and Explanation of Revisions. The comments suggested that the final regulations include a rule that treats assets that give rise to income subject to section 1297(b)(2)(C) as a passive or non-passive asset to the extent the income that is received with respect to such asset is treated as passive or non-passive by the tested foreign corporation. The Treasury Department and the IRS agree that it is consistent with the statutory language and intent of section 1297(a)(2) to treat assets that give rise to both passive and non-passive income as partly passive and partly non-passive. The Treasury Department and the IRS believe that it was clear under proposed § 1.1297-1(d)(2)(i) and (f)(6) that assets that produced income subject to the related person look-through rule of section 1297(b)(2)(C) were treated as non-passive in proportion to the non-passive income produced by the asset, subject to the special rules in § 1.1297-1(d). However, for the avoidance of doubt, the final regulations provide an explicit cross-reference to section 1297(b)(2)(C) to clarify that assets that produce income subject to the related person look-through rule are subject to the general and special rules with respect to treatment of assets under § 1.1297-1(d),

for example related party stock, loans, leases or licenses that produce dividends, interest, rent or royalties that are treated as passive and non-passive under section 1297(b)(2)(C). See § 1.1297-1(d)(3)(i). Accordingly, assets that give rise to income subject to section 1297(b)(2)(C) generally are treated as a passive or non-passive asset to the extent the income that is received with respect to such asset is treated as passive or non-passive by the tested foreign corporation.

The proposed regulations also provided that stock of a related person with respect to which no dividends are received or accrued during a taxable year but that previously generated dividends that were characterized as non-passive income, in whole or in part, under section 1297(b)(2)(C) is characterized based on the dividends received or accrued with respect thereto for the prior two years. See proposed § 1.1297-1(d)(2)(iii).

Comments noted that there may be instances in which the related person has not paid dividends in more than two years. One comment suggested that, in this instance, stock be apportioned in proportion to the average percentage of the dividends that were characterized as passive and non-passive in the last two years in which the related person paid dividends. If the related person never paid a dividend that was excluded under section 1297(b)(2)(C), the comment recommended that the stock be characterized based on the earnings during the last two years in which the related person generated earnings or, if the related person has never generated earnings, based on the earnings that are reasonably expected to be generated in the future. Another comment requested that proposed § 1.1297-1(d)(2)(iii) be replaced with a general rule with respect to stock of a related party that would characterize the stock based on whether the stock is expected to generate passive income. The comment asserted that this rule would allow for taxpayers to use reasonable methods to determine if the stock is expected to generate passive income.

One comment argued that, for purposes of characterizing stock that does not generate dividends in the current year, a look-back period of two years would be appropriate if the final regulations adopt an approach that characterizes the stock based on the character of hypothetical dividends and uses the proportionate amount of non-passive gross income over the look-back period to determine the character of the dividends. If such an approach is not adopted, the comment recommended that, instead of a look-back period of

two years, the stock could be characterized based on dividends paid during the preceding five years or, if shorter, the period during which the subsidiary was a related person under section 954(d)(3).

Proposed § 1.1297-1(d)(2)(iii) was premised on the understanding that stock that has recently generated dividends that are, in whole or in part, non-passive under the related person look-through rule can be understood to be held for the production of non-passive income. If, however, the stock has not recently generated dividends, it is more appropriate to treat the stock as held for the production of gains upon disposition, which would generally be passive income. Accordingly, the Treasury Department and the IRS have determined that it would not be appropriate to allow stock to be treated as a non-passive asset on the basis of speculation that dividends might be received with respect to the stock and that such dividends could be non-passive under section 1297(b)(2)(C) as most of the comments' recommendations would provide. Moreover, the changes to the rules for determining the passive or non-passive character of dividends, discussed in Part III.C.2 of this Summary of Comments and Explanation of Revisions, also take into account the actual history of the stock and allow taxpayers to treat the most recent prior years as most relevant in determining the character of the stock. Thus, the final regulations do not adopt these comments and, instead, the final regulations provide that stock that did not produce dividends within the current taxable year or within either of the preceding two taxable years is characterized as a passive asset. See § 1.1297-1(d)(3)(iii); *but see* section 1297(c) and § 1.1297-2(c)(1)(i) (eliminating stock of look-through subsidiaries for purposes of the Asset Test).

E. Stapled Entities

Proposed § 1.1297-1(e) provided that, for purposes of determining whether any stapled entity (as defined in section 269B(c)(2)) is a PFIC, all entities that are stapled entities with respect to each other are treated as one entity. A comment suggested that the definition of stapled entities provided in section 269B(c)(2) and § 1.269B-1 could be overbroad and thus lead to planning opportunities for purposes of PFIC testing. Therefore, the comment recommended that the final regulations provide a more restrictive definition for stapled entities so that, for purposes of PFIC testing, single-entity treatment would be limited to situations in which

nearly 100 percent of the outstanding equity interests in both entities are stapled to each other. Alternatively, the comment suggested, the Treasury Department and the IRS could issue rules applicable to the holders of stapled interests clarifying the application of the anti-abuse rule in section 1298(b)(4) (which would treat separate classes of stock (or other interests) in a corporation as interests in separate corporations, pursuant to regulations, where necessary to carry out the purposes of the PFIC regime) to such stapled interests by providing that the rule would apply only if unusual features exist and the arrangement would allow avoidance of the PFIC rules. The comment also highlighted the inappropriateness of potentially applying the rule in proposed § 1.1297-1(e) to treat a shareholder of an entity that would not be a PFIC, but for the rule, as the shareholder of a PFIC.

Another comment requested clarification on the extent to which stapled entities that were treated as a single entity for purposes of PFIC testing would be treated as a single entity with respect to other provisions in the PFIC regime. In particular, the comment requested that the final regulations indicate whether the stapled entities are treated as one PFIC for purposes of including income under the PFIC regime and for purposes of making an election with respect to income inclusions under the PFIC regime. Like the first comment, it also requested guidance when not all interests are stapled.

The Treasury Department and the IRS have determined that it is appropriate to apply the single entity treatment of proposed § 1.1297-1(e) even when not all interests in the stapled entities are stapled because section 269B(c)(2) applies only when controlling interests in the stapled entities are stapled, but that the application of the rule should be limited to apply only to U.S. persons that hold stapled interests and should not affect U.S. persons that directly or indirectly own only one of the stapled entities. Accordingly, the rule in proposed § 1.1297-1(e) is modified to apply only if a U.S. person that would be a shareholder of the stapled entities owns stock in all entities that are stapled entities with respect to each other. In this case, the stapled entities are treated as an interest in a single entity for all purposes of the PFIC rules, which may have the effect of causing a stapled entity that would not be a PFIC on a stand-alone basis to be treated as a PFIC when stapled, or the reverse. See § 1.1297-1(e). Given these modifications to the rule and the fact that the

definition of stapled entities in section 269B(c)(2) already limits stapling to situations in which more than 50 percent in the value of the beneficial ownership in each of the entities consists of stapled interests, the Treasury Department and the IRS have determined that it is not necessary at this time to provide guidance on the application of section 1298(b)(4) or to further limit the interests that can be stapled.

IV. Comments and Revisions to Proposed § 1.1297-2—Special Rules Regarding Look-Through Subsidiaries and Look-Through Partnerships

Proposed § 1.1297-2 provided guidance on the application of the look-through rule of section 1297(c) for purposes of the Income Test and the Asset Test.

A. Overview

1. Treatment of Income and Assets

Under the final regulations, a tested foreign corporation is treated as directly owning the assets of, and directly deriving the gross income of, a look-through subsidiary or look-through partnership. See § 1.1297-2(b)(2) and (b)(3). The tested foreign corporation disregards the equity interest in the look-through entity for purposes of the Asset Test. See § 1.1297-2(c)(1)(i) and (c)(3). As discussed in more detail in Part IV.D of this Summary of Comments and Explanation of Revisions, dividends from a lower-tier subsidiary and distributions and the distributive share of income from a lower-tier partnership generally are treated as if they did not exist (“eliminated”) for purposes of the Income Test. See § 1.1297-2(c)(2)(i) and (c)(3).

For Income Test purposes, the proposed regulations provided that the disposition of the stock of a look-through subsidiary is treated as the disposition of stock and provided rules for the calculation of gain. See proposed § 1.1297-2(f)(1). The final regulations also include rules addressing the disposition of partnership interests in a look-through partnership, which are similar in concept to the rules that apply to the disposition of stock of a look-through subsidiary, and rules addressing the disposition of partnership interests in a partnership described in section 954(c)(4)(B). See § 1.1297-2(f)(4). Where both rules could potentially apply, the disposition is subject to the rules of section 954(c)(4). See § 1.1297-2(f)(4)(i) and (ii). Consequently, it is anticipated that the sale of interests in a partnership that a tested foreign corporation owns at least

25 percent of by value generally will be subject to section 954(c)(4), and therefore will be treated as a disposition of assets rather than a disposition of the partnership interest, while the sale of interests in a partnership that a tested foreign corporation owns less than 25 percent of by value may or may not be subject to section 954(c)(4) in light of the different 25-percent ownership test in that statutory provision. The effect on the determination of gain under section 954(c)(4) of partnership earnings that have been included in income by the tested foreign corporation but not distributed is beyond the scope of these regulations.

Payments of interest, rent and royalties, and the related debt obligation, lease or license, between the tested foreign corporation and the look-through entity or between look-through entities generally also are eliminated for purposes of both the Income and the Asset Tests, as discussed in Part IV.D of this Summary of Comments and Explanation of Revisions. See § 1.1297-2(c)(1)(ii), (c)(2)(ii), and (c)(3). If the obligation is between look-through entities that are not wholly owned by the tested foreign corporation, a proportionate part of the obligation and income from it is eliminated. See *id.*

2. Definition of Look-Through Subsidiary

A subsidiary of a tested foreign corporation is treated as a look-through subsidiary if both an asset test and an income test are satisfied. See § 1.1297-2(g)(3). If only one test is satisfied, the subsidiary is not treated as a look-through subsidiary. See *generally id.* The asset test is satisfied for any measuring period (for example, one quarter of a taxable year) if on the relevant measuring date (for example, the end of a quarter) the tested foreign corporation owns at least 25 percent of the value of the stock of the subsidiary. See § 1.1297-2(g)(3)(i). The income test is satisfied if either (i) the tested foreign corporation owns an average of at least 25 percent of the value of the subsidiary’s stock on the measuring dates of an entire taxable year, or (ii) the tested foreign corporation owns at least 25 percent of the value of the subsidiary’s stock on a measuring date and the subsidiary’s gross income for the measuring period can be determined. See § 1.1297-2(g)(3)(ii). Consequently, if a tested foreign corporation owns at least 25 percent of a subsidiary’s stock for part but not all of a taxable year, the subsidiary is treated as a look-through subsidiary for that part of the taxable year only if the tested foreign corporation can determine

the subsidiary’s gross income on the measuring dates within that part of the taxable year. These rules are intended to ensure that a subsidiary is not treated as a look-through subsidiary unless the tested foreign corporation can determine the proportionate share of the subsidiary’s assets and income that it is treated as directly owning and deriving.

B. Look-Through Partnerships

1. Overview

The proposed regulations defined a look-through partnership as a partnership in which the tested foreign corporation owned at least 25 percent in value. See proposed § 1.1297-1(c)(2)(i), (d)(3)(i), and (f)(1). The preamble to the proposed regulations indicated that the look-through partnership rules were drafted to apply look-through treatment as provided in section 1297(c) consistently to lower-tier partnerships and lower-tier corporations. See 84 FR 33120, at 33124. The preamble stated that the difference between the 25 percent threshold for look-through partnerships in the proposed regulations and the treatment of partnership income for FPHCI purposes is warranted because of the flexibility that entities have in their characterization under § 301.7701-3 and because of the fact that treating a subsidiary as a partnership may not have U.S. income tax consequences for a tested foreign corporation as it could for a CFC. See *id.* The preamble also noted that this rule ensured that the tested foreign corporation would have significant control over the partnership activities, such that a partnership interest could represent an active business interest. See *id.* The preamble requested comments on whether 25 percent was the right threshold, whether different rules should apply to general partnerships and limited partnerships, and whether a material participation test should apply.

The definition of look-through partnership in the final regulations is revised to more closely align with the definition of look-through subsidiary. Under the final regulations, a look-through partnership is a partnership that would be a look-through subsidiary with respect to the tested foreign corporation if the partnership were a corporation. See § 1.1297-2(g)(4)(i)(A). Accordingly, as noted by one comment, the taxpayer-favorable rules of section 1297(c) will apply to look-through partnerships, for example by allowing attribution of the activities of other affiliates in determining whether rental or royalty income of the partnership is treated as passive or non-passive. In

response to other comments, additional changes have been made to the definition of look-through partnership to allow look-through treatment for certain minority interests in partnerships. See § 1.1297–2(g)(4)(i)(B). These changes are discussed in Part IV.B.2 of this Summary of Comments and Explanation of Revisions.

The look-through partnership rules were located in proposed § 1.1297–1, which provided general rules concerning the Income and Asset Tests. Because look-through treatment for purposes of PFIC testing is provided in section 1297(c) and § 1.1297–2 provides guidance on the application of section 1297(c), the rules in the final regulations concerning look-through partnerships are in § 1.1297–2 along with all of the other rules discussing look-through treatment. See § 1.1297–2(b)(3) and (g)(4).

2. Definition of Look-Through Partnership

Under the proposed regulations, a look-through partnership with respect to a tested foreign corporation was defined as a partnership if (i) for purposes of section 1297(a)(2), the tested foreign corporation owned at least 25 percent of its value on a measuring date and (ii) for purposes of section 1297(a)(1), the tested foreign corporation owned at least 25 percent of its value on the date on which income was received or accrued by the partnership. See proposed § 1.1297–1(f)(1). The proposed regulations also provided that, if a tested foreign corporation owns, directly or indirectly, less than 25 percent of the value of a partnership, the corporation's distributive share of the partnership's income was treated as passive income for purposes of the Income Test and the corporation's interest in the partnership was treated as a passive asset for purposes of the Asset Test. See proposed § 1.1297–1(c)(2)(ii) and (d)(3)(ii).

Three comments were received addressing these rules. The comments supported the proposed regulations' general treatment of look-through partnerships and addressed the determination of when a partnership is treated as a look-through partnership. Two comments recommended that the 25-percent threshold be eliminated so that look-through treatment would apply to all partnerships regardless of the ownership level by the tested foreign corporation. A third comment stated that the proper approach to partnerships in applying look-through rules raises difficult issues and made several alternative recommendations.

The two comments recommending that all partnerships be treated as look-through partnerships noted that partnerships are pass-through entities that are generally treated as aggregates for many purposes throughout the Code and asserted that section 1297(c) implicitly indicates that aggregate treatment was intended to apply to all partnerships because it provides a 25-percent threshold only for corporations. The comments also stated that the differences between corporate treatment and partnership treatment have ramifications for many other parts of the Code, such as subpart F, GILTI, and the anti-hybrid rules. The comments asserted that minority shareholders generally cannot compel an upper-tier foreign corporation to make an election for a lower-tier foreign corporation to be treated as a partnership under § 301.7701–3 and that it is unlikely that a tested foreign corporation would make a non-commercial investment in order to benefit minority shareholders.

The Treasury Department and the IRS do not agree with these comments, other than the comment that partnerships are treated as aggregates for many Code purposes. Many of the legal entities potentially treated as look-through partnerships under section 1297 would have been treated as corporations for U.S. federal income tax purposes when section 1297(c) was enacted, because the enactment of section 1297(c) preceded the promulgation of § 301.7701–3 by approximately ten years and before that time foreign corporate entities were generally classified as corporations for U.S. federal income tax purposes. The differences between corporate treatment and partnership treatment referred to by the comments generally are not relevant to foreign corporations that are not subject to U.S. net income taxation or to U.S. shareholders as to whom a foreign corporation is not treated as a CFC. As stated in the preamble to the proposed regulations, an election under § 301.7701–3 to treat a foreign subsidiary of such a foreign corporation as a partnership for U.S. federal income tax purposes may have no U.S. tax consequences other than to affect the determination of whether the foreign corporation is a PFIC.

The Treasury Department and the IRS recognize that minority shareholders may not be able to compel a foreign corporation to make a U.S. tax election or to make particular investments. However, a foreign corporation may cause a subsidiary to make an election to be treated as a partnership for U.S. tax purposes or take other steps in order to avoid classification as a PFIC in order

to retain or attract U.S. investors, since there are likely to be no non-tax and no foreign tax consequences to the election.

The two comments indicated that the subpart F regime characterizes a partner's distributive share of partnership income without regard to the partner's level of control or involvement for purposes of determining subpart F income and recommended that the same approach apply in these regulations. The final regulations do not adopt this comment. The Treasury Department and the IRS believe that the difference in treatment between these regulations and the subpart F regime is warranted in light of the fact that Congress imposed a 25-percent threshold for look-through treatment for subsidiaries in section 1297 but not in subpart F, and that consistency of treatment for look-through subsidiaries and look-through partnerships in these regulations is consistent with Congressional intent.

One comment recommended, as an alternative to automatic passive treatment for less than 25-percent-owned interests, that the distributive share of income from, and the interest in, a less than 25-percent-owned partnership be characterized as passive only if the necessary information cannot be obtained for purposes of the Income Test and the Asset Test. The Treasury Department and the IRS agree that it may be difficult for a tested foreign corporation to obtain adequate information from a subsidiary in which a tested foreign corporation holds a less-than-25-percent investment, and that if that is the case, the investment should be treated as passive. The Treasury Department and the IRS have taken this comment into account in the new rules described at the end of this Part IV.B.2. The Treasury Department and the IRS do not agree that a tested foreign corporation that has less than a 25-percent-interest in an active partnership should be able to automatically treat such partnership interest as active if such information is available, for the reasons already stated.

A third comment stated that the approach proposed in the proposed regulations has the advantage of certainty and ease of administration because it provides a relatively clear bright-line test and limits the need to obtain information about the assets and income of a lower-tier partnership that may be difficult for small partners to obtain. The comment also noted that the proposed approach creates greater equivalence between lower-tier entities that have or have not elected to be treated as pass-through entities, but observed that the proposed regulations

did not create complete equivalence between such entities because the distributive share from a related partnership was not subject to the same rules as dividends from a related corporation. The final regulations address this concern by providing that the distributive share derived by a tested foreign corporation from a related partnership is subject to rules similar to such dividends. *See* § 1.1297–1(c)(4)(vii).

This comment also stated that a 25-percent threshold is not a good proxy for an active business interest and is not consistent with long-standing market practice. The comment recommended four alternatives for the threshold for partnership look-through treatment. Under the first alternative, the comment suggested that the final regulations adopt a 25 percent threshold similar to that of section 954(c)(4). Under a second alternative, the comment suggested that the final regulations not take into account elections under § 301.7701–3 for purposes of PFIC testing. Under a third alternative, the comment proposed that the final regulations treat every pass-through entity as an aggregate without regard to ownership threshold. Under the fourth alternative, the comment recommended that the final regulations adopt a “material participation” approach pursuant to which look-through with respect to a partnership applies if the tested foreign corporation materially participates in the underlying business of the partnership.

The Treasury Department and the IRS recognize that although Congress has mandated a 25-percent threshold in order to treat a corporate subsidiary as a look-through entity, that threshold may not be a good proxy for an active business interest. The Treasury Department and the IRS considered whether the alternatives suggested would better identify an active partnership interest. The final regulations do not adopt any of the alternatives suggested by the third comment but do adopt an approach similar in concept to the fourth of the alternatives. With respect to the first and third alternatives, the Treasury Department and the IRS have determined that the 25-percent threshold should be the same for lower-tier entities regardless of whether they have elected pass-through treatment for the reasons already discussed. With respect to the second alternative, the Treasury Department and the IRS do not believe that it is appropriate in this context to draw distinctions between entities in the legal form of a partnership and other entities treated as

partnerships for U.S. federal income tax purposes.

In regard to the fourth alternative, the Treasury Department and the IRS agree that if a tested foreign corporation is actively involved in the business of a partnership with active business operations, look-through treatment may be appropriate, even if the tested foreign corporation is a minority investor in the partnership, so that the tested foreign corporation may take into account the active assets and income of the partnership rather than treating the partnership investment as passive. The Treasury Department and the IRS considered a material participation test but determined that the passive activity loss rules of section 469 are not appropriate for a foreign corporate investor in a partnership owned directly or indirectly by a tested foreign corporation. The section 469 material participation rules focus primarily on the activities of individuals. *See* § 1.469–5 and –5T. While section 469 also provides rules for partners that are closely held corporations, those rules are likely to be difficult to apply and to audit in the PFIC context.

The Treasury Department and the IRS also considered other participation and attribution rules of the Code, including proposed rules addressing when a corporate partner would be attributed the trade or business assets and activities of a partnership for purposes of the active trade or business requirement in section 355(b). *See* 88 FR 26012 (REG–123365–03) (proposing a rule that a partner that owns a meaningful interest in a partnership would be attributed the trade or business assets and activities of the partnership if the partner performs active and substantial management functions for the partnership with respect to the trade or business assets or activities (for example, by making decisions regarding significant business issues of the partnership and regularly participating in the overall supervision, direction, and control of the employees performing the operational functions for the partnership)). However, the Treasury Department and the IRS determined that such a rule would not be appropriate for purposes of section 1297. As stated in a comment, the disadvantage of participation-based tests is that they are factual and potentially subjective, and therefore less administrable. For example, the proposed section 355(b) test described above would be difficult for the IRS to audit in the case of a foreign corporation that is not controlled by U.S. shareholders. Moreover, if the “meaningful interest” requirement

applied, look-through treatment might apply only to a small number of partnerships that are not already treated as look-through partnerships. The Treasury Department and the IRS did not consider these approaches to be more appropriate than applying the rules of section 1297 at the partner level as a means of testing whether an investment in a partnership is an active business interest. Accordingly, the definition of look-through partnership is further altered to include certain partnerships in which the tested foreign corporation owns a minority interest if the tested foreign corporation has sufficient active assets and income as determined under the rules of section 1297 apart from the partnership. *See* § 1.1297–2(g)(4)(i)(B).

Under the final regulations, a look-through partnership is defined as (i) a partnership that would be a look-through subsidiary if such partnership were a corporation—as discussed in Part IV.B.1 of this Summary of Comments and Explanation of Revisions—or (ii) any other partnership if the tested foreign corporation satisfies the active partner test. *See* § 1.1297–2(g)(4)(i). The active partner test is satisfied if the tested foreign corporation would not be a PFIC if both the Income and the Asset Test were applied to it without including its interest in any partnership that would not be a look-through subsidiary if such partnership were a corporation. *See* § 1.1297–2(g)(4)(ii). If the tested foreign corporation has no passive assets or income, even a very small active business would allow the interest to qualify as a look-through partnership under the active partner test. On the other hand, qualifying under the active partner test can only prevent a partnership interest from tainting an otherwise non-PFIC corporation, rather than be used affirmatively. Because the Treasury Department and the IRS understand that it may be difficult for minority investors in partnerships to obtain the information necessary to apply the Income and Asset Tests taking into consideration the income and assets of a look-through partnership, the final regulations provide an election out of the look-through partnership definition for partnerships that would not be a look-through subsidiary if such partnership were a corporation. *See* § 1.1297–2(g)(4)(iii). The final regulations also provide two new examples illustrating the active partner test. *See* § 1.1297–2(g)(4)(iv).

C. Overlap Between Section 1297(c) and Section 1298(b)(7)

The proposed regulations provided that the look-through rule of section 1297(c) does not apply to a domestic corporation if the stock of the domestic corporation is characterized under section 1298(b)(7) as a non-passive asset that produces non-passive income. See proposed § 1.1297–2(b)(2)(iii). The preamble to the proposed regulations noted that the Treasury Department and the IRS determined that section 1298(b)(7) should generally take precedence over section 1297(c) when both rules would apply simultaneously because section 1298(b)(7) contains the more specific rule applicable to a tested foreign corporation that owns a domestic subsidiary.

Comments asserted that the legislative history concerning section 1297(c) and section 1298(b)(7) does not support the approach taken by proposed § 1.1297–2(b)(2)(iii). These comments argued that section 1298(b)(7) was intended to apply only in circumstances in which income and assets would be passive if section 1297(c) applied. According to the comments, Congress did not intend for one section to take precedence over the other because the legislative history does not discuss whether section 1298(b)(7) is supposed to take precedence over section 1297(c) or express any limitations on the application of section 1297(c).

Because section 1298(b)(7) contains the more specific rule applicable to a tested foreign corporation that owns a domestic subsidiary, the Treasury Department and the IRS have determined that the section 1298(b)(7) coordination rule is consistent with the relevant statutory provisions and results in appropriate treatment with respect to look-through subsidiaries. Accordingly, the final regulations do not adopt these comments.

D. Elimination of Certain Assets and Income for Purposes of Applying Section 1297(a)

The proposed regulations provided that, for purposes of applying the Income and Asset Tests, certain intercompany payments of dividends and interest from a look-through entity, and the related stock and debt receivables, are eliminated. See proposed § 1.1297–2(c)(1) and (2). The preamble to the proposed regulations indicated that the Treasury Department and the IRS intended for the elimination of such items to prevent double counting of intercompany income and assets. In response to comments, the final regulations revise the rules relating

to intercompany dividends and expand the elimination rules to address intercompany rents and royalties and to address distributions and the distributive share of income from a look-through partnership.

1. Treatment of Intercompany Dividends

Proposed § 1.1297–2(c)(2) provided that, for purposes of applying the Income Test, intercompany payments of dividends between a look-through subsidiary and a tested foreign corporation are eliminated to the extent the payment is attributable to income of a look-through subsidiary that was included in gross income by the tested foreign corporation for purposes of determining its PFIC status.

A comment expressed concern that the proposed regulation did not eliminate a payment of a dividend by a look-through subsidiary to a tested foreign corporation that is made out of earnings and profits not attributable to income of the subsidiary previously included in the gross income of the tested foreign corporation for purposes of determining its PFIC status. One example of such a case would be a dividend paid after a look-through subsidiary is acquired out of earnings and profits accumulated before the tested foreign corporation's acquisition of the look-through subsidiary. Another example of such a dividend would be a dividend paid to a tested foreign corporation from a subsidiary that was a subsidiary but not a look-through subsidiary when the relevant earnings and profits were accumulated and the dividend was paid but later became a look-through subsidiary. The comment questioned whether a dividend from pre-acquisition earnings and profits represents true economic income of the tested foreign corporation, since the tested foreign corporation "purchased" the pre-acquisition earnings and profits, and observed that it could be difficult for a tested foreign corporation to determine what portion of a dividend received is attributable to pre-acquisition earnings and profits, particularly if the acquisition was not recent. As a result, the tested foreign corporation might not in practice be able to determine when it can eliminate a dividend from a look-through subsidiary from its gross income.

The proposed regulation eliminated dividends from a look-through subsidiary only to the extent attributable to gross income included by the tested foreign corporation. The comment recommended that the final regulations remove the limitation. In the alternative, the comment requested that the final regulations provide that dividends in an

amount equal to current-year earnings would be deemed attributable to income included by the tested foreign corporation and that dividends in excess of that amount would be deemed to be paid first from years in which the subsidiary was a look-through subsidiary and treated as attributable to income included by the tested foreign corporation during that period. As an additional alternative, the comment proposed that taxpayers be allowed to determine the earnings to which dividends were considered attributable in the case of an acquisition of the look-through subsidiary based on the ratio of pre-acquisition earnings to post-acquisition earnings over a limited period.

The Treasury Department and the IRS agree that dividends should be treated as paid out of current earnings and profits and then out of accumulated earnings and profits (beginning with the most recently accumulated), in accordance with section 316, and the final regulations so provide. See § 1.1297–2(c)(2). However, the final regulations do not adopt the comment's recommendation to treat all dividends from a look-through subsidiary as eliminated from the tested foreign corporation's gross income even if the dividend is paid out of earnings and profits that are attributable to gross income of the subsidiary that the tested foreign corporation has not included in income. As explained in the next two paragraphs, the rules regarding dividends paid out of earnings not taken into account by a tested foreign corporation must be coordinated with the rules that apply to determine residual gain when the stock of a look-through subsidiary is sold in order to avoid elimination of income for purposes of the Income Test.

Under § 1.1297–2(f), if a tested foreign corporation disposes of the stock of a look-through subsidiary, the amount of gain taken into account for purposes of the Income Test generally is the total gain recognized by the tested foreign corporation less unremitted earnings (residual gain). Unremitted earnings are the excess of income taken into account by the tested foreign corporation with respect to that look-through subsidiary less dividends from the subsidiary. The amount of gain derived from the disposition of stock of a look-through subsidiary and dividends received from the look-through subsidiary is determined on a share-by-share basis under a reasonable method, such as the rules under section 951 or 1248.

Thus, if a look-through subsidiary with a value of \$1000 earns \$20 that is taken into account by a tested foreign

corporation owner, any gain on a sale of the subsidiary's stock for \$1020 will be reduced by \$20 of unremitted earnings. If the subsidiary pays a \$15 dividend before the sale, the receipt of the dividend is disregarded for purposes of the Income Test and a sale of the subsidiary's stock for \$1005 should give rise to the same amount of residual gain. Thus, the \$20 will be taken into account for purposes of the Income Test and will not affect the amount of residual gain regardless of whether a dividend is paid. By contrast, if the look-through subsidiary pays a \$15 dividend out of earnings that do not reflect income taken into account by the tested foreign corporation, the dividend would reduce the amount of gain on the sale of the look-through subsidiary's stock compared to not paying a dividend because the dividend would reduce unremitted earnings pursuant to § 1.1297-2(f). Consequently, if the payment of the dividend were disregarded as requested by the comment, the \$15 dividend would reduce potential future gain but never give rise to corresponding income to the tested foreign corporation for purposes of the Income Test.

In order to prevent such a dividend from reducing potential future gain on the sale of the look-through subsidiary, it would be necessary to reduce the basis of the stock of the look-through subsidiary held by the tested foreign corporation or make some other adjustment to the taxation of gain upon the disposition of the look-through subsidiary's stock. A basis reduction or adjustment of that kind raises potentially broader issues that were not addressed in the proposed regulations. The Treasury Department and the IRS continue to study this recommendation and additional guidance on such elimination is proposed in the 2020 NPRM. See proposed § 1.1297-2(c)(2).

2. Treatment of Intercompany Rents and Royalties

The proposed regulations provided that intercompany debt receivables and interest are eliminated in proportion to the shareholder's direct and indirect ownership (by value) in the look-through subsidiary with respect to a tested foreign corporation that owns less than 100 percent of a look-through subsidiary. See proposed § 1.1297-2(c)(1) and (2). The preamble to the proposed regulations explained that this rule was based on the legislative history of the PFIC rules and was intended to prevent duplication of passive assets or passive income, for example if a wholly-owned look-through subsidiary with

entirely passive income paid a dividend to the tested foreign corporation parent.

Comments supported the approach taken in the proposed regulations with regard to interest. A comment indicated that payments of intercompany rents and royalties raises similar concerns with respect to double counting. Accordingly, the comment requested that, for purposes of applying the Income Test and the Asset Test, the final regulations extend the elimination rules to payments of intercompany rents and royalties and any associated intangible assets in proportion to the tested foreign corporation's direct and indirect ownership (by value) in the look-through subsidiary or look-through partnership. The Treasury Department and the IRS agree with the comments, and § 1.1297-2(c) accordingly extends the rules applicable to debt and interest to rents, royalties, leases, and licenses.

The application of the elimination rule to leases and licenses raises issues not present with debt receivables. A lease or license held by a look-through entity provides legal rights to use underlying property, such as a building or an intangible. If the lease or license is disregarded by a tested foreign corporation, it would not be taken into account by the tested foreign corporation in determining whether the underlying property produces non-passive income or is held for the production of non-passive income. Moreover, while the underlying property may be used as part of an active business, it may be used as part of the business of the lessee or licensee and not by the owner of the property. Accordingly, the final regulations provide that, for purposes of the Asset Test as applied to a tested foreign corporation, the underlying property that is the subject of the eliminated lease or license is characterized as a passive or non-passive asset by taking into account the activities of qualified affiliates of the tested foreign corporation (as discussed in Part IV.E of this Summary of Comments and Explanation of Revisions). A new example illustrates the expansion. See § 1.1297-2(c)(4)(v).

The final regulations also address more precisely the calculations required in order to determine how much of an obligation and related income is eliminated if the obligation runs between two look-through entities that are not wholly-owned. The final regulations provide that the tested foreign corporation's proportionate share of a LTS obligation (as defined in § 1.1297-2(c)(1)(ii)) or a TFC obligation (as defined in § 1.1297-2(c)(1)(ii)) is the value (or adjusted basis) of the item

multiplied by the tested foreign corporation's percentage ownership (by value) in each relevant look-through subsidiary. See § 1.1297-2(c)(1)(ii). Examples 3 and 4 of § 1.1297-2(c)(4) illustrate that when an obligation runs between two non-wholly-owned look-through entities, the percentage ownership in each of those entities is taken into account. In Example 2, LTS2 has borrowed \$200x from LTS1. The tested foreign corporation owns 40 percent of LTS1's stock and 30 percent of LTS2's stock. If the loan had been made to LTS2's shareholders, on a *pro rata* basis, 30 percent of the loan held by LTS1 (\$60x) would be a TFC obligation and 70 percent of the loan held by LTS1 (\$140x) would be a third-party obligation. The tested foreign corporation would be treated for purposes of the Asset Test as owning 40 percent of the TFC obligation, which would be eliminated. See § 1.1297-2(c)(1)(ii). The tested foreign corporation also would be treated for purposes of the Asset Test as owning 40 percent of the hypothetical \$140x third-party loan, or \$56x. Example 3 illustrates the same principle.

3. Ownership Interests and Obligations of a Look-Through Partnership

The final regulations provide that for purposes of the Asset Test and the Income Test, the principles applicable to the elimination of stock and obligations of look-through subsidiaries and dividends, interest, rents and royalties paid by look-through subsidiaries apply to look-through partnerships. See § 1.1297-2(c)(3). Since partnerships do not pay dividends, the regulations provide that those principles apply to distributions and the distributive share of income from a look-through partnership. See *id.* It is intended that the same amount of assets and income will be eliminated regardless of whether the look-through entity or entities involved are look-through subsidiaries or look-through partnerships that would be look-through subsidiaries absent an election under § 301.7701-3.

E. Attribution of Activities of Look-Through Subsidiaries and Look-Through Partnerships

1. Scope of Attribution

The proposed regulations provided that, for purposes of section 1297, 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

if character were determined based on the activities of the income-earning entity is not passive income if the item would be excluded from FPHCI under section 954(c)(2)(A) and § 1.954-2(b)(6), (c), and (d), determined by taking into account the activities performed by the officers and employees of the tested foreign corporation, certain look-through subsidiaries, and certain partnerships in which the tested foreign corporation or one of the look-through subsidiaries is a partner. *See* proposed § 1.1297-2(e)(1).

One comment agreed that the activities of the look-through subsidiary should be taken into account to determine whether an item of rent or royalty income of the tested foreign corporation is passive or non-passive and suggested that activity attribution be extended to apply to the section 954(h) and commodity producer tests. The comment indicated that such treatment would be proper because financial businesses generally segregate assets and operations that are part of an integrated business into different entities for non-tax reasons. Because these final regulations do not treat section 954(h) as applicable for purposes of section 1297(b)(1), the portion of the comment relating to section 954(h) is addressed in the preamble to the 2020 NPRM and not here. However, the Treasury Department and the IRS agree that it is appropriate to extend the activity attribution rules for purposes of certain exceptions under section 954(c) that are based on whether the entity is engaged in the active conduct of a trade or business. Accordingly, the final regulations extend the activity attribution rules to income that would be excluded from FPHCI under section 954(c)(1)(B) (relating to property transactions), (c)(1)(C) (relating to commodities), (c)(1)(D) (relating to foreign currency gains), (c)(2)(A) (relating to active rents and royalties), (c)(2)(B) (relating to export financing), and (c)(2)(C) (relating to dealers). *See* § 1.1297-2(e)(1).

Another comment noted that under the rule in the proposed regulations, the income or assets of a look-through subsidiary classified as non-passive in the hands of a tested foreign corporation might nevertheless be classified as passive in the hands of the look-through subsidiary, for example in the case where one look-through subsidiary held rental real estate and another look-through subsidiary employed the employees who managed the rental property. Under the rule in the proposed regulations the first look-through subsidiary would be a PFIC and residual gain with respect to the sale of

the look-through subsidiary may be classified as passive, even if the attribution of both the property owned by the first subsidiary and the activities of the employees of the second subsidiary caused the rental income from the property to be treated as active for a tested foreign corporation owner. To mitigate this potential issue, the comment suggested the final regulations provide that such a look-through subsidiary be treated as a non-PFIC with respect to that tested foreign corporation under certain circumstances. The Treasury Department and the IRS have determined that the ultimate concerns raised by the comments should largely be addressed by the modifications to the activity attribution rules suggested by other comments and adopted in the final regulations, as discussed in Part IV.E.2 of this Summary of Comments and Explanation of Revisions. Those modifications should generally result in income and assets of a look-through subsidiary that are treated as non-passive in the hands of a tested foreign corporation also being treated as non-passive in the hands of the look-through subsidiary, in which case the look-through subsidiary could be a non-PFIC and residual gain on the sale of the look-through subsidiary could be characterized as non-passive.

One comment recommended that rules in the proposed regulations be modified to apply the rules for active rents and royalties under section 954(c)(2)(A) as they existed in 1986, as discussed in Part III.A of this Summary of Comments and Explanation of Revisions, and if the regulations were not modified in that manner the activity attribution rules should be revised to take into account the “transition” rules in the 2016 modifications to the active rents and royalties rules. *See* TD 9792 (81 FR 76497) (adding the express requirement to the active development tests in § 1.954-2(c)(1)(i) and (d)(1)(i) that the relevant activities be performed by the lessor’s or licensor’s own officers or staff of employees, and providing a transition rule that the modified active development tests apply only with respect to property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015). The 2016 modifications are taken into account through the cross-reference in § 1.1297-1(c)(1)(i)(A) to section 954(c)(2)(A) (relating to active rents and royalties). The Treasury Department and the IRS have determined that no revisions to the PFIC activity attribution rule are necessary, given that the PFIC

activity attribution rules clearly apply to take into account the activities of officers and employees of other specified entities whether the rules under section 954(c)(2)(A) apply as modified (in the case of property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015) or the rules under section 954(c)(2)(A) pre-modification apply (because no changes to the property have occurred since September 1, 2015). Accordingly, the comment is not adopted.

2. Ownership Threshold for Activity Attribution

The proposed regulations provided that, for purposes of the activity attribution rule described in Part IV.E.1 of this Explanation of Comments and Summary of Revisions, a tested foreign corporation may take 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 50 percent by value. *See* proposed § 1.1297-2(e)(1). The preamble to the proposed regulations indicated that the Treasury Department and the IRS determined that an ownership level of more than 50-percent would prevent the activities of the look-through subsidiary or look-through partnership from being attributed to an unrelated entity.

In response to a request for comments in the preamble to the proposed regulations concerning the appropriate ownership threshold for attribution of activities, one comment recommended an affiliation approach for the ownership threshold. Under this approach, activities would be attributed among members of the income-earning entity’s affiliated group, determined under principles of § 1.904-4(b)(2)(iii) modified to include partnerships that are owned at least 50 percent by value and corporations that are owned at least 50 percent by vote or value. For example, under this affiliation approach, the activities of a group member could be attributed not only “up” to a tested foreign corporation that owned a sufficient amount of stock in that group member (as would be the case under the approach in the proposed regulations), but also “across” to a sister member that is a part of the affiliated group or “down” to a subsidiary member that is a part of the affiliated group.

Some comments noted that an approach that takes into account voting rights in lieu of value may be

appropriate to take into account instances where more than one owner materially participates in the underlying activity. One of the comments suggested that an ownership threshold of at least 25 percent by vote would provide the tested foreign corporation with sufficient control over the subsidiary for it to be appropriate to attribute a portion of the subsidiary's activities to the tested foreign corporation. Another comment recommended an ownership threshold of more than 50 percent by vote or value by the tested foreign corporation, with a requirement that the tested foreign corporation materially participate in the same or complementary line of business of the activity-conducting subsidiary if it owns more than 50 percent by vote but less than 50 percent by value of the activity conducting subsidiary. In the alternative, the comment suggested that the activities be attributed in proportion to the ownership interest in the activity-conducting subsidiary.

The Treasury Department and the IRS disagree that satisfying a 25 percent threshold for ownership of an entity is sufficient to conclude that the entity's business is sufficiently integrated with that of a tested foreign corporation that the entity's activities should be taken into account for purposes of determining the character of income and assets of the tested foreign corporation. However, the Treasury Department and the IRS agree with the comments that it is generally appropriate to expand the activity attribution rule to attribute activities among members of an affiliated group, determined by applying a more than 50 percent threshold and by including partnerships and U.S. affiliates in which corporate members of the affiliated group satisfy such ownership requirements. Accordingly, the final regulations so provide. See § 1.1297-2(e)(1) and (2) (defining qualified affiliates of the affiliated group). However, the Treasury Department and the IRS have determined that because the rule applies for purposes of section 1297(c), which focuses on ownership of at least 25 percent by value, the threshold for inclusion in the group should be determined by value. See § 1.1297-2(e)(2)(iv). Moreover, the parent of the affiliated group must also be foreign (a foreign corporation or partnership) in order to apply the activity attribution rule. See § 1.1297-2(e)(2)(v). If the parent of the affiliated group were domestic (a U.S. corporation or partnership), then any qualified affiliate that is a foreign corporation (including the tested foreign corporation) would

qualify as a controlled foreign corporation, and any U.S. investor with at least a 10 percent ownership interest in the tested foreign corporation would be subject to the subpart F rules rather than the PFIC rules under section 1297(d). Accordingly, an upstream foreign owner of the tested foreign corporation and entities that are held directly or indirectly by such same upstream foreign owner as the tested foreign corporation may be considered qualified affiliates, assuming the requisite ownership percentage requirements are met.

V. Comments and Revisions to Proposed § 1.1297-4—Qualifying Insurance Corporation

Section 1297(f) provides that a qualifying insurance corporation ("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 percent of its total assets on its applicable financial statement ("AFS") ("the 25 percent test"), or (B) meets an elective alternative facts and circumstances test which lowers the AIL ratio to 10 percent ("alternative facts and circumstances test"). Proposed § 1.1297-4 elaborated on these requirements accordingly.

A. 25 Percent Test

1. Applicable Insurance Liabilities

The 25 percent test in section 1297(f)(1)(B) requires that the ratio of a foreign corporation's AIL to total assets exceed 25 percent. Section 1297(f)(3)(A) defines AIL as loss and loss adjustment expenses ("LAE") and reserves (other than deficiency, contingency, or unearned premium reserves) for life and health insurance risks and life and health insurance claims with respect to contracts providing coverage for mortality or morbidity risks.

Proposed § 1.1297-4(f)(2) provided that with respect to any life or property and casualty insurance business of a foreign corporation, AIL mean (1) occurred 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, including unpaid claims for death benefits, annuity contracts, and health insurance benefits; (2) unpaid expenses (including reasonable estimates of anticipated expenses) of investigating and adjusted unpaid losses described in (1); and (3) the 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, including annuity benefits dependent upon the life expectancy of one or more individuals.

Comments requested that the term "occurred losses" be changed because it is not an industry standard term. Some comments suggested that the word "occurred" be replaced with the word "incurred" or "unpaid" and be clarified to explicitly include incurred but not reported ("IBNR") losses. Other comments suggested that the term be defined as the term is used in the Code, U.S. regulatory statements, or under U.S. generally accepted accounting principles ("GAAP") or international financial reporting standards ("IFRS"). Two comments also requested clarification that unpaid LAE related to both paid and unpaid losses be included in the definition of AIL.

The Treasury Department and the IRS agree that further clarification of the definition of AIL is necessary. While still covering only losses that have occurred, the final regulations clarify the definition of AIL to adopt the comments which requested that AIL include incurred losses (both reported and unreported) and unpaid LAE on all incurred losses (whether the losses are paid or unpaid).

Comments differed as to what items should be included in the definition of AIL. For example, several comments suggested that AIL include insurance liabilities or loss reserves as reported on an AFS (without further modification) while other comments suggested that paid losses and paid LAE be included as AIL (even though they are not liabilities since they have been paid and, as a result, do not appear on the AFS as liabilities).

A comment also requested that special rules be created for financial guaranty insurers and another comment requested a special rule for mortgage guaranty insurers. The first comment recommended that final regulations permit a financial guaranty insurer to include in losses the greater of two amounts: (1) The aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held for future unaccrued insurance claims or (2) the average of losses incurred for policies over the previous ten years of the life of the policy, whichever is shorter. The second comment requested that the 25 percent test be waived for a foreign corporation engaged in the business of mortgage insurance and reinsurance if at least 80 percent of its net written premiums are

derived from mortgage guaranty insurance (or reinsurance) and its gross investment income is less than 50 percent of its net written premiums as reported on its AFS.

The final regulations do not adopt the suggestion that paid losses or paid LAE be treated as AIL nor the proposed special rules for financial guaranty insurers and mortgage guaranty insurers. These suggestions are contrary to the statute and the intent of Congress. Section 1297(f) is limited to amounts that constitute liabilities, whereas losses and LAE that have been paid are no longer liabilities and therefore do not qualify as AIL. Further, when losses and LAE are paid, assets are also reduced. It would not be appropriate to include loss and LAE amounts in the numerator of the 25 percent test (or alternative facts and circumstances test), when the corresponding assets are no longer reported on the AFS and included in the denominator. The statute also requires that liabilities include only insurance liabilities and further excludes certain types of insurance liabilities that may be included in a financial statement, such as unearned premium reserves, contingency reserves, and deficiency reserves. See section 1297(f)(3)(A); H. Rpt. No. 115–409, 115th Cong. 1st Sess., at 411; and Conference Rpt. No. 115–466, 115th Cong. 1st Sess., at 670 (“Unearned premium reserves with respect to any type of risk are not treated as applicable insurance liabilities for purposes of the provision.”). Therefore, § 1.1297–4(f)(2)(ii) provides that liabilities not within the definition of AIL are not included in the numerator of the 25 percent test (or alternative facts and circumstances test) and also specifies that amounts that are not insurance liabilities (for example, liabilities related to non-insurance products issued by an insurance company that may be treated as debt, such as certain deposit arrangements, structured settlements, and guaranteed investment contracts or GICs) are not AIL. The statute also does not contemplate averaging liabilities over a multi-year period because section 1297(f)(1)(B) provides for an annual calculation by looking to the foreign corporation’s AFS “for the last year ending with or within the taxable year.” Therefore, the final regulations do not include special rules for specialty insurers that would require multi-year averaging or disregard the liability requirement.

Section 1297(f) contemplates that QIC status is determined on an entity-by-entity basis. Therefore, § 1.1297–4(f)(2)(i)(D)(2) clarifies that the liabilities eligible to be taken into

account in determining AIL include only the liabilities of the foreign corporation whose QIC status is being determined. For example, if a parent and subsidiary both issue insurance contracts to unrelated parties and the AFS is a combined financial statement, the AIL of parent and subsidiary must be separately determined and each of parent and subsidiary includes only the liabilities from the contracts that it has issued (without regard to the contracts issued by the other party). This rule is consistent with § 1.1297–4(f)(2)(i)(D)(1) which provides the general principle that no item may be taken into account more than once.

2. Conformity Among Financial Reporting Standards in Computing Applicable Insurance Liabilities

Section 1297(f)(4) contemplates that a foreign corporation can use GAAP, IFRS, or the accounting standard used for the annual statement required to be filed with the local regulator (if a statement prepared for financial reporting purposes using GAAP or IFRS is not available) as the starting point to determine AIL. The annual statement required to be filed with the local regulator may typically be prepared in compliance with local statutory accounting standards. The Treasury Department and IRS are aware that GAAP, IFRS, and local statutory accounting sometimes have different categories (and nomenclature) and different methods of measuring losses and reserves for insurance companies. The final regulations define AIL more specifically so that only those liabilities that meet the regulatory definition are included in AIL irrespective of differences in nomenclature and methods that may be used by different financial reporting standards.

It is anticipated that the starting point for determining the amount of AIL will be the AFS balance sheet. However, it may be necessary in some circumstances to disaggregate components of balance sheet liabilities to determine the amount of a company’s insurance liabilities that meet the regulatory definition of AIL. For example, the International Accounting Standards Board (“IASB”) issued a new accounting standard called IFRS 17 for the accounting of insurance contracts which was expected to become effective January 1, 2021, and is now deferred to be effective January 1, 2023. Some companies may have already adopted IFRS 17 for financial reporting purposes on an optional basis. IFRS 17 generally does not use the terms unpaid losses and LAE or unearned premium reserve on its balance sheet. Instead, those

amounts are included in the overall insurance liabilities on the balance sheet and are required to be separately identified in the notes, as respectively, “liability for incurred claims” and “liability for remaining coverage.” While they bear a different name, they are intended to be substantially the same in concept to claims reserves and unearned premium reserves. Therefore, it is expected that a foreign corporation using IFRS 17 only include those amounts derived from the balance sheet that fall within the final regulation’s definition of AIL. Similarly, a foreign corporation using IFRS 17 (or any other financial reporting standard) is expected to exclude contingency reserves and deficiency reserves (in addition to unearned premium reserves), as applicable, even when those categories do not separately appear on the balance sheet as a liability and are subsumed within another reported line item.

The Treasury Department and IRS recognize that IFRS 17 is a new accounting standard and that questions may arise as to how amounts relevant to the PFIC insurance exception are derived from an IFRS 17 AFS. Similar questions may also arise with respect to financial statements prepared using GAAP and local statutory accounting, particularly as accounting reporting standards evolve. The Treasury Department and IRS request comments on whether further guidance is necessary to clarify how AILs are determined or make further adjustments to ensure that similarly situated taxpayers are treated similarly without regard to the financial reporting standard adopted by the foreign corporation.

B. Alternative Facts and Circumstances Test

If a foreign corporation predominantly engaged in an insurance business fails the 25 percent test solely due to runoff-related or rating-related circumstances involving its insurance business, and the ratio of its applicable insurance liabilities to its total assets is at least 10 percent, section 1297(f)(2) allows a United States person that owns stock in the corporation to elect to treat such stock as stock of a QIC. Proposed § 1.1297–4(d) provided guidance regarding this election.

1. Predominantly Engaged in an Insurance Business

Section 1297(b)(2)(B) provides that passive income does not include income derived in the active conduct of an insurance business by a QIC. Section 1297(f)(1)(A) provides that a QIC must be a foreign corporation which would be

subject to tax under subchapter L if such corporation were a domestic corporation. Then, for purposes of the alternative facts and circumstances test, section 1297(f)(2)(B)(i) adds another requirement that the foreign corporation be predominantly engaged in an insurance business under regulations provided by the Secretary based upon the applicable facts and circumstances.

Proposed § 1.1297-4(d)(2) provided more specific guidance regarding the circumstances under which a foreign corporation is considered to be predominantly engaged in an insurance business for purposes of the alternative facts and circumstances test by setting forth a predominantly engaged test (separate from the active conduct test and the requirements of subchapter L) by reference to the facts and circumstances that tend to show (or not show) that a foreign corporation is predominantly engaged in an insurance business based upon the factors set forth in the legislative history. The proposed rule provided that the determination is made based on whether the particular facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's length transactions.

A comment pointed to a number of ambiguities in the predominantly engaged standard and asked for clarification. First, it stated that it is not clear whether the proposed regulation's predominantly engaged test is in addition to the insurance company status test in subchapter L. Second, it stated that it is unclear how non-arm's length insurance transactions are taken into account when determining whether more than half the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies and how to compare related party transactions to commercial insurance arrangements. Third, it stated that it is unclear whether the list of facts and circumstances is an exclusive set of factors.

In response to the comment, the final regulations make clear that the predominantly engaged requirement in the alternative facts and circumstances test is in addition to the subchapter L requirement that more than half the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. It also deletes the sentence regarding comparable commercial insurance arrangements because the standard was unclear and instead replaces it with a

statement that the determination is made upon the character of the business actually conducted in the taxable year. Lastly, it clarifies that the list of facts and circumstances is not exclusive and can include other factors as may be relevant to a specific situation.

2. Runoff-Related Circumstances

Proposed § 1.1297-4(d)(3) provided that "runoff-related circumstances" means that the foreign corporation: (1) Was actively engaged in the process of terminating its pre-existing, active insurance or reinsurance underwriting operation pursuant to an adopted plan of liquidation or termination of operations under the supervision of its applicable insurance regulatory body; (2) did not issue or enter into any insurance, annuity, or reinsurance contract, other than a contractually obligated renewal of an existing insurance contract or a reinsurance contract pursuant to and consistent with the plan of liquidation or a termination of operations; and (3) made payments during the annual reporting period covered by the AFS to satisfy the claims under insurance, annuity, or reinsurance contracts, and the payments cause the corporation to fail to satisfy the 25 percent test.

A comment recommended that the final regulations remove the requirement that the runoff company have a plan of liquidation, remove the requirement that amounts paid by the runoff company cause the corporation to fail to satisfy the 25 percent test, and add a condition that the foreign corporation has no current plan or intention to enter into any insurance, annuity, or reinsurance contract other than in the case of a contractually obligated renewal. The comment stated that there is no prevailing practice in the insurance industry for a regulator to supervise a plan of liquidation or termination of a runoff company. The comment further stated that runoff carriers may be part of a larger insurance group, and that management of the runoff business is not necessarily a prelude to liquidation but can be a way for the active insurance businesses to shift their core business segments and maximize their use of capital. In addition, some companies (known as "runoff specialists") are in the business of acquiring reserve liabilities to profitably manage the settlement and payout of claims until all of the liabilities are exhausted.

The Treasury Department and IRS have considered these comments and believe that the exception from the 25 percent test should not be extended to runoff occurring in the context of the

ordinary course of an ongoing business. The Conference Report to the Act describes a company with runoff-related circumstances as "not taking on new insurance business" and "using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books." See H.R. Rep. No. 115-466, at 671 (2017) (Conf. Rep.). The lower 10 percent threshold (which permits an insurance company to hold assets that are 1000 percent of its AIL) should be limited to extraordinary circumstances in which the insurance company fails the 25 percent test solely because it is in the process of exiting the insurance business and is required to hold additional capital in excess of the 400 percent of AIL permitted by the 25 percent test due to its business being in runoff.

The final regulations delete, however, the requirement that the runoff company have a plan of liquidation and instead require that the company be in the process of terminating its pre-existing, active conduct of an insurance business under the supervision of its applicable insurance regulatory body or any court-ordered receivership proceeding (liquidation, rehabilitation, or conservation), which covers a broader array of circumstances than the proposed regulation. See § 1.1297-4(d)(3)(i).

The final regulations retain the requirement in the proposed regulations that the insurance company make claims payments during the annual reporting period. See § 1.1297-4(d)(3)(iii). However, in response to comments, the final regulations do not require such payments to cause the insurance company's ratio of liabilities to assets to fail the 25 percent test and instead clarify in § 1.1297-4(d)(3)(i) that the company must fail to satisfy the 25 percent test because it is required to hold additional assets due to its business being in runoff. Finally, for clarity and consistent with the comment's suggestion, § 1.1297-4(d)(3)(ii) adds a condition that the foreign corporation has no plan or intention to enter into any insurance, annuity, or reinsurance contract other than in the case of a contractually obligated renewal.

3. Rating-Related Circumstances

Proposed § 1.1297-4(d)(4) provided that "rating-related circumstances" means that a foreign corporation's failure to satisfy the 25 percent test was a result of specific requirements with respect to its capital and surplus that a generally recognized credit rating agency imposes that the foreign corporation must comply with to

maintain the minimum credit rating required for it to be classified as secure to write new insurance business for the current year. This condition in the proposed regulations was based upon the premise that although the generally recognized credit rating agencies (A.M. Best, Fitch, Moody's, and Standard and Poor) may use separate rating codes, the ratings could be classified into "secure" and "vulnerable" categories, and that the rating agencies require reporting entities to maintain a minimum amount of capital appropriate to support its overall business operations in consideration of its size and risk profile.

Comments suggested that the proposed regulation's reference to "secure" be changed. Some comments suggested that the standard should be revised to reflect only a rating agency's requirements that are "necessary" to write new business in accordance with the foreign corporation's regulatory or board supervised business plan.

Another comment requested that the term necessary be defined to mean that a foreign corporation complies with the requirements of the credit rating agency to maintain a rating equivalent to A – by A.M. Best for reinsurers or BBB+ by Standard & Poor's for all other insurers.

The Treasury Department and IRS agree that the use of the term "secure" should be amended. Therefore, the final regulations provide that the rating-related circumstances standard requires that the 25 percent test is not met due to capital and surplus amounts that a generally recognized credit rating agency considers necessary for the foreign corporation to obtain a public rating with respect to its financial strength, and the foreign corporation maintains such capital and surplus in order to obtain the minimum credit rating necessary for the current year by the foreign corporation to be able to write the business in its regulatory or board supervised business plan.

A comment also requested that the proposed regulations be revised to provide that the rating-related circumstances standard not be an annual test. The comment requested that once the foreign corporation satisfies the rating-related circumstances standard, the alternative facts and circumstances test should not need to be reapplied unless there is a change in circumstances. The final regulations do not adopt this comment because the test for a foreign corporation's PFIC status and the AIL tests are annual tests.

Several comments requested that additional categories of rating-related circumstances be included under which certain types of entities or businesses would be treated as per se meeting the

rating-related circumstances requirement. These businesses include reinsurance that is fully collateralized, mortgage insurance and reinsurance, and financial guaranty insurance. Another comment noted that lines of business that require a higher level of capital as compared to reserves are those that cover risks that are low frequency but high severity, such as catastrophic risk (for example, hurricanes and earthquakes) and financial obligation insurance such as mortgage and financial guaranty insurance.

Comments noted that financial guaranty and mortgage guaranty insurers are generally required to operate as monoline businesses, such that the company does not have the option to pool its financial obligation risks with other types of risks (whereas pooling of different types of risks can reduce overall risk exposure, and thus capital needs). Comments also noted that the loss experience of mortgage and financial guaranty insurers is closely tied to the economy as a whole, such that insurance liabilities are relatively low when the economy is strong but much higher in times of economic crisis, and that credit rating agencies correspondingly expect such companies to hold additional capital to protect policyholders due to the monoline nature and volatility of the businesses.

With respect to mortgage insurers, the Federal Housing Agency (FHA), in its role as regulator of Fannie Mae and Freddie Mac (government-sponsored entities who purchase or guarantee a majority of U.S. home mortgage loans), also prescribes capital requirements that must be satisfied by private mortgage insurers to be eligible to provide mortgage insurance on loans owned or guaranteed by Fannie Mae or Freddie Mac. These guidelines were set after the 2007–2008 financial crisis and are designed to ensure that mortgage guaranty insurers maintain sufficient capital to cover obligations in times of financial distress, when defaults and foreclosures increase. Rating agencies evaluate satisfaction of FHA guidelines when rating mortgage guaranty insurers, and FHA and rating agency capital standards geared to ensuring capital adequacy in times of crisis may result in a mortgage guaranty insurer being required to hold an amount of capital that causes its current insurance liabilities to be less than 25 percent of its assets in low loss years when the economy is strong.

Financial guaranty insurance is a line of insurance business in which an insurance company guarantees scheduled payments of interest and

principal on a bond or other debt security in the event of issuer default. A comment explained that financial guaranty insurance is unique in that the policyholder is effectively paying for use of the financial guaranty insurer's credit rating. For example, if a municipality insures its municipal bond obligations with a financial guarantee insurer, the municipality can charge a lower interest rate on its bond, because the obligation is guaranteed by the insurer's high credit rating. A very high credit rating is thus essential for a financial guarantee insurer to write new business. Further (and similar to mortgage guaranty insurers) rating agency capital standards for financial guaranty insurers are geared to ensuring capital adequacy in times of crisis and may require a higher level of capital to get the same rating as an insurer with a different portfolio of risks. The combination of enhanced rating agency capital requirements and the need for a very high credit rating to write new business often results in a financial guaranty insurer being required to hold capital such that its current insurance liabilities are less than 25 percent of its assets in low loss years.

The Treasury Department and IRS considered these comments and the circumstances under which an insurance company would need assets in excess of 400 percent of its insurance liabilities in order to obtain the credit rating needed to write new business. As described in comments, companies that may require a higher level of capital as compared to insurance liabilities are companies that provide primarily catastrophic loss coverage and also monoline companies providing mortgage or financial guaranty insurance that experience significant losses on a low frequency but high severity basis. In low loss years, these types of companies may have less than 25 percent insurance liabilities to assets, but the additional assets may be viewed as necessary by rating agencies for the companies to meet insurance obligations in high loss years, and thus to receive the credit rating that the companies require to write the business in their business plan. Thus, the final regulations provide that the rating related circumstances exception is only available to a foreign corporation if it is a company that exclusively provides mortgage insurance or if more than half of the foreign corporation's net written premiums for the annual reporting period (or the average of the net written premiums for the foreign corporation's annual reporting period and the two immediately preceding annual reporting

periods) are from insurance coverage against the risk of loss from a catastrophic loss event (that is, a low frequency but high severity loss event). See § 1.1297-4(d)(4)(i).

The final regulations also provide that a financial guaranty insurance company that fails the 25 percent test is deemed to satisfy the rating-related circumstances requirement. See § 1.1297-4(d)(4)(ii). The final regulations define a financial guaranty insurance company as an insurance company whose sole business is to insure or reinsure only the type of business written by (or that would be permitted to be written by) a company licensed under, and compliant with, a U.S. state law, modeled after the National Association of Insurance Companies Financial Guaranty Insurance Guideline, that specifically governs the licensing and regulation of financial guaranty insurance companies. See § 1.1297-4(f)(5).

The final regulations do not include a special rule for fully collateralized reinsurance because the decision to fully collateralize reinsurance obligations is not necessarily linked to rating agency requirements and (as noted in comments) many fully collateralized reinsurance companies do not obtain credit ratings.

4. Election To Apply Alternative Facts and Circumstance Test

Section 1297(f)(2) requires a United States person to make an election in order to treat a foreign corporation that satisfies the alternative facts and circumstances test as a QIC. Proposed § 1.1297-4(d)(5) provided that the election could not be made unless the foreign corporation directly provided the United States person with a statement or made a publicly available statement, in each case indicating that the foreign corporation satisfied the requirements of the alternative facts and circumstances test. However, the foreign corporation's statement could not be relied on if the shareholder knew or had reason to know that the statement was incorrect.

One comment objected to the proposed rule providing that a shareholder cannot rely on a statement of the foreign corporation if it has reason to know that the statement is incorrect. The comment asserted that a shareholder may not have access to the information needed to determine the accuracy of a foreign corporation's representations. In response to this comment, the final regulations clarify that a shareholder is permitted to rely on a statement provided by the foreign corporation unless it has reason to know

the statement is incorrect based on reasonably accessible information. Whether information is reasonably accessible is determined based on all relevant facts and circumstances, including the size of the shareholder's ownership interest and whether the shareholder is an officer or employee of the foreign corporation. Thus, reliance is not permitted under circumstances in which a reasonable person in the shareholder's position would know, based on information to which the shareholder has reasonable access, that the foreign corporation's statement is incorrect. In any case, an election is not valid unless the foreign corporation actually meets the requirements of § 1.1297-4(d)(1), regardless of whether the foreign corporation represents that those requirements have been met.

A shareholder makes the election on Form 8621, which must be attached to the shareholder's U.S. federal income tax return (under the final regulations, there is no requirement to attach also the statement provided by the foreign corporation). A shareholder who makes the election is not required to disclose the value of the foreign corporation's stock and, therefore, is not treated as having reported the foreign corporation's stock as an asset on Form 8621 for purposes of § 1.6038D-7(a)(1)(i)(C). As a result, the shareholder would be required to report the stock on Form 8938, subject to the thresholds and exceptions provided in section 6038D and the regulations thereunder. The final regulations clarify that the election can be made by a United States person who holds an option to purchase stock in a foreign corporation that meets the requirements of section 1297(f)(2).

One comment requested a special rule for foreign corporations owned indirectly through a foreign parent corporation, under which the foreign parent corporation could provide (or make publicly available) the statement required by the proposed regulations, and the election could be made at the level of the foreign parent corporation. In response to this comment, the final regulations have been modified to allow a foreign parent corporation to make the required statement publicly available on behalf of its subsidiaries. However, the final regulations do not permit the election to be made at the foreign parent level.

Some comments asserted that it would be unduly burdensome for certain shareholders to file Form 8621 in order to make the election under section 1297(f)(2). The comments requested that shareholders of publicly traded companies or small shareholders of non-publicly traded companies be

deemed to make the election under section 1297(f)(2) without the need for an affirmative filing.

In response to these comments, the final regulations provide that a shareholder in a publicly traded foreign corporation who owns stock (either directly or indirectly) with a value of \$25,000 or less is deemed to make the election under section 1297(f)(2) with respect to the publicly traded foreign corporation and its subsidiaries. If a shareholder owns stock in a publicly traded foreign corporation through a domestic partnership, an election will not be deemed made unless the stock held by the partnership has a value of \$25,000 or less. The same rule applies to stock owned through a domestic trust or estate, or through an S corporation. All the requirements necessary to permit an actual election under section 1297(f)(2) must be satisfied in order to permit a deemed election under this rule. For example, an election will not be deemed made unless the foreign corporation (or its foreign parent) provides a statement to the United States person or makes a publicly available statement indicating that it has satisfied the requirements of the alternative facts and circumstances test.

In addition, the final regulations provide that if a shareholder fails to make the election under section 1297(f)(2) on its original return for a taxable year, the election may be made on an amended return, provided there is reasonable cause for the failure to make the election on the original return. A United States person that makes the election on an amended return must be prepared to demonstrate reasonable cause upon request, but is not required to provide documentation of reasonable cause when the amended return is filed. This rule is intended to provide relief to a shareholder that inadvertently neglects to make the election under section 1297(f)(2) and does not qualify for a deemed election (for example, if the shareholder owns stock with a value in excess of \$25,000).

C. Limitations on Amount of Applicable Insurance Liabilities

1. Mechanics of the Limitation

Proposed § 1.1297-4(e) provided rules limiting the amount of AIL for purposes of the 25 percent test and the alternative facts and circumstances test and stated that AIL may not exceed the lesser of (1) AIL shown on the most recent AFS, (2) the minimum AIL required by the applicable law or regulation of the jurisdiction of the applicable insurance regulatory body, and (3) AIL reported on the most recent financial statement

made on the basis of GAAP or IFRS if such financial statement was not prepared for financial reporting purposes.

A comment requested changes to the second limitation amount under the proposed regulations (the minimum AIL required by the applicable law or regulation of the jurisdiction of the applicable insurance regulatory body). The comment asserted that the reference to a “minimum amount” is either redundant (because the amount required under the applicable law or regulation will always be a minimum amount) or ambiguous (because the “minimum amount” could be interpreted to mean a hypothetical minimum amount required for any insurer without regard to its particular circumstances, including its lines of business). The same comment also noted that proposed § 1.1297–4(e)(2)(ii) did not take into account AIL actually reported to the applicable insurance regulatory body, if lower than the minimum required amount (which a local regulator sometimes allows as a permitted practice). Other comments requested that the minimum amount required under the applicable law or regulation be determined by reference to GAAP or IFRS requirements.

With respect to the third limitation amount under the proposed regulations (AIL reported on the most recent financial statement made on the basis of GAAP or IFRS if such financial statement was not prepared for financial reporting purposes), one comment expressed concern that a statement which is not prepared for financial reporting purposes is potentially unreliable and should not be used as a basis for determining AIL. In addition, the comment requested guidance as to the meaning of the terms “financial statement” and “financial reporting standard.”

The limitation under § 1.1297–4(e) has been modified in response to these comments. Under the final regulations, a foreign corporation’s AIL may not exceed the lesser of (1) the amount shown on any financial statement filed (or required to be filed) with the applicable insurance regulatory body for the same reporting period covered by the applicable financial statement; (2) the amount determined on the basis of the most recent AFS, if the AFS is prepared on the basis of GAAP or IFRS, regardless of whether the AFS is filed with the applicable insurance regulatory body; or (3) the amount required by the applicable law or regulation of the jurisdiction of the applicable regulatory body (or a lower amount allowed as a permitted practice). If one of the

limitation amounts is not applicable (for example, if the AFS is not prepared on the basis of GAAP or IFRS), the limitation is equal to the lesser of the other amounts described.

Although the limitation under section 1297(f)(3) refers to the amount reported to the applicable insurance regulatory body in the AFS, the final regulations clarify that an AFS prepared under GAAP or IFRS is taken into account as part of the limitation under § 1.1297–4(e)(2)(ii) regardless of whether it is filed with the local regulator. This rule is intended to prevent foreign corporations that choose not to file GAAP or IFRS statements with the local regulator from relying on statutory accounting standards that define liabilities more broadly than GAAP or IFRS. The limitation in the proposed regulations addressing financial statements prepared for a purpose other than financial reporting has been deleted.

The definition of the term “financial statement” has been revised to treat a statement as such only if it is prepared for a reporting period in accordance with the rules of a financial accounting or statutory accounting standard and includes a complete balance sheet, statement of income, and a statement of cash flows (or equivalent statements under the applicable reporting standard). Consequently, a statutory accounting statement that is used for purposes of the limitation should provide all information necessary to apply the 25 percent test and the alternative facts and circumstances test.

2. Discounting

Under proposed § 1.1297–4(e)(3), if an AFS that was not prepared under GAAP or IFRS did not discount losses on an economically reasonable basis, AIL were required to be reduced under the discounting rules that would apply if a financial statement had been prepared under either GAAP or IFRS. Some comments requested that the discounting requirement be removed because GAAP does not require discounting of liabilities in certain circumstances.

The Treasury Department and the IRS agree that AIL reported on a financial statement that have been discounted to reflect the time value of money only to the extent required by GAAP or IFRS have been discounted on an economically reasonable basis. Therefore, additional discounting of AIL is not necessary under circumstances in which it is not required under either GAAP or IFRS. For example, IFRS 17 does not require discounting of liabilities under nonlife insurance

contracts with terms of one year or less. However, the Treasury Department and the IRS have determined that discounting is required where AIL have not been otherwise discounted on a reasonable basis. Accordingly, the final regulations clarify that, where a financial statement described in § 1.1297–4(e)(2) does not discount AIL on an economically reasonable basis, the foreign corporation may meet this requirement by choosing to apply the discounting methods required under either GAAP or IFRS.

3. Change of Financial Reporting Standard

Under proposed § 1.1297–4(e)(4), if a foreign corporation had previously prepared a financial statement under GAAP or IFRS, it could not cease to do so in subsequent years without a non-Federal tax business purpose. If the foreign corporation failed to prepare a financial statement under GAAP or IFRS in a subsequent year without a non-Federal tax business purpose, it was treated as having no AIL for purposes of the 25 percent test and the 10 percent test.

A comment requested that this rule be removed because taxpayers should not be required to establish a business purpose for their choice of an accounting standard. In addition, financial reports are prepared to inform a corporation’s stakeholders and regulators of its financial condition, and this function is so significant that a corporation is unlikely to change its accounting standard for tax purposes. The Treasury Department and the IRS have concluded that other rules and limitations provided in the final regulations are sufficient to protect the integrity of the amounts reported on the AFS. Therefore, the final regulations delete the special rule addressing a change of financial reporting standard.

D. Definition of an Insurance Business

The proposed regulations defined an insurance business to include the investment activities and administrative services that are required to support (or that are substantially related to) insurance, annuity, or reinsurance contracts issued or entered into by the QIC. See proposed § 1.1297–5(c)(2). One comment interpreted this definition as potentially excluding any investment activities in excess of the minimum amount required to meet the QIC’s insurance obligations from the scope of the exception under section 1297(b)(2)(B). The comment requested that the definition be broadened to include all investment activities related to insurance, annuity, or reinsurance

contracts issued or entered into by the QIC. Although the definition of an insurance business (now contained in § 1.1297-4(f)(8)) has not been changed, it is not intended to provide a maximum threshold for investment assets and income that may qualify for non-passive treatment under section 1297(b)(2)(B). This definition merely requires a sufficient factual relationship between a company's insurance contracts and its investment activity.

VI. Comments and Revisions to Proposed § 1.1297-5 and New § 1.1297-6: Exception From the Definition of Passive Income for Active Insurance Income

Section 1297(b)(2)(B) provides an exclusion from the definition of passive income for income derived in the active conduct of an insurance business by a QIC. Proposed § 1.1297-5(b) provided a general rule that excluded from passive income certain income of a QIC and income of a qualifying domestic insurance corporation (QDIC). Proposed § 1.1297-5(c) described the requirements for income to be treated as derived in the active conduct of an insurance business and provided rules for determining the amount of a QIC's income that is excluded. Proposed § 1.1297-5(d) provided rules for determining whether income of a domestic corporation is income of a QDIC. Proposed § 1.1297-5(e) provided that assets of a QIC are not treated as passive assets if they are available to satisfy liabilities of the QIC related to its insurance business. In addition, proposed § 1.1297-5(e) provided that assets of a QDIC generally are not treated as passive assets. Proposed § 1.1297-5(f) provided a special look-through rule for interests held by a QIC in subsidiary entities.

A. Active Conduct of an Insurance Business

Under proposed § 1.1297-5(c)(1), a QIC's passive income was treated as derived in the active conduct of an insurance business only if its active conduct percentage was at least 50 percent. The active conduct percentage was computed for each taxable year based on the amount of expenses incurred by a QIC for services of its officers and employees (including employees of qualifying related entities) related to the production or acquisition of premiums and investment income as a fraction of all expenses related to the production or acquisition of premiums and investment income.

Proposed § 1.1297-5(c)(3)(i) provided that active conduct is determined based on all the facts and circumstances. In

general, a QIC was treated as actively conducting an insurance business only if the officers and employees of the QIC carried out substantial managerial and operational activities. A QIC's officers and employees were considered to include the officers and employees of an affiliate if the QIC satisfied the control test under proposed § 1.1297-5(c)(3)(ii), which incorporated requirements relating to ownership, control and supervision, and compensation.

Comments were generally critical of the proposed active conduct test. Some noted that outsourcing is a common practice in the insurance industry for reasons of cost and efficiency, and an insurance company should be treated as engaged in the active conduct of an insurance business even if the fees it pays for outsourced activities (for example, to investment advisors or insurance brokers) exceed employee expenses. Others expressed concern that some reinsurers (which hold substantial investments but employ a limited staff) and alternative risk vehicles could have difficulty satisfying the active conduct test under the proposed regulations. Comments also criticized the "cliff effect" of the active conduct percentage, which precluded an insurance company with an active conduct percentage that is slightly below 50 percent from treating any of its income or assets as non-passive under section 1297(b)(2)(B).

Many comments recommended that the proposed active conduct test be replaced with a broader facts and circumstances test. Some comments alternatively requested that the active conduct percentage be used as a safe harbor alongside a more flexible test, or that the threshold for the active conduct percentage be reduced to 25 percent.

A number of comments requested that an insurance company be treated as engaged in the active conduct of an insurance business even if its day-to-day activities are not performed by employees, so long as its officers and employees adequately supervise the outsourced functions. For example, some comments recommended a management and control test based upon the Limitation on Benefits Article of the 2016 U.S. Model Income Tax Convention (which requires a company's executive officers and senior management employees to exercise day-to-day responsibility for strategic, financial, and operational policy decision-making) or regulations issued by the Bermuda Monetary Authority (which permit outsourcing subject to the insurance company's supervision and oversight). Others proposed that if an entity is treated as an insurance company under subchapter L or is

treated as a QIC under section 1297(f), it should be deemed to be engaged in the active conduct of an insurance business without meeting any additional requirements.

Several comments recommended that the active conduct test focus on the assumption of insurance risk. One comment specifically identified underwriting as a core insurance function that must be performed by an insurance company's officers and employees. Another requested that an insurance company be treated as engaged in the active conduct of an insurance business if it assumes risk under contracts with multiple counterparties that are unrelated to one another, or under contracts covering multiple divergent lines of business. Some comments proposed an active conduct test tied to the amount of premium and investment income earned by the QIC.

For purposes of computing the active conduct percentage, some comments requested clarification about whether overhead and claims expenses are treated as expenses incurred to produce or acquire premium and investment income. One comment recommended that certain functions (for example, investment management) be excluded from both the numerator and denominator of the fraction.

Some comments requested that the control test be expanded to cover employees of entities that are related to the QIC within the meaning of section 954(d)(3) or are under common practical control with the QIC. Another proposed that a single active conduct percentage be computed on an aggregate basis when multiple insurance companies are wholly owned within a single corporate group.

The Treasury Department and the IRS have determined that the active conduct of an insurance business is a requirement mandated by the statute in addition to (and separate from) the requirements of subchapter L and section 1297(f), but that in response to comments, the active conduct test should be amended to provide more flexibility in determining whether a QIC is engaged in the active conduct of an insurance business. Therefore, the Treasury Department and the IRS are issuing a notice of proposed rulemaking (the 2020 NPRM) with a new proposed § 1.1297-5 published in the same issue of the **Federal Register** as these final regulations that proposes rules for determining whether an insurance company is engaged in the active conduct of an insurance business.

The new active conduct rules are proposed to apply to taxable years of

QICs beginning on or after the date the Treasury Decision adopting those rules as final regulations is published in the **Federal Register**. The rules contained in proposed § 1.1297–5(c) and (d) are withdrawn. The other rules in proposed § 1.1297–5 have been modified as described below and are provided in the final regulations under new § 1.1297–6.

B. Qualifying Domestic Insurance Corporations

Proposed § 1.1297–5(d) defined a QDIC as a domestic corporation that is subject to tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Code and is subject to Federal income tax on its net income. Proposed §§ 1.1297–5(b)(2) and 1.1297–5(e)(2) provided that a QDIC's income and assets are non-passive for purposes of determining whether a non-U.S. corporation is treated as a PFIC (the QDIC Rule). However, proposed §§ 1.1297–5(b)(2) and 1.1297–5(e)(2) provided that the QDIC Rule did not apply for purposes of section 1298(a)(2) and determining if a U.S. person indirectly owns stock in a lower tier PFIC (QDIC Attribution Exception). Consequently, for attribution purposes, a tested foreign corporation was required to apply the section 1297(a) income and assets tests without applying the QDIC Rule.

Several comments requested that the QDIC Attribution Exception be removed because U.S. shareholders of a tested foreign corporation that would not otherwise be a PFIC but that owns a PFIC and a U.S. insurance subsidiary that is a QDIC can become indirect owners of a PFIC as a result of the section 1298(a)(2) attribution rule. Another comment requested that, if the QDIC Attribution Exception is retained, a special exception be provided for active domestic mortgage insurance companies if certain criteria are satisfied. The Treasury Department and IRS agree that the QDIC Attribution Exception is overbroad, and therefore the final regulations do not include it. However, the Treasury Department and IRS believe that it may be appropriate to limit the amount of a QDIC's assets and income that are treated as non-passive if they exceed a certain threshold. Accordingly, the 2020 NPRM proposes a new limitation.

The final regulations also clarify that a U.S. insurance company must be a look-through subsidiary in order to qualify as a QDIC. If a QDIC is a look-through subsidiary of a QIC, the QIC's proportionate share of the QDIC's assets that is treated as non-passive may be subject to limitation under the special look-through rule provided in § 1.1297–

6(d), which is described in Part VI.C of this Summary of Comments and Explanation of Revisions. Because of the renumbering of sections described in Part VI.A of this Summary of Comments and Explanation of Revisions, the QDIC rules are now contained in § 1.1297–6(b)(2), (c)(2), and (e)(1) of the final regulations.

C. Treatment of Income and Assets of Certain Look-Through Subsidiaries and Look-Through Partnerships Held by a QIC

The proposed regulations provided a special look-through rule that applied to a subsidiary entity in which the QIC owned at least 25 percent by value (that is, a look-through subsidiary or a look-through partnership) and which was subject to the look-through rules provided in section 1297(c), proposed § 1.1297–1(c)(2) and (d)(3), and proposed § 1.1297–2(b)(2) (the “general look-through rules,” which are now provided in § 1.1297–2(b)(2) and (3)). Under the general look-through rules, a QIC is treated as earning directly its proportionate share of the income, and holding directly its proportionate share of the assets, of a look-through subsidiary or a look-through partnership.

Proposed § 1.1297–5(f) provided that, if a QIC was treated as earning passive income or holding passive assets of a subsidiary entity under the general look-through rules, then the income could be treated as derived by the QIC in the active conduct of an insurance business (and thus treated as non-passive under proposed § 1.1297–5(c)), and the assets could be treated as assets of the QIC held to satisfy liabilities related to its insurance business (and thus treated as non-passive under § 1.1297–5(e)). However, for this rule to apply, the subsidiary entity's assets and liabilities were required to be included in the QIC's AFS.

A number of comments asserted that look-through treatment should not be denied for subsidiary entities that do not have assets and liabilities included in the QIC's AFS (which would typically occur if a subsidiary entity is not consolidated with the QIC under the relevant financial accounting standard). The comments noted that the equity value of a subsidiary entity is reflected on a QIC's AFS even if it is not consolidated for financial reporting purposes. Some comments requested that the look-through rule under proposed § 1.1297–5(f) apply without regard to whether a subsidiary entity's assets and liabilities are included in the QIC's AFS. Others requested that the look-through rule be applied to a

proportionate amount of the income and assets of a subsidiary entity, depending on how the value of the subsidiary entity is reflected on the AFS.

In response to these comments, the special look-through rule for assets and income of a subsidiary entity held by a QIC (now provided in § 1.1297–6(d)) has been modified to apply in all cases in which a QIC is treated as owning the assets or earning the income of the subsidiary entity under the general look-through rules. However, under § 1.1297–6(d)(2), the amount of assets or income that can be treated as non-passive under the revised rule is limited to the greater of two amounts. The first amount is determined by multiplying the QIC's proportionate share of the subsidiary entity's income or assets by a fraction equal to (i) the net equity value of the QIC's interests in the subsidiary entity divided by (ii) the value of the subsidiary entity's assets. The second amount is the amount of income or assets that are treated as non-passive in the hands of the subsidiary entity.

If assets are measured based on value for purposes of applying the asset test under section 1297(a)(2), the amount of otherwise passive assets that may be treated as non-passive under § 1.1297–6(d) (that is, the first amount described above) is limited to the net equity value of the interests held by the QIC in the subsidiary entity. If assets are measured instead using adjusted bases, the fraction test is designed to provide a proportionate limitation. Two examples are added to illustrate the operation of these rules. See § 1.1297–6(d)(3).

Several comments requested clarification regarding the treatment of an interest held by a QIC in an entity other than a look-through subsidiary or a look-through partnership (for example, a corporation in which a QIC owns less than 25 percent of the stock). The income and assets of such a subsidiary entity are not treated as earned or held by the QIC in the active conduct of an insurance business, consistent with the general look-through rules. However, the stock or partnership interest held by the QIC (and the income it derives from the subsidiary entity) is eligible for the exception under section 1297(b)(2)(B) and § 1.1297–6(b) and (c) in the same manner as any other (non-look-through) asset held by a QIC.

VII. Comments and Revisions to Proposed § 1.1298–4—Rules for Certain Foreign Corporations Owning Stock in 25-Percent-Owned Domestic Corporations

Section 1298(b)(7) provides a special characterization rule that applies when

a tested foreign corporation owns at least 25 percent of the value of the stock of a domestic corporation and is subject to the accumulated earnings tax under section 531 (or waives any benefit under a treaty that would otherwise prevent imposition of such tax). In that case, section 1298(b)(7) treats the qualified stock held by the domestic corporation as a non-passive asset, and the related income as non-passive income.

A. Interaction of the Domestic Subsidiary Rule and Section 1298(a)(2) Attribution Rule

The proposed regulations included rules that disregarded the application of section 1298(b)(7) for purposes of determining whether a foreign corporation is a PFIC for purposes of the ownership attribution rules in section 1298(a)(2) and § 1.1291–1(b)(8)(ii) (“domestic subsidiary attribution rules”). See proposed §§ 1.1291–1(b)(8)(ii)(B) and 1.1298–4(e).

Several comments recommended that the final regulations eliminate the domestic subsidiary attribution rules in proposed §§ 1.1291–1(b)(8)(ii)(B) and 1.1298–4(e). These comments asserted that Congress intended for stock that is treated as non-passive pursuant to section 1298(b)(7) to be characterized as non-passive for all purposes, including for purposes of section 1298(a)(2). Specifically, some of these comments noted that the statutory text of section 1298(a)(2) already specifies that application of section 1297(d) is excluded and, thus, asserted that an additional exclusion from section 1298(a)(2) is precluded. The comments also asserted that legislative history suggests that Congress intended for section 1298(b)(7) to incentivize investments in domestic corporations. Other comments argued that the domestic subsidiary attribution rules would be administratively burdensome on minority shareholders who would not be able to obtain information with respect to lower-tier PFICs to comply with the PFIC rules. One comment suggested that Congress acknowledged the lack of control that minority investors have in parent companies by providing the 50-percent threshold in section 1298(a)(2) to facilitate administrability. Another comment recommended that, if the domestic subsidiary attribution rules are retained, the final regulations provide an exception to allow shareholders who own less than 5-percent of the top-tier foreign corporation in a structure to apply section 1298(b)(7) to determine PFIC status for purposes of the ownership attribution rules in section 1298(a)(2).

The Treasury Department and the IRS have given further consideration to the purpose of section 1298(b)(7), and have determined that it is appropriate for section 1298(b)(7) generally to apply for purposes of the attribution of ownership rules of section 1298(a), provided that adequate measures are taken to prevent taxpayers from holding primarily passive assets in domestic subsidiaries in order to avoid PFIC classification. The Treasury Department and the IRS also agree with the comment that the domestic subsidiary attribution rule can be administratively burdensome. Accordingly, the Treasury Department and the IRS have determined that the application of the domestic subsidiary anti-abuse rule discussed in Part VII.B of this Explanation of Comments and Summary of Revisions is sufficient to address concerns about abusive planning related to section 1298(b)(7) without a need for the domestic subsidiary attribution rules. Therefore, the domestic subsidiary attribution rules are eliminated in the final regulations.

Several comments were received recommending clarification concerning the consequences of disregarding section 1298(b)(7) for purposes of the Income Test and the Asset Test and excepting minority shareholders from the domestic subsidiary rule. Because the final regulations do not adopt the domestic subsidiary attribution rules, these recommendations are not adopted.

B. Revisions to Domestic Subsidiary Anti-Abuse Rules

The proposed regulations provided that section 1298(b)(7) did not apply if (i) the tested foreign corporation would be a PFIC if the qualified stock held by the 25-percent-owned domestic corporation or any income received or accrued with respect thereto were disregarded (“qualified stock anti-abuse rule”) or (ii) a principal purpose for the tested foreign corporation’s formation or acquisition of the 25-percent-owned domestic corporation was to avoid classification of the tested foreign corporation as a PFIC (“principal purpose anti-abuse rule”). See proposed § 1.1298–4(f). The preamble to the proposed regulations explained that the Treasury Department and the IRS believed that a taxpayer should not be permitted to use the domestic subsidiary rule in section 1298(b)(7) to avoid the PFIC rules by indirectly holding predominantly passive assets through a two-tiered chain of domestic subsidiaries.

1. Qualified Stock Anti-Abuse Rule

Several comments requested that the qualified stock anti-abuse rule in

proposed § 1.1298–4(f)(1) be withdrawn. These comments asserted that Congress was aware of the potential for taxpayers to rely on section 1298(b)(7) to avoid PFIC status by treating otherwise passive investments as non-passive and intended for the accumulated earnings tax (“AET”) to mitigate potential abuse. The comments argued that the AET imposed on the tested foreign corporation, the U.S. corporate tax imposed on the domestic subsidiaries, and the withholding tax imposed on distributions to the tested foreign corporation serve to discourage a tested foreign corporation from artificially overweighing its investment assets held through domestic subsidiaries. Another comment asserted that the qualified stock anti-abuse rule creates a hypothetical PFIC test that supersedes the statute when it causes a tested foreign corporation to be a PFIC in a fact pattern in which the domestic subsidiary rule in section 1298(b)(7) would otherwise cause the tested foreign corporation to not be a PFIC.

The Treasury Department and the IRS have determined that the qualified stock anti-abuse rule is unnecessary to address the concerns of abuse that were expressed in the preamble to the proposed regulations and that tailoring the scope of the principal purpose anti-abuse rule as discussed in Part VII.B.2 of this Summary of Comments and Explanation of Revisions would better target the concerns of abuse. Accordingly, the qualified stock anti-abuse rule in proposed § 1.1298–4(f)(1) is withdrawn.

2. Principal Purpose Anti-Abuse Rule

Under the principal purpose anti-abuse rule in proposed § 1.1298–4(f)(2), a principal purpose was deemed to exist when the 25-percent-owned domestic corporation was not engaged in an active trade or business in the United States. One comment asserted that the principal purpose anti-abuse rule in proposed § 1.1298–4(f)(2) was overbroad and should be narrowly drawn to prevent potential abuse. Other comments requested that the principal purpose anti-abuse rule be eliminated, because, according to such comments, Congress contemplated that taxpayers would plan into section 1298(b)(7) and intended for the AET to be the sole limitation on the applicability of the domestic subsidiary rule. Some of these comments asserted that the principal purpose anti-abuse rule was inconsistent with two private letter rulings that, according to such comments, endorsed the use of domestic subsidiaries to manage PFIC status.

One comment noted that the 25-percent-owned domestic corporation is likely to be a holding company without an active trade or business and, thus, the tested foreign corporation would likely be deemed to have a principal purpose of avoiding PFIC classification. Another comment argued that the standard for deeming a principal purpose of avoiding PFIC status to exist is misguided because a corporation need not be engaged in an active trade or business in order to generate non-passive income. Other comments expressed concern that the principal purpose anti-abuse rule would disallow planning to manage the PFIC risk of start-up companies and active companies undergoing transition.

The Treasury Department and the IRS have determined that the final regulations should retain a principal purpose anti-abuse rule to prevent the holding of passive assets through a two-tiered chain of domestic subsidiaries for the purpose of avoiding the PFIC rules with respect to passive assets held in foreign affiliates. Absent an anti-abuse rule, a two-tiered chain of domestic subsidiaries could be used to shield U.S. investors in a tested foreign corporation from the application of the PFIC rules with respect to substantial amounts of passive assets held by the tested foreign corporation or its foreign subsidiaries. The Treasury Department and the IRS have concluded that the promulgation of a principal purpose anti-abuse rule is consistent with section 1298 and the broad regulatory authority under section 1298(g). The legislative history of section 1298(b)(7) envisions that U.S. shareholders that hold passive assets through a U.S. corporate structure rather than in a foreign corporation in order to avoid the PFIC regime will be subject to tax treatment essentially equivalent to that of the shareholders of a PFIC. While Congress intended that the AET serve this function, because the AET is rarely applied in practice, the Treasury Department and the IRS have determined that the AET is not, by itself, sufficient to curtail abuse. The imposition of U.S. net income tax on the income from passive assets held by a domestic subsidiary also does not serve as a sufficient disincentive to hold those assets in a domestic subsidiary, because the passive assets may generate a small amount of income or the domestic subsidiary may be leveraged so that its net income subject to taxation is much less than the gross income that would be taken into account under the PFIC rules if the assets were held by a foreign affiliate. Section 1298(g) provides authority to prevent abuse of the PFIC

rules. Moreover, the Treasury Department and the IRS have determined that the comments did not appreciate the underlying facts of the private letter rulings and that the promulgation of the principal purpose anti-abuse rule is not inconsistent with the private letter rulings.

However, the Treasury Department and the IRS agree that it is appropriate to more closely tailor the scope of the principal purpose anti-abuse rule to the potential abuses of greatest concern. Accordingly, the principal purpose anti-abuse rule in the final regulations is modified to strike the appropriate balance between preventing section 1298(b)(7) from applying inappropriately to avoid the PFIC rules and allowing for planning to manage the PFIC risk of start-up companies and active companies undergoing transition phases in the business cycle. Under the principal purpose anti-abuse rule in the final regulations, section 1298(b)(7) does not apply if either (i) a principal purpose for the formation, acquisition, or holding of stock of either domestic corporation was to avoid PFIC classification or (ii) a principal purpose of the capitalization or other funding of the second-tier domestic corporation is to hold passive assets through such corporation to avoid PFIC classification. *See* § 1.1298-4(e)(1). Unlike the proposed regulations, which applied the principal purpose anti-abuse rule only at the level of the upper tier domestic corporation, the final regulations were modified to apply the principal purpose anti-abuse rule at both levels. *See id.* Because a two-tiered domestic structure can be planned into at either tier level in the structure, the first prong of the anti-abuse rule—which targets corporate formations, acquisitions, or stock holding—applies at both levels. *See id.* On the other hand, the second prong of the anti-abuse rule—which targets capitalizing or funding—applies at the level of the second-tier domestic subsidiary because the benefit of section 1298(b)(7) applies only with respect to assets held at that level. *See id.* The Treasury Department and the IRS continue to study the need to narrow the principal purpose anti-abuse test to avoid concerns with respect to temporary holdings of passive assets in a U.S. corporate structure for valid business reasons, and additional guidance on safe harbors to address those concerns is proposed in the 2020 NPRM. *See* proposed § 1.1298-4(e)(2) and (e)(3).

VIII. Comments and Revisions Regarding Applicability Dates

The preamble to the proposed regulations generally provided that until they were finalized, taxpayers could choose to apply the proposed regulations other than the rules related to the PFIC insurance exception in their entirety to all open tax years as if they were final regulations provided that taxpayers consistently applied those rules. Similarly, the preamble provided that the rules of proposed §§ 1.1297-4 and 1.1297-5 could be applied for taxable years beginning after December 31, 2017, provided those rules were applied consistently.

A. Applicability Dates Relating to the PFIC Insurance Exception

Comments related to the PFIC insurance income exception requested that the final regulations apply to taxable years of a U.S. shareholder beginning on or after December 31, 2020 (or such date that generally provides foreign corporations at least one year to comply with the final regulations) or the date of publication of the final regulations. Comments asserted that foreign corporations needed additional time to make changes to come into compliance with the regulations, and that U.S. shareholders needed additional time to evaluate whether they were shareholders of a PFIC. Because the final regulations have removed rules turning off the QDIC rule and section 1298(b)(7) for purposes of testing for indirect ownership of a PFIC and the rules defining active conduct of an insurance business have been revised and repropounded, the final regulations are significantly less burdensome than as originally proposed. Accordingly, the Treasury Department and the IRS have decided that additional time is not necessary to comply given that section 1297(f) has been in effect since January 1, 2018, and §§ 1.1297-4 and 1.1297-6 merely implement section 1297(f).

Sections 1.1297-4(g) and 1.1297-6(f) therefore provide that the final PFIC insurance regulations apply to taxable years beginning on or after January 14, 2021. Taxpayers may choose to apply the final PFIC insurance regulations to any taxable year beginning after December 31, 2017, provided that all of those rules are applied consistently with respect to that tested foreign corporation for the same year and all succeeding taxable years. *Id.*

B. Applicability Dates Relating to Other Rules

Comments with respect to the rules unrelated to the PFIC insurance

exception argued that allowing taxpayers to rely on the 2019 proposed regulations for open years would provide insufficient relief, given that a foreign corporation is generally treated as a PFIC on an ongoing basis with respect to a shareholder if it was ever treated as a PFIC with respect to that shareholder (the “once-a-PFIC, always-a-PFIC” rule). See sections 1291(a)(1) and 1298(b)(1) and § 1.1298–3(a). The comments expressed concern that a taxpayer that treated a tested foreign corporation as a PFIC in closed years, based on its understanding of the rules at that time, would be required to file amended returns. The comments stated that requiring taxpayers to file amended returns could limit the relief provided by allowing taxpayers to rely on the 2019 proposed regulations for open years. One comment expressed concern that the application of the once-a-PFIC, always-a-PFIC rule in this context would penalize taxpayers that took conservative positions under prior law, and that filing amended returns may involve significant administrative burdens. Another comment expressed concern that new investors in a tested foreign corporation that would have been a PFIC under prior law but not under the proposed regulations would be subject to more favorable rules than historic investors in that corporation. Accordingly, comments requested that taxpayers be permitted to apply the regulations to closed taxable years for purposes of section 1298(b)(1), provided that the relevant tested foreign corporation would never have been a PFIC during the taxpayer’s holding period as a result.

The Treasury Department and the IRS agree that the once-a-PFIC, always-a-PFIC rule is implicated, because in some cases these regulations may cause a tested foreign corporation that was previously a PFIC with respect to a shareholder to not satisfy the Asset Test or Income Test going forward and therefore to become a “former PFIC” as defined in § 1.1291–9(j)(2)(iv), but the foreign corporation would still be treated as a PFIC with respect to the shareholder by reason of the once-a-PFIC, always-a-PFIC rule. The Treasury Department and the IRS do not agree that taxpayers subject to the once-a-PFIC, always-a-PFIC rule should be permitted to avoid the need to file amended returns or to make an election under section 1298(b)(1) and § 1.1298–3 (“purging election”). The possible applicability dates of the final regulations do not include closed years, and the Treasury Department and the IRS do not believe that it would be

appropriate for the final regulations to apply in whole or part to closed years for purposes of alleviating the effects of the once-a-PFIC, always-a-PFIC rule. For example, providing the relief requested by commenters would afford a benefit to taxpayers that invested in a tested foreign corporation treated as a section 1291 fund in a now-closed year and continue to hold the stock compared to taxpayers that acquired the stock of the tested foreign corporation at the same time but sold the stock in a now-closed year, which may be viewed as unfair. If the tested foreign corporation would not be treated as a PFIC under the proposed regulations or the final regulations, the taxpayers who sold the stock during a closed year may have been subject to tax under section 1291 on an excess distribution while taxpayers who continue to hold the stock would be spared taxation under section 1291.

Finally, while it is true that the application of the once-a-PFIC, always-a-PFIC rule may apply to historic shareholders and not to new shareholders, the rule as enacted by Congress is designed to work in that manner. For example, an investor that buys shares in a tested foreign corporation that is a start-up with no operating income may be required to treat that corporation as a PFIC during its entire holding period for the shares, while an investor that buys shares in the same corporation once it is a going concern may never be required to treat the tested foreign corporation as a PFIC.

However, in light of the issues raised by commenters, the Treasury Department and the IRS have concluded that it is appropriate to provide taxpayers with some flexibility in choosing if and when to end PFIC treatment by causing a former PFIC to no longer be subject to the once-a-PFIC, always-a-PFIC rule. Under current law, a shareholder seeking to end PFIC treatment as a result of a change of facts or law would need to make a purging election under section 1298(b)(1) and § 1.1298–3(b) or (c) on Form 8621 attached to the shareholder’s tax return (including an amended return filed within three years of the due date, as extended under section 6081, of the original return for the election year), or request the consent of the Commissioner to make an election with respect to a closed taxable year under section 1298(b)(1) and § 1.1298–3(e) (“late purging election”) on Form 8621–A. A timely purging election under section 1298(b)(1) and § 1.1298–3(b) or (c) may be made if the tested foreign corporation ceased to qualify as a PFIC under the Income Test and the Asset Test in an open taxable year, but the election

would not affect the treatment of the tested foreign corporation as a PFIC in the earliest open year because it takes effect at the end of the year for which the election is made, as described in the next paragraph. If the tested foreign corporation ceased to qualify as a PFIC at the beginning of the earliest open year, the shareholder may request the consent of the Commissioner to make a late purging election, as described in the next paragraph.

When a deemed sale purging election is made, the stock of the former PFIC is deemed sold for its fair market value on the last day of the last taxable year of the tested foreign corporation during which it qualified as a PFIC (the “termination date”). See § 1.1298–3(b)(2) and (d). Accordingly, a taxpayer that files a timely deemed sale purging election for an open taxable year is treated as selling the stock of the PFIC at the end of the tested foreign corporation’s taxable year, and accordingly the shareholder is subject to the PFIC rules with respect to that stock during its relevant taxable year and any prior open years. If the taxpayer wishes to end PFIC treatment as of its earliest open taxable year, it must request the consent of the Commissioner to make a late purging election taking effect as of the end of the tested foreign corporation’s taxable year in the taxpayer’s most recent closed taxable year. For example, if a taxpayer had chosen to apply the proposed regulations to its earliest open taxable year with respect to a tested foreign corporation that has the same taxable year and that qualified as a PFIC in closed taxable years, and the application of the proposed regulations resulted in the tested foreign corporation no longer qualifying as a PFIC, to prevent PFIC treatment from continuing into that earliest open taxable year and beyond the taxpayer would have had to request the consent of the Commissioner to make a late purging election by filing Form 8621–A for the year immediately preceding its first open taxable year. See also § 1.1298–3(c) (deemed dividend purging election available if former PFIC was a CFC during its last taxable year that it qualified as a PFIC). The result of both timely and late purging elections with respect to former PFICs is that the shareholder’s holding period resets solely for PFIC purposes, such that the shareholder is treated as no longer holding stock of a foreign corporation that was ever a PFIC during the shareholder’s holding period, so the once-a-PFIC, always-a-PFIC rule no longer applies.

The Treasury Department and the IRS are aware that the reference to “all open

tax years” in the preamble to the proposed regulations may have caused confusion as to whether taxpayers could choose to apply the proposed regulations prospectively to the first taxable year for which they had not yet filed a return, or, alternatively, whether the proposed regulations, if applied at all, had to be applied to all open taxable years, including taxable years for which returns had already been filed, resulting in the necessity to amend returns. As suggested by the comments, there may also have been confusion regarding the need to make a purging election in order to end PFIC status, even though that is the result under the statute and regulations.

Given these considerations, a taxpayer may choose to apply the final regulations (other than the rules related to the PFIC insurance exception), with respect to a particular tested foreign corporation, to any open taxable year of the taxpayer, provided that all of the rules are applied consistently with respect to that tested foreign corporation for that year and all succeeding taxable years. See §§ 1.1291–1(j)(4), 1.1297–1(g)(1), 1.1297–2(h), 1.1297–4(g), 1.1297–6(f), 1.1298–2(g), and 1.1298–4(f). (This was also how the proposed regulations, other than the rules related to the PFIC insurance exception, were intended to apply.) For taxable years ending on or before December 31, 2020, a taxpayer may rely on proposed § 1.1297–1(c)(1)(A) in the 2019 proposed regulations concerning the application of section 954(h) rather than § 1.1297–1(c)(1)(i)(A) with respect to a tested foreign corporation.

The Treasury Department and the IRS recognize that the determination of whether to apply the 2019 proposed regulations or the final regulations to a tested foreign corporation may be advantageous with respect to some tested foreign corporations and not with respect to others. In order to provide flexibility to U.S. investors in tested foreign corporations, taxpayers may apply the final regulations in any open taxable year to all or less than all of the tested foreign corporations whose shares are owned by the taxpayer, subject to the consistency rule described in the prior paragraph with respect to any particular tested foreign corporation. However, if the consequence of applying either the proposed regulations or these final regulations to prior open taxable years is that, as of the date of application, a tested foreign corporation that was a PFIC ceases to qualify as a PFIC, then the once-a-PFIC, always-a-PFIC rule is implicated and a taxpayer seeking to end PFIC status must make a purging election or request the consent

of the Commissioner to make a late purging election.

A taxpayer may choose to apply the rules to open taxable years even if a qualified electing fund election under section 1295 or a mark-to-market election under section 1296 was in effect. See section 6511(a) (period of limitation for filing refund claim).

Effect on Other Documents

The eighth (concerning the average value of assets for purposes of the Asset Test), ninth (concerning the characterization of assets for purposes of the Asset Test), fourteenth through sixteenth (concerning dealer inventory and investment assets for purposes of the Asset Test), eighteenth (concerning look-through rules for purposes of the Income Test), and nineteenth (concerning look-through treatment under section 1297(c)) paragraphs of Notice 88–22, 1988 1 C.B. 489, are obsolete.

Special Analyses

I. Regulatory Planning and Review—Economic Analyses

Executive Orders 13771, 13563, and 12866 direct agencies to assess costs and benefits of available regulatory alternatives and, if regulation is necessary, to select regulatory approaches that maximize net benefits, including potential economic, environmental, public health and safety effects, distributive impacts, and equity. Executive Order 13563 emphasizes the importance of quantifying both costs and benefits, reducing costs, harmonizing rules, and promoting flexibility. The Executive Order 13771 designation for this final rule is regulatory.

The final regulation has been designated by the Office of Information and Regulatory Affairs (OIRA) as subject to review under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations. OIRA has determined that the final rulemaking is significant and subject to review under Executive Order 12866 and section 1(b) of the Memorandum of Agreement. Accordingly, the final regulations have been reviewed by OMB.

A. Background

Various provisions of the tax code allow tax on certain sources of income to be deferred, which means that the income is not taxed when it is earned but at some later date, based on specific events or conditions. Tax deferral is

advantageous to taxpayers because the taxpayer can in the meantime earn a return on the amount that would otherwise have been paid as tax. Prior to the Tax Cuts and Jobs Act (TCJA), income earned abroad by foreign corporations owned by U.S. taxpayers generally was not taxed by the United States until the income was repatriated to the United States or, as holds broadly for capital gains, the stock of the corporation was sold. However, under controlled foreign corporation (CFC) and passive foreign investment company (PFIC) rules, U.S. persons owning stock of foreign corporations were in some circumstances subject to current tax on some or all of the foreign corporation’s income. After TCJA, passive income and certain insurance income earned abroad by a CFC continues to be taxed immediately to the United States shareholders of the CFC. However, income of U.S. persons earned by foreign corporations that are not CFCs may still be eligible for deferral, or, in the case of certain corporate shareholders, exempt from U.S. corporate tax. Deferral is not available, however, for income of foreign corporations that are identified as PFICs. The immediate taxation of this income discourages U.S. taxpayers from holding mobile, passive investments, such as stock, in a foreign corporation in order to defer U.S. tax.

The PFIC rules of the Internal Revenue Code address situations in which taxable U.S. persons indirectly hold assets that earn passive income (generally interest, dividends, capital gains, and similar types of income) through a foreign corporation. Without the PFIC rules, the income earned by these assets would be subject to U.S. tax only when and if that income is distributed as dividends by the foreign corporation or, as capital gains, when the shares of the foreign corporate stock are sold by the U.S. shareholder. In the absence of the PFIC rules, these types of investment arrangements could significantly lower the effective tax rate on passive income faced by U.S. investors from that incurred if the assets were held directly.

Under the PFIC statutory rules, a foreign corporation is considered a PFIC if at least 75 percent of the corporation’s gross income for a given taxable year is passive income (the Income Test) or if at least 50 percent of the corporation’s assets are assets that produce passive income (the Asset Test). The PFIC itself is not subject to U.S. tax under the PFIC regime; rather, only the U.S. owner of a foreign corporation is subject to that regime. The U.S. owner of shares of a foreign corporation consequently must

obtain the appropriate information, usually from the corporation, in order to determine whether that corporation is a PFIC (by satisfying these and other tests) and if so what tax is due as a result.

The PFIC provisions provide a long-standing exception from these passive income rules for any income earned in the active conduct of an insurance business by an insurance company. This exception (the PFIC insurance exception) allows insurance companies, which hold significant amounts of investment assets (which generate income that would otherwise be classified as passive) in the normal course of business to fund their insurance obligations, to avoid PFIC status, provided they meet other statutory conditions.

TCJA substantially revised the PFIC insurance exception. Before its amendment by TCJA, this exception was provided to a foreign corporation that (i) was predominantly engaged in an insurance business and (ii) would be taxed as an insurance company if it were a domestic corporation. TCJA modified and narrowed the PFIC insurance exception by requiring that the excepted income be derived in the active conduct of an insurance business by a “qualifying insurance corporation” (QIC). To be a QIC, a foreign insurance corporation must be an entity that would be taxed as an insurance company if it were a domestic corporation (consistent with prior-law requirements) and, in addition, be able to show that its “applicable insurance liabilities” constitute more than 25 percent of its total assets. TCJA defines applicable insurance liabilities for this purpose as including a set of enumerated types of insurance-related loss and expense items. Failing this test, the Code provides that U.S. owners of the foreign corporation may elect to treat their stock in the corporation as stock of a QIC provided the corporation can satisfy an “alternative facts and circumstances test.” If a corporation is determined to be a QIC, only income that is derived in the active conduct of an insurance business qualifies as income eligible for the PFIC insurance exception.

The Treasury Department and the IRS previously published proposed regulations pertaining to the PFIC regime and changes due to TCJA (the proposed regulations.) See 84 FR 33120.

B. Need for the Final Regulations

The final regulations are needed because many of the terms and calculations required for the determination of PFIC status would benefit from greater specificity. The

final regulations provide such details so that taxpayers can readily and accurately determine if their investment is in a PFIC, given the significant tax consequences of owning a PFIC. The regulations further resolve ambiguities in determining ownership of a PFIC and in the application of the PFIC Income and Asset Tests. These final regulations are also needed to respond to comments received on the proposed regulations.

The Treasury Department and the IRS have also identified actions or positions that foreign companies might take to claim qualification for the passive income exception for income earned in the active conduct of an insurance business even though the nature of their insurance business would not merit an exception under the intent and purpose of the statute. The final regulations are needed to prevent U.S. investors from taking certain of these tax avoidance measures.

C. Overview

The final regulations can be divided into two parts: General guidance regarding PFICs (the general rules) and guidance that relates specifically to the implementation of the PFIC insurance income exception (the PFIC insurance exception rules).

The economic analysis first discusses the regulations under the general rules that: (1) Clarify how assets are measured for the PFIC Asset Test; (2) provide rules for applying the statutory rules regarding look-through subsidiaries to partnerships; and (3) attribute activities undertaken by certain affiliates of the corporation being tested for its PFIC status for the purpose of applying certain exceptions contained in the passive income definitional rules.

The economic analysis then discusses the regulations under the PFIC insurance exception rules that provide guidance regarding: (1) The discounting of applicable insurance liabilities on certain financial statements; (2) issues related to the facts and circumstances test for treating a foreign corporation as a QIC, including (i) “runoff-related circumstances,” (ii) “rating-related circumstances,” and (iii) the deemed election under the facts and circumstances test for small shareholders; and (3) application of the insurance exception as it relates to look-through subsidiaries of a QIC.

D. Economic Analysis

1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of the final regulations relative to a no-action

baseline reflecting anticipated Federal income tax-related behavior in the absence of these final regulations.

2. Summary of Economic Effects

The final regulations provide certainty and consistency in the application of sections 1297 and 1298 of the Internal Revenue Code with respect to passive foreign investment companies and qualifying insurance corporations by providing definitions and clarifications regarding the statute’s terms and rules. In the absence of such guidance, the chances that different U.S. owners (or potential owners) of foreign companies would interpret the statute differentially (either differently from each other or distinct from the intent and purpose of the statute) would be exacerbated. This divergence in interpretations could cause U.S. investors to choose investment vehicles based on different interpretations of the statute rather than on different economic prospects. For example, one investor might undertake an investment opportunity that another investor might forego based on different interpretations of how the income from that investment would be treated under the Code. When economic investment is not guided by uniform incentives across otherwise similar investors and otherwise similar investments, the resulting pattern of investment will generally be inefficient. Thus, in the context of U.S. investment in foreign corporations, the final regulations help to ensure that similar economic activities, representing similar passive and non-passive attributes, are taxed similarly. The Treasury Department and the IRS expect that the definitions and guidance provided in the final regulations will lead to an improved allocation of investment among U.S. taxpayers, contingent on the overall Code.

In assessing the economic effects of the final regulations, the Treasury Department and the IRS separately considered (i) those provisions that may reduce the opportunities for foreign corporations to avoid PFIC status, relative to the no-action baseline; and (ii) those provisions that may expand the opportunities for foreign corporations to avoid PFIC status, relative to the no-action baseline.

As a result of the first set of provisions, some corporations that may not have had PFIC status under the baseline may be treated for tax purposes as PFICs under the final regulations. In response to such provisions, some foreign companies that are close to qualifying as a QIC, for example, may take steps to adjust operations to ensure

that they meet the QIC qualifications.⁵ Other foreign companies may not be able to profitably undertake these actions, possibly because of the business's structure or the local regulatory environment and thus would now be treated as a PFIC. Yet other foreign companies, particularly those that are not reliant on U.S. investors, may also remain (following these regulations) classified for U.S. tax purposes as PFICs. The Treasury Department and the IRS expect that in these latter two cases, current U.S. owners will largely continue to retain their holdings of these companies but future investors may turn to other foreign corporations that are not classified as PFICs under the final regulations or to domestic investments.

This reduction in the pool of non-PFIC investment opportunities can be expected to lower the after-tax return to U.S. investors relative to the no-action baseline. To the extent that investors retain their investments in companies that have been determined to be PFICs or turn to domestic investments, U.S. tax revenue may rise relative to the no-action baseline. These possible responses by U.S. investors (investing in a different non-PFIC; retaining investment in the PFIC; investing in U.S. companies) will also change the amount and nature of risk in the affected investors' portfolios. The nature of this shift is difficult to gauge because foreign companies whose PFIC status may change as a result of these final regulations (relative to the no-action baseline) will generally be earning a mix of passive and non-passive income. Thus, the change in the nature of the risk in U.S. investors' portfolios cannot be readily determined.

As a result of the second set of provisions (those that expand opportunities for foreign companies to avoid PFIC status relative to the no-action baseline), some corporations that may have had PFIC status under the baseline may be determined not to be PFICs under the final regulations. This expansion of the pool of non-PFIC investment opportunities can be expected to raise the after-tax return to U.S. investors relative to the no-action baseline and, to the extent that investors increase their investment in foreign non-PFICs as a substitute for domestic

investment, U.S. tax revenue may fall. These effects again also change the amount and nature of risk in the affected investors' portfolios and in an undetermined direction.

The Treasury Department and the IRS project that these final regulations will have economic effects less than \$100 million per year (\$2020), relative to the no-action baseline. The Treasury Department and the IRS have not undertaken more precise estimates of the differences in economic activity that might result between the final regulations and the no-action baseline because they do not have readily available data or models that capture in sufficient detail the investments that taxpayers might make under the final regulations relative to the no-action baseline. They similarly have not estimated the differences in compliance costs or administrative burden that would arise under the final regulations or the no-action baseline because they do not have readily available data or models that capture these aspects in sufficient detail.

The proposed regulations solicited comments on the economic effects of the proposed regulations. No such comments were received.

3. Economic Analysis of Specific Provisions of the General PFIC Rules

a. Treatment of Look-Through Subsidiaries and Look-Through Partnerships

For the purpose of testing whether a foreign corporation is a PFIC, the look-through rule of section 1297(c) treats the tested foreign corporation ("TFC") as holding its proportionate share of the assets of a look-through entity and having received directly its proportionate share of the income of the look-through entity. This rule affects both the amount of assets that the TFC is treated as owning and the characterization of those assets as passive or non-passive. The statute is silent regarding the application of look-through rules to a TFC's ownership interest in a partnership. Therefore, the Treasury Department and the IRS deemed it necessary to provide rules addressing the treatment of TFC ownership interests in partnerships.

One regulatory option was to apply rules similar to those that apply to subsidiaries treated as corporations for tax purposes. Under these rules, a partnership generally would be treated as a look-through partnership (LTP) only if the TFC owned at least 25 percent of the value of the partnership interest during a taxable year ("minimum ownership threshold").

A second regulatory option was to apply a complete look-through rule to partnerships ("aggregate approach"). Under this option, a TFC would treat its proportionate share of partnership assets and income as assets and income of its own, regardless of the size of its partnership ownership share. This option is consistent with the "aggregate" theory of partnerships under which each partner is treated as incurring an allocable share of each partnership item, such as gain, loss, income, and expense, with the tax attributes of that item passing through to the partner.

A third regulatory option was to adopt an intermediate approach under which look-through rules would apply to partnerships if either (i) the partnership would be a look-through subsidiary if it were treated as a corporation, or (ii) the TFC partner is actively engaged in the business of the partnership. In practice, this approach is likely to have consequences similar to the aggregate approach for many TFCs engaged in an active business.

The proposed regulations adopted the first approach, using a minimum ownership threshold of 25 percent. The 2019 NPRM asked for comments regarding whether this threshold is the appropriate threshold for look-through partnership treatment. No comments were received recommending a lower threshold. Instead, commenters recommended that the aggregate approach be adopted, which in this context would be similar to a zero percent minimum ownership threshold.

Under the aggregate approach, TFCs that are interested in attracting capital from U.S. investors would have an incentive to purchase small minority investment interests in one or more active partnerships in order to increase their share of non-passive assets and income so as to enable the TFC to avoid PFIC status. The TFC could do this without having any of the partnership activities being connected with the business of the TFC and without requiring the TFC to exercise control over any of the business activities of these partnerships. In this fashion, the aggregate option would create a bias in favor of business structures containing entities treated for U.S. tax purposes as partnerships and against a structure using corporate subsidiaries, since those subsidiaries would require 25 percent ownership shares in order to obtain look-through status for the TFC. This bias toward such business structures would be tax-driven rather than market-driven and unlikely to confer general economic benefits.

⁵ The Treasury Department and the IRS are aware of foreign companies that have redomiciled to the U.S. and thereby avoided PFIC status, although the number of such companies is believed to be small and the business calculations likely involved more than PFIC/non-PFIC considerations. The Treasury Department and the IRS expect that the number of foreign companies that do not re-domicile but that are likely to change how they operate as the result of these final regulations will also be quite small.

An aggregate approach to LTPs could allow TFCs that hold significant amounts of passive investment assets to purchase sufficient amounts of minority investment interests in active business partnerships so as to increase the TFC's non-passive assets and income to levels that enable the TFC to avoid PFIC status. Thus, the purpose of the PFIC regime could be meaningfully defeated, especially if foreign corporate subsidiaries chose to be treated as partnerships for this purpose.

The Treasury Department and the IRS determined that minor investment shares of TFCs in partnerships are more indicative of passive investments on the part of TFCs, so that, in those cases, it is appropriate to treat the TFC's distributive share of partnership income as wholly passive. Moreover, a 25-percent minimum ownership threshold for partnerships has the advantage of being consistent with the look-through threshold for corporate subsidiaries. It is also broadly consistent with a rule (found in the statutory definition of passive income) that treats sales of partnership interests by a CFC as sales of the partnership's assets if the CFC owns 25 percent of the partnership's capital or profits interests. The drawing of a bright line for strictly passive treatment of limited partnership interests offers greater compliance certainty and ease of tax administration because it reduces the informational requirements concerning the character of the assets and income of a partnership when the partner has only very limited investments. It may be difficult for a TFC that holds a less-than-25-percent investment in either a subsidiary or partnership to obtain the necessary information for determining the character of its share of the entity's income. Furthermore, entities with ownership percentages below 25 percent generally do not exercise control of the decisions and actions of the owned entity. Consequently, there are both policy and administrability reasons supporting the treatment of ownership percentages of less than 25 percent in a similar fashion for PFIC purposes.

Because a 25-percent minimum ownership threshold for partnerships is not necessarily an accurate proxy for an active business interest, one commenter proposed an option under which a look-through approach would be taken if a TFC materially participates in the business of the partnership; in other words, an aggregate approach would be used but only if the TFC showed, through a separate demonstration, that the TFC is actively involved in the business of the partnership. The

Treasury Department and the IRS agreed that, if a tested foreign corporation is actively involved in the business of a partnership with active business operations, then look-through treatment may be appropriate even if the TFC has less than a 25 percent ownership interest. In considering material participation and similar standards, however, the Treasury Department and the IRS found that current material participation standards under the passive activity loss rules are not appropriate in the PFIC context. Thus, the final regulations instead modify the LTP standard by introducing an active partner test in order to allow look-through treatment to be applied in certain cases when the ownership percentage falls below 25 percent. The active partner test is met as of a measurement date if the TFC would not be a PFIC if both the PFIC Asset Test and the PFIC Income Test were applied without regard to any partnership interest owned by the TFC other than interests in those partnerships that qualify as LTPs using the LTS tests. However, the final regulations did not make this modification of the look-through ownership test mandatory and instead provide an annual election to allow the TFC to not to treat a partnership qualifying under the active partner test as an LTP.

The Treasury Department and the IRS have not estimated the volume or character of investment that investors would undertake under the 25 percent minimum ownership threshold relative to other percentages or under the aggregate approach applied to taxpayers that satisfy an active partner test because they do not have readily available data or models that capture this level of specificity.

b. Attribution of Activities for Look-Through Entities

The definition of passive income contains exceptions for certain income that is derived in the active conduct of a trade or business or is a gain or loss from the sale of certain business property. Under the look-through rules of the statute and these final regulations, a tested foreign corporation is treated as if it holds its proportionate share of the income and assets of its look-through subsidiaries (LTSs) and look-through partnerships (LTPs), where a 25 percent ownership requirement is needed to define such entities. Further, the passive or non-passive character of the attributed income or assets is determined in the hands of the LTS or LTP. However, for legal or commercial reasons, some businesses structure their organizations to have all employees in

one foreign corporation, say FC1, while the assets of the business are held in, and income is received by, another foreign corporation, say FC2. Without attribution of the business activities of FC1 to FC2, the assets and income of the latter corporation do not qualify for an exception from the definition of passive income. This can result in FC1 being designated as a PFIC even though its income and assets would be treated as non-passive if FC1 and FC2 were considered as a single entity.

To address the attribution of activities in foreign businesses having such structures, the Treasury Department and the IRS considered three options: (1) Do not allow any attribution of business activities among separate corporations; (2) allow attribution of business activities to a TFC from its LTSs or LTPs; or (3) allow attribution of business activities only if the entities are affiliated using an ownership standard of greater than 50 percent.

Under the no-attribution option, a foreign corporate structure that separates activities and income could satisfy the passive income exception only if it reorganizes in a manner that the TFC not only earns rents, royalties or other normally passive income items, but also employs the officers and employees that perform the related business activities or owns the property that is being sold. This reorganization is potentially costly or perhaps even infeasible, depending on requirements in the foreign jurisdiction and commercial considerations. The Treasury Department and the IRS determined that this alternative would either lead to costly reorganizations or, in the absence of such reorganizations, inhibit U.S. investment in a foreign corporation that carries on an active business activity, both of which are economically undesirable outcomes relative to other regulatory options.

Under the second option, activities of LTSs and LTPs could be attributed to a TFC in a manner similar to the look-through rules. The look-through rules attribute assets and income of a look-through entity to its owner on a proportionate share basis. There are some difficulties applying this concept in the context of attribution of activities. While income and assets can be allocated between owners based on their ownership percentages, activities are not as easily allocated among multiple owners. The purpose of activity attribution, in combination with the look-through rules, is effectively to treat the corporations as a single commercial enterprise; that is, as an affiliated group of corporations. But affiliation in this sense usually demands a recognition of

a unified business purpose and combined business activity. The typical thresholds in the Code for treating related parties as members of an affiliated or consolidated or similar group are more than 50 percent and 80 percent thresholds, not 25 percent.

The third option would require more-than-50-percent ownership in order to be able to attribute the business activities of one corporation to another. The proposed regulations adopted this third alternative but limited its application to rents and royalties earned in the active conduct of a trade or business, taking into account only the activities performed by the officers and employees of the TFC and those of an LTS or LTP in which the TFC owns more than 50 percent by value.

A comment pointed out this attribution rule would allow a TFC to recognize certain rents or royalties of an LTS as non-passive income if the business activity was conducted in one 50-percent subsidiary and assets and income were held in a separate 50-percent subsidiary. However, the rule would not prevent the look-through holder of the property from being a PFIC, since the rule applied only to income received by the TFC. Comments also requested that activity attribution apply to other types of income and not only to rents and royalties.

The final regulations modify the proposed regulations in two respects. First, they extend the application of the provision to other items of income other than rents and royalties that would be excluded from passive income if the income is earned in the active conduct of a trade or business. Second, they expand the types of affiliated entities from which activities could be attributed. Under these rules, an entity is deemed to be engaged in the active conduct of a trade or business by taking into account the activities performed by the officers and employees of the TFC as well as activities performed by the officers and employees of any qualified affiliate of the tested foreign corporation. For this purpose, a qualified affiliated group is defined using an affiliation standard of more than 50 percent. In addition, the group includes only LTSs and LTPs of the parent entity, and the parent entity must be a foreign corporation or partnership. This rule allows the LTS that holds the relevant assets in the preceding example to avoid PFIC status and extends the attribution rules to activities of sibling and parent companies of the TFC.

Accordingly, this final regulation is less restrictive than current law by allowing a greater variety of organizational structures among foreign

corporations and partnerships than would be available by applying the passive income rules under current law. The Treasury Department and the IRS project that this final regulation will allow entities to satisfy the passive income exception under conditions consistent with the intent and purpose of the statute without requiring potentially substantial reorganization costs relative to alternative regulatory approaches or the no-action baseline. The adopted activity attribution rule is neither overly restrictive by causing certain active foreign corporations to be treated as PFICs nor overly permissive by allowing U.S. shareholders to evade the application of the PFIC regime through an overindulgent application of attribution rules.

4. Economic Analysis of Specific Provisions Related to the PFIC Insurance Exception

a. Description of the PFIC Insurance Exception

For PFIC purposes, passive income does not include income derived in the active conduct of an insurance business by a qualifying insurance corporation (QIC). Under the statute, a QIC must have “applicable insurance liabilities” (AIL) that generally constitute more than 25 percent of its total assets. AIL generally include amounts shown on a financial statement for unpaid loss reserves (including unpaid loss adjustment expenses) of insurance and reinsurance contracts and certain life and health insurance reserves and unpaid claims with respect to contracts providing coverage for mortality or morbidity risks.

For the purpose of the QIC test, AIL are based on insurance liabilities as they are accounted for on the taxpayer’s applicable financial statement (AFS). Under the statute, an AFS is a financial statement prepared for financial reporting purposes that is based on U.S. generally accepted accounting principles (GAAP), or international financial reporting standards (IFRS) if there is no statement based on GAAP. If neither of these statements exists then an AFS can be an annual statement that is required to be filed with an applicable insurance regulatory body. Thus, the statute has a preference for financial statements prepared on the basis of GAAP or IFRS, which are rigorous and widely-respected accounting standards, but will permit a foreign corporation to have an AFS that uses a local regulatory accounting standard if the foreign corporation does not do financial reporting based on GAAP or IFRS.

b. Discounting of Applicable Insurance Liabilities

Accounting standards have different requirements regarding the use of discounting in the measurement of unpaid loss insurance reserves. Discounting of unpaid loss reserves would generally be appropriate to account for the amount of time expected before future loss payments are made. GAAP generally does not require the discounting of current non-life insurance liabilities but does require discounting for future liabilities under life insurance and annuity contracts. IFRS 17 (an IFRS standard applicable to insurance contracts with an anticipated effective date of January 1, 2023) requires discounting of all insurance liabilities whose expected payment exceeds one year.

To address the discounting of AIL in situations where the foreign corporation’s AFS was not prepared on the basis of GAAP or IFRS, the proposed regulations provided that in situations where the taxpayer’s AFS does not discount reserves on an economically reasonable basis, then the amount of AIL would be reduced in accordance with the discounting principles that would have applied under GAAP or IFRS. The foreign corporation could choose whether to apply either GAAP or IFRS for this purpose. In view of comments received, the Treasury and the IRS reconsidered these requirements.

As one alternative, the Treasury Department and the IRS considered not issuing a regulation to govern the discounting of insurance losses. This option was rejected as being possibly inconsistent with the intent and purpose of the statute because other financial standards specified by the statute have rules regarding the discounting of future cash flows.

As a second alternative, the Treasury Department and the IRS considered capping the amount of AIL at the amounts that would be permitted to a domestic insurance company under the Internal Revenue Code; these amounts would have been discounted according to the relevant rules. This approach would be considerably more burdensome to a foreign corporation than other regulatory alternatives because, as a practical matter, it would require foreign corporations to apply complex U.S. tax rules with which they are likely not familiar. An excessive compliance burden on foreign corporations not subject to U.S. taxation would make it less likely that they would do the work necessary to enable their minority U.S. owners to determine

if the corporation is a PFIC. Thus, this alternative was rejected because it was not reasonable to require foreign companies to recalculate insurance liabilities based on U.S. law requirements and it could unduly inhibit U.S. investors from investing in foreign corporations that are legitimate active insurance companies, an activity that is economically beneficial under the intent and purpose of the statute.

The final regulations specify that if an AFS is not prepared on the basis of GAAP or IFRS and does not discount ALL on an economically reasonable basis, the amount of AIL must be reduced by applying the discounting principles that would apply under either GAAP or IFRS. The choice of which accounting standard to use for discounting is left to the foreign corporation. Thus, if GAAP or IFRS would not require discounting for any of the AIL of the foreign insurer, then no additional discounting is required with respect to a non-GAAP/IFRS statement filed with a local regulator.

Compared to the no-action baseline, this regulation could impose additional compliance costs on foreign insurance companies, although those costs are incurred only if the foreign corporation files a financial statement with a local insurance regulator that is not based on GAAP or IFRS. This additional compliance cost is felt indirectly by U.S. investors and potential investors in these foreign insurers. A company may find it too costly to comply with these rules in order to attract U.S. investors, in which case it may not be possible for U.S. investors to determine whether the company qualifies as a QIC; an insurance company that is not a QIC would likely be a PFIC. Thus, the Treasury Department and the IRS recognize that under this regulation, some U.S. investors may avoid investing in such a company, when they would have done so under the no-action baseline. The Treasury Department and the IRS recognize further, however, that such investment (under the no-action baseline) would not have been consistent with efficient behavior under the intent and purpose of the statute.

The Treasury Department and the IRS have not estimated the amounts that U.S. shareholders might invest in foreign insurance companies with or without the discounting requirement because they do not have a model with this level of specificity. However, because the rule is quite flexible, the Treasury Department and the IRS project that the discounting requirement will not represent a significant cost burden for foreign corporations and thus will not have any meaningful effect on

investment patterns by U.S. shareholders relative to the no-action baseline.

c. Issues Related to the Alternative Facts and Circumstances Test

Under the statute, a foreign corporation that fails the 25 percent AIL-to-total assets test (but satisfies the 10 percent AIL-to-total asset test) may still be treated as a QIC if it satisfies a “facts and circumstances test,” which requires that (1) the corporation is predominantly engaged in an insurance business, and (2) the failure to have AIL in excess of 25 percent of total assets is due solely to runoff-related or rating-relating circumstances involving the corporation’s insurance business. Each of these items would benefit from guidance that provides further clarification of the terms involved.

i. Runoff-Related Circumstances

The proposed regulations defined a corporation satisfying the runoff-related circumstances requirement as one that (1) is actively engaged in the process of terminating its pre-existing, active insurance or reinsurance underwriting operation pursuant to an adopted plan of liquidation or a termination of operations under the supervision of its applicable insurance regulatory body, (2) does not issue or enter into any insurance, annuity, or reinsurance contract other than a contractually obligated renewal, consistent with the plan of liquidation or termination, and (3) is making payments during the year to satisfy claims, and the payments cause the corporation to fail the 25 percent test.

The Treasury Department and the IRS considered whether runoff-related circumstances should be limited to insurance companies that plan to terminate their business operations, as was required under the proposed regulations, or whether it should also include situations in which (1) an insurance company is merely shifting the focus of its business and running off contracts from an “old” business that it had entered into in the past, or (2) an insurance company acquires and manages insurance business that is in runoff, but the company itself does not have a plan of termination. Stated another way, this issue is whether or why an insurance company described in either of these two situations would require assets that are more than four times the company’s AIL. For example, foreign companies facing a planned termination may be required by foreign regulators to hold additional capital and assets relative to their insurance liabilities in order to ensure that those

liabilities will be satisfied when the companies are no longer able to rely on new business or new inflows of equity or debt to bolster cash flows from which to pay claims. This additional capital may not be needed by ongoing firms in either of the two situations described above. Unfortunately, no comments on the proposed regulations presented data or other information that address this issue.

The Treasury Department and the IRS concluded that the legislative history of the provision supported the argument that “runoff-related circumstances” was intended to be limited to situations in which a corporation is engaged in the process of terminating its pre-existing business, but they also concluded that such termination need not be pursuant to a supervised plan of liquidation or termination, and could also be pursuant to any court-ordered receivership proceeding for the company’s liquidation, rehabilitation, or conservation. The final regulations also clarify that the reason for failing the 25 percent test must be that the corporation is required to hold additional assets due to its business being in runoff.

If the definition of runoff-related circumstances were broadened further to include active, non-terminating businesses, then, without additional restrictions and rules, the facts and circumstances test may provide a means by which companies could be treated as QICs in a manner that is not consistent with the intent and purpose of the statute. If any company with a terminating line of business could qualify, then the 25 percent test might effectively become a 10 percent test, an outcome that would not be consistent with the intent and purpose of the statute.

The final regulations broaden slightly the circumstances under which a runoff of business can be conducted, relative to the regulatory option provided in the proposed regulations. The Treasury Department and the IRS recognize that this change may increase the number of foreign insurance companies that are able to meet the requirements for being treated as a QIC relative to the proposed regulations.

The Treasury Department and the IRS have not estimated the number of QICs or the nature of their operations under the final regulations or alternative regulatory approaches or the no-action baseline because they do not have a model with this level of specificity. The Treasury Department and the IRS do not have readily available data on the number of foreign corporations that would currently be conducting a runoff

business under the conditions of the final regulations.

ii. Rating-Related Circumstances

The rating-related circumstances condition required under the alternative facts and circumstances test is not defined in the statute and thus requires regulatory guidance. The proposed regulations provided that a foreign corporation could satisfy the rating-related circumstances requirement if failure to satisfy the 25 percent QIC test was a result of specific capital and surplus requirements that a generally recognized credit rating agency (generally, A.M. Best, Fitch, Moody's, and Standard and Poor) imposes, and that the corporation complies with these requirements in order to maintain a minimum credit rating needed by the corporation to be classified as "secure" to write new business for any line of insurance that it is underwriting.

Upon further reflection and after reviewing comments on the proposed regulations, the Treasury Department and the IRS decided that the rating-related circumstances requirement should focus on those corporations that would need to hold assets in excess of 400 percent of their AIL because of unique circumstances. The Treasury Department and the IRS determined that the proposed rule failed to capture the purpose of the PFIC requirements for QICs, but that certain types of business often needed higher levels of capital and surplus in order to meet rating requirements. As a result, the above requirements were maintained in the final regulations, with some technical changes and clarifications, but the provision is limited to companies that might require at times a higher level of assets to insurance liabilities. These companies include insurers that cover risks that are typically low-frequency events but with high aggregate costs, such as coverage against the risk of loss from a catastrophic loss event, and coverage by certain financial guaranty insurance companies.

The final regulations restrict the application of the provision to a foreign corporation for which more than half of its net written premiums for the annual reporting period (or the average net written premiums over the current year and preceding two years) are from insurance coverage against the risk of loss from a catastrophic event. Such insurance is characterized by relatively frequent "good" years in which accumulated assets must be accrued as capital and surplus in order to provide sufficient funds to handle the relatively infrequent "bad" years in which losses are exceptionally large. Because unpaid

loss reserves qualifying as AIL are limited to amounts that represent losses that have already been incurred prior to the end of the accounting period (whether or not a claim has been made), such reserves do not reflect the unknown future losses of the "bad" years.

Under the final regulations, the rating-related circumstances provision is also available for insurers whose sole business is to insure or reinsure against a lender's loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor. Aggregate losses associated with such insurance are highly correlated with the business cycle. In low loss years, the ratio of total assets to AIL may exceed 400 percent, but the additional assets may be viewed as necessary by rating agencies for the companies to meet insurance obligations in high loss years. The two largest insurance reserve categories of mortgage guaranty insurers are their unearned premium reserves (often including single premium amounts for long-term contracts) and contingency reserves (usually established as a fixed percentage of net written premiums), but neither of these types of reserves are included in the definition of AIL. Consequently, AIL are relatively small on average compared with the assets of these insurers. In addition, a mortgage guaranty insurer under the final regulations is required to operate as monoline business to qualify for the exception (in order to isolate the benefit of this provision and as reflective of general industry practice), because a monoline company does not have the option to pool its financial obligation risks with other types of risks (whereas pooling of different types of risks can reduce overall risk exposure, and thus capital needs). Credit rating agencies correspondingly expect such companies to hold additional assets to protect policyholders due to the monoline requirements for such business and because of the volatility of their losses.

The final regulations also apply the rating-related circumstances provision to financial guaranty insurance companies. Financial guaranty insurance is a line of insurance business in which an insurer guarantees scheduled payments of interest and principal on a bond or other debt security in the event of issuer default. The policyholder of a financial guaranty insurer is effectively paying for use of the insurer's credit rating. For example, if a municipality insures its municipal bond obligations with a financial guarantee insurer, the municipality can charge a lower interest rate on its bond,

because the obligation is effectively supported by the insurer's high credit rating. A very high credit rating is thus essential for a financial guaratee insurer to write new business. Furthermore (and similar to mortgage guaranty insurers), rating agency capital standards for financial guaranty insurers are geared to ensuring capital adequacy in times of crisis and may require a higher level of capital to obtain the same rating as an insurer with a different portfolio of risks. The combination of enhanced rating agency capital requirements and the need for a very high credit rating to write new business often results in a financial guaranty insurer being required at times to hold assets in excess of 400 percent of current insurance liabilities. The final regulations provide that a financial guaranty insurance company that fails the 25 percent test is deemed to automatically satisfy the rating-related circumstances requirement, but it must still satisfy the 10 percent test in order to be treated as a QIC. The Treasury Department and the IRS project that the final regulations will more accurately identify those insurance businesses whose activities are economically similar to the activities targeted by Congress in creating the PFIC insurance exception and the alternative facts and circumstances election for QIC treatment.

Relative to the proposed regulations, the final regulations will likely permit fewer foreign insurance corporations to qualify as QICs due to rating-related circumstances, and therefore may result in more such corporations being designated as PFICs absent other changes in business practices.

iii. Requirements for Making the Facts and Circumstances Election and Relief for Small Shareholders

Under the statute, a U.S. shareholder must make an election in order to treat a foreign corporation that would not otherwise be a QIC but that satisfies the alternative facts and circumstances test (including the 10 percent test) as a QIC. To specify the terms of this election, the final regulations specify that such election cannot be made unless the foreign corporation directly provides the U.S. person with a statement, or makes a publicly available statement, indicating that the foreign corporation satisfies the requirements of the alternative facts and circumstances test, including the 10 percent test, and includes a brief description of its runoff-related or rating-related circumstances. A shareholder generally makes the election on Form 8621, which must be attached to the shareholder's U.S.

federal income tax return for each year in which the election applies.

For this election, the final regulations further contain a provision under which a U.S. person who owns stock with a value of \$25,000 or less (\$50,000 or less if filing a joint return) in a publicly traded foreign corporation is deemed to make the alternative facts and circumstances election with respect to the publicly traded foreign corporation and its subsidiaries (“deemed election”). If a shareholder owns stock through a domestic partnership or other domestic passthrough entity, an election will not be deemed made unless the stock held by the passthrough entity has a value of \$25,000 or less. All requirements necessary to permit an actual election must be satisfied in order to permit a deemed election under this rule. These dollar amounts were chosen in part because they were consistent with the filing thresholds for Part I of Form 8621.

A deemed election provision is not required by the statute. The Treasury Department and the IRS created the deemed election to relieve the burden from taxpayers of making an actual election. Small domestic taxpayers may not be very familiar with the PFIC rules, may have difficulty in determining their ownership shares of possible PFICs and QICs, or may not know how to obtain information on whether a foreign corporation has provided the requisite statement regarding the alternative facts and circumstances test, especially if they are indirect owners.

The Treasury Department and the IRS considered not providing such a deemed election by small shareholders but decided that the reduction in compliance burden that the deemed election would provide outweighed the tax administrative benefit that a requirement for an explicit election would provide. For example, under an explicit election, the IRS would know with certainty that the taxpayer has made the election.

The Treasury Department and the IRS have not estimated the change in compliance costs or administrative burden under the final regulations versus an alternative regulatory approach of requiring an affirmative election because they do not have data or models that capture such items.

d. Passive Income Exception for Income and Assets of QIC Look-Through Entities

Under the statute, passive income does not include income derived in the active conduct of an insurance business by a QIC, and assets held to produce such income are treated as assets that

produce non-passive income. The final regulations contain rules to clarify the application of this rule. For example, certain companies structure their insurance operations by placing some or all of their investment assets in one or more lower-tier investment corporations or partnerships while investment managers are employed by the QIC or by a related or unrelated service provider. In these cases, unless there is an attribution of non-passive status to the income and assets of the lower-tier affiliated company, the QIC exclusion granted to income earned by the “active” entity is somewhat meaningless.

Under the general PFIC look-through rules, a tested foreign corporation (TFC) is treated as receiving directly its proportionate share of the income, or holding its proportionate share of the assets, of a look-through subsidiary (LTS) or look-through partnership (LTP), but the income and assets generally retain the character that they had in the hands of the LTS or LTP for purposes of determining the TFC’s PFIC status. See § 1.1297–2(b) and (c). Under the proposed regulations and the final regulations, if certain requirements are met, otherwise-passive income or assets of an LTS or LTP owned by a QIC may be treated as active in the hands of the QIC, to the extent that such income is attributed to the active conduct of the QIC’s insurance business and such assets are available to satisfy liabilities of the QIC’s insurance business (“look-through recharacterization rule”).

Under the proposed regulations, this attribution of non-passive character to otherwise-passive income and assets of an LTS or LTP of a QIC was not allowed unless the applicable financial statement (AFS) used to test the QIC status of the foreign corporation included the assets and liabilities of the subsidiary entity. This rule was intended to ensure that all otherwise-passive LTS or LTP assets available to satisfy the QIC’s insurance liabilities and treated as non-passive under the look-through recharacterization rule would also necessarily be taken into account for purposes of the 25 percent test for judging the corporation’s QIC status. However, assets and liabilities of a subsidiary entity are not included on the parent’s financial statement unless the financial statement is prepared on a consolidated basis. If the QIC’s AFS is prepared using separate entity accounting, only the QIC’s share of the net equity value of the lower-tier entity would be included in assets under the 25 percent QIC test. Thus, a QIC could not take advantage of the proposed QIC look-through recharacterization rule

unless it used a consolidated financial statement as its AFS.

A consolidated financial statement generally (but not always) requires at least a 50 percent ownership share in a controlled subsidiary in order to include the assets and liabilities of the subsidiary in the consolidated financial statement. Less-than-50-percent subsidiaries generally must be accounted for on an equity basis, such that the financial statement reflects the net equity value of the subsidiary. Thus, the look-through recharacterization rule of the proposed regulations would not have allowed non-passive treatment of otherwise-passive assets of an LTS unless the QIC owned at least 50 percent interest in the subsidiary and had a consolidated AFS. This meant that the income and assets of an LTS in which the QIC owned between 25 percent and 50 percent interest would generally be treated as passive under the proposed regulations, even if all of those income and assets were available to satisfy the QIC’s insurance liabilities, because consolidated accounting treatment was not available. A beneficial aspect of the rule, however, was that it treated QICs that chose to place their investment assets in a wholly-owned subsidiary (which would generally be consolidated with the QIC for financial statement purposes) in the same manner as QICs that conducted their insurance operations and held their investment assets in a single corporation.

These considerations led the Treasury Department and the IRS to adopt an alternative regulatory option. Under the final regulations, the amount of assets and income of an LTS or LTP that may be treated as non-passive assets and income of the QIC are limited, respectively, to the greater of (i) the QIC’s proportionate share of assets and income of the LTS or LTP, respectively, multiplied by a fraction, the numerator of which is the net equity value of the interests held by the QIC in the LTS or LTP, and the denominator of which is the QIC’s proportionate share of the value of assets of the LTS or LTP; or (ii) the QIC’s proportionate share of assets and income that are treated as non-passive in the hands of the LTS or LTP without regard to the look-through recharacterization rule. This rule reflects the idea that only assets of the LTP or LTS that exceed the liabilities of the look-through entity are available to satisfy liabilities of the insurance business of the QIC and should be excludable from passive income under the QIC look-through recharacterization rule. However, if the general look-through rules determine a greater

amount of non-passive assets or income, then that rule prevails.

When assets are measured by value, rather than by adjusted basis, part (i) of the above asset formula reduces the amount of potentially non-passive assets to the net equity value of the QIC's ownership interest in the LTS or LTP. This is the same asset value used in the 25 percent test for testing QIC status in the case of a non-consolidated AFS. Thus, this solution ensures that assets treated as being available to satisfy insurance liabilities of the QIC are also taken into account for the purpose of the 25 percent test for judging the corporation's QIC status.

Whenever the QIC's subsidiary has liabilities, this rule will likely limit the amount of the subsidiary's assets and income that are treated as non-passive under the look-through recharacterization rule, in which case the QIC would have a greater value of non-passive assets if it operated instead as a single corporation. However, the value of total assets used in the 25 percent test would also be correspondingly higher in that case, perhaps making it less likely for the foreign insurance company to satisfy the 25 percent test.

The Treasury Department and the IRS have not estimated whether the adopted option would lead to different values for amounts treated as non-passive assets and non-passive income of QICs under the insurance exception relative to the no-action baseline. The Treasury and the IRS do not have data or models that could estimate quantitatively the relative impacts of the alternatives considered. However, the adopted option is expected to result in a more accurate identification of non-passive income used in the active conduct of the QIC's insurance business and non-passive assets used to satisfy the insurance liabilities of the QIC relative to the no-action baseline and alternative regulatory approaches.

5. Number of Affected Taxpayers

A U.S. person must generally file a separate Form 8621 for each PFIC for which it has an ownership interest. Exceptions currently exist for persons that indirectly own PFIC stock through another U.S. shareholder of a PFIC, unless such persons are required to report PFIC income or need to file a Form 8621 in order to make an election. Further exceptions exist under current rules, including exemptions for tax-

exempt entities and for taxable U.S. shareholders owning less than \$25,000 in aggregate PFIC stock (\$50,000 if filing a joint return) that is not owned through another U.S. shareholder of a PFIC or through another PFIC (unless such shareholders are required to report PFIC income or need to file a Form 8621 in order to make an election).

The accompanying table indicates how many persons have filed at least one Form 8621 between 2016 and 2018 based on currently available IRS master files of tax return filings. To date, nearly 62,000 Forms 8621 have been filed for 2018. Over 70 percent of the filings are individuals. Another 27 percent are pass-through entities, the overwhelming number of which are partnerships, but which also include S corporations, estates, and non-grantor trusts. These pass-through entities primarily have individuals as partners, shareholders, or beneficiaries, but may also have corporate partners. It is likely there is some double counting whereby both partnerships and partners are filing a Form 8621 for the same PFIC. C corporations constitute just over one percent of these filings. Just under two percent of Forms 8621 do not identify on the form the filing status of the filer.

TABLE

	Number of U.S. persons filing Form 8621		
	2016	2017	2018
Individuals	36,978	40,891	43,406
Passthrough Entities	15,326	16,133	16,607
C Corporations	713	733	739
Unreported Filer Type	1,114	1,053	1,084
All Entities	54,131	58,810	61,836

In 2018, reporting taxpaying persons filed an average of 12 Forms 8621. This average was 11 forms for individuals, 16 forms for partnerships and other pass-through entities, and 28 forms for C corporations.

The Treasury Department and the IRS do not have information in current tax filings regarding how many U.S. persons own shares in qualifying insurance companies or how many potential filings of Form 8621 would be avoided by the regulatory provision regarding a small investor deemed election for applying the facts and circumstances test for purposes of the insurance income exception to passive income. In 2018 there were 40 actual such elections made on Form 8621, 26 of which involved partnerships and 11 of which involved non-grantor trusts, and only one that was an individual.

The numbers in the accompanying table provide a general idea of the number of entities that must pay attention to the final regulations but do not measure the number of investors whose investment decisions are affected by the final regulations. This is because most current PFICs will remain PFICs after application of the final regulations. Similarly, most non-PFIC foreign corporations will continue not to be PFICs after application of the final regulations. The Treasury Department and the IRS expect that only a small percentage of current PFIC and non-PFIC shareholders will be affected by these regulations.

II. Paperwork Reduction Act

The collections of information in these final regulations are in § 1.1297-1(d)(1)(ii)(B), (d)(1)(iii), and (d)(1)(iv),

§ 1.1297-4(d)(5)(i), (ii), and (iii), and § 1.1298-4(d)(2). The information in all of the collections of information provided will be used by the IRS for tax compliance purposes.

A. Collections of Information Under Existing Tax Forms

The collections of information in § 1.1297-1(d)(1)(ii)(B), (d)(1)(iii), and (d)(1)(iv) are required to be provided by taxpayers that make an election or revoke an election to use an alternative measuring period or adjusted bases to measure assets for purposes of the Asset Test with respect to a foreign corporation. These collections of information are satisfied by filing Form 8621 or attachments thereto. For purposes of the Paperwork Reduction Act, 44 U.S.C. 3501 *et seq.* ("PRA"), the reporting burden associated with the

collection of information in the Form 8621 will be reflected in the Paperwork Reduction Act Submission associated with that form (OMB control number 1545–1002). If a Form 8621 is not required to be filed, the collections of information under § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii), and (d)(1)(iv) are satisfied by attaching a statement to the taxpayer’s return. For purposes of the PRA, the reporting burden associated with these collections of information will be reflected in the Paperwork Reduction Act Submissions associated with Forms 990–PF and 990–T (OMB control number 1545–0047); Form 1040 (OMB control number 1545–0074); Form 1041 (OMB control number 1545–0092); Form 1065 (OMB control number 1545–0123); and Forms 1120, 1120–C, 1120–F, 1120–L, 1120–PC, 1120–REIT, 1120–RIC, and 1120–S (OMB control number 1545–0123).

The collection of information in § 1.1297–4(d)(5)(iii) is required to be provided by taxpayers that make an election under section 1297(f)(2) to treat a foreign corporation as a QIC in order to qualify for the exception from passive income under section 1297(b)(2)(B). In response to comments addressing the notice of proposed rulemaking preceding the final regulations, the

Treasury Department and the IRS have revised the collection of information with respect to section 1297(f)(2).

The collection of information in § 1.1297–4(d)(5)(iii) requires a United States person to make an election with respect to an eligible foreign corporation under section 1297(f)(2) by completing the appropriate part of Form 8621 (or successor form) for each taxable year of the United States person in which the election applies. In response to comments, § 1.1297–4(d)(5)(iv) generally provides that any United States person that owns stock in a publicly traded foreign corporation eligible for the election with a value of \$25,000 or less (\$50,000 or less if a joint return) is deemed to make the election under section 1297(f)(2) without the need to file Form 8621. This rule is intended to provide relief to small shareholders who may not be aware that an election is required. In addition, § 1.1297–4(d)(5)(iii) provides that the election under section 1297(f)(2) may be made on an amended return.

The collection of information in § 1.1297–4(d)(5)(iii) is satisfied by filing Form 8621. For purposes of the PRA, the reporting burden associated with the collection of information in the Form 8621 will be reflected in the Paperwork

Reduction Act Submission associated with Form 8621 (OMB control number 1545–1002).

The number of entities subject to these collections of information will be those entities filing Form 8621 or attaching a statement to their tax return. The number of filers of Form 8621 in 2018 based on current filings was approximately 62,000. The Treasury Department and the IRS project that at most, an additional 10 percent of filers (6,200) that were not required to file Form 8621 in 2018 may be subject to these collections of information. Thus, the upper bound estimate of the number of entities subject to these collections of information is 68,200.

The accompanying Table shows the upper bound estimates of the number of filers filing an election, by Form. The first column shows estimates under the assumption that all filers will file the required election by filing Form 8621. The second column shows these estimates under the assumptions that: (i) Filers who generally file Form 8621 will file the required election as part of the filing of Form 8621; and (ii) an additional ten percent of filers will file the required election as an attachment to Form 1040, 1065, 1120–S, 1120, or other form, as appropriate.⁶

	Number of filers (upper bound), assuming all elections are made on Form 8621	Number of filers (upper bound), assuming a portion of elections are made as attachments to standard forms
Attachment to Form 1040	0	4,300
Attachment to Form 1065 or 1120–S	0	1,700
Attachment to Form 1120 other than 1120–S	0	100
Attachment to Form 1040, 1065, 1120–S, 1120 or other form (2018 Filing status unknown)	0	100
Form 8621	68,200	62,000
Total	68,200	68,200

Source: Compliance Data Warehouse (IRS). See text for explanation.

The current status of the PRA submissions related to the tax forms on which reporting under these regulations will be required is summarized in the following table. The burdens associated with the information collections in the forms are included in aggregated burden estimates for the OMB control numbers 1545–0047 (which represents a total estimated burden time for all forms and schedules for tax-exempt entities of 50.5 million hours and total estimated monetized costs of \$3.59 billion

(2018)), 1545–0074 (which represents a total estimated burden time for all forms and schedules for individuals of 1.784 billion hours and total estimated monetized costs of \$31.764 billion (2017)), 1545–0092 (which represents a total estimated burden time for all forms and schedules for trusts and estates of 307.8 million hours and total estimated monetized costs of \$9.95 billion (2016)), and 1545–0123 (which represents a total estimated burden time for all forms and schedules for

corporations of 3.157 billion hours and total estimated monetized costs of \$58.148 billion (2017)). The burden estimates provided in the OMB control numbers in the following table are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and will in the future include, but not isolate, the estimated burden of only those information collections associated with these final regulations. These numbers are therefore unrelated to the future

⁶ Upper bound estimates of the number of filers who will file attachments to specific tax forms are derived by multiplying the number of filers shown

in the Table in I.D.4. by 10 percent, for each filing status. The Table in I.D.4 shows that there were 43,406 individuals, 16,607 passthrough entities, 739

corporations, and 1,084 unknown filers who filed Form 8621 in 2018 using currently available filings, for a total of 61,836 filers.

calculations needed to assess the burden imposed by these regulations. To guard against over-counting the burden that international tax provisions imposed before the Act, the Treasury Department and the IRS urge readers to recognize that these burden estimates have also been cited by regulations (such as the foreign tax credit regulations, 84 FR 69022) that rely on the applicable OMB control numbers in order to collect information from the applicable types of filers.

In 2018, the IRS released and invited comment on drafts of Forms 990–PF

(Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation), 990–T (Exempt Organization Business Income Tax Return), 1040 (U.S. Individual Income Tax Return), 1041 (U.S. Income Tax Return for Estates and Trusts), 1065 (U.S. Return of Partnership Income), 1120 (U.S. Corporation Income Tax Return), and 8621 (Return by a Shareholder of a Passive Foreign Investment Co. or Qualified Electing Fund). The IRS received comments only regarding Forms 1040, 1065, and 1120 during the comment period. After

reviewing all such comments, the IRS made the forms available on December 21, 2018 for use by the public.

The Treasury Department and the IRS have not estimated the burden for any new information collections arising from either the Act or these final regulations. The Treasury Department and the IRS request comment on all aspects of information collection burdens related to the final regulations. In addition, when available, drafts of IRS forms are posted for comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.htm>.

Form	Type of filer	OMB No.(s)	Status
Forms 990	Tax exempt entities (NEW Model).	1545–0047	Approved by OIRA 2/12/2020 until 2/28/2021.
Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201912-1545-014			
Form 1040	Individual (NEW Model)	1545–0074	Approved by OIRA 1/30/2020 until 1/31/2021.
Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021			
Form 1041	Trusts and estates	1545–0092	Approved by OIRA 5/08/2019 until 5/31/2022.
Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014			
Form 1065 and 1120	Business (NEW Model)	1545–0123	Approved by OIRA 1/30/2020 until 1/31/2021.
Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001			
Form 8621	Share-holders	1545–1002	Approved by OIRA 12/31/2018 until 12/31/2021.
Link: https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201805-1545-007			

B. Collections of Information Generally Not Included on Existing Forms

The collection of information in § 1.1298–4(d)(2) is required for a foreign corporation that relies on the rule in section 1298(b)(7) and § 1.1298–4(b)(1). This collection of information is satisfied by filing a statement attached to the foreign corporation’s return. For purposes of the PRA, the reporting burden associated with this collection of information will be reflected in the Paperwork Reduction Act Submissions associated with Form 1120–F (OMB control number 1545–0123). The number of affected filers, burden estimates, and PRA status for this OMB control number are discussed in connection with the Form 1120 in Part II.A of the Special Analyses.

Alternatively, if a foreign corporation is not required to file a return, the collection of information in § 1.1298–4(d)(2) is satisfied by the foreign corporation’s maintaining a statement in its records or including it in its public filings.

The collection of information in § 1.1297–4(d)(5)(i) and (ii) is required for a foreign corporation for which a

taxpayer makes an election under section 1297(f)(2). In response to comments addressing the notice of proposed rulemaking preceding the final regulations, the Treasury Department and the IRS have revised the collection of information from foreign corporations with respect to section 1297(f)(2). The collection of information under § 1.1297–4(d)(5)(i) and (ii) requires a foreign corporation to provide a statement to a shareholder or make a statement publicly available. In response to comments, § 1.1297–4(d)(5)(i) permits a foreign parent corporation to make a publicly available statement on behalf of its subsidiaries.

The collection of information contained in § 1.1298–4(d)(2) (for foreign corporations that are not required to file Form 1120–F) and § 1.1297–4(d)(5)(i) and (ii) has been reviewed and approved by the Office of Management and Budget under control number [X].

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

III. Regulatory Flexibility Act

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that the final regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act (“small entities”).

The statutory provisions in sections 1291 through 1298 (the “PFIC regime”) generally affect U.S. taxpayers that have ownership interests in foreign corporations that are not CFCs.

A U.S. person must generally file a separate Form 8621 for each PFIC for which it has an ownership interest. To date, nearly 62,000 Forms 8621 have been filed for 2018. Over 70 percent of the filings are individuals. Another 27 percent are pass-through entities, the overwhelming number of which are

partnerships, but which also include S corporations, estates, and non-grantor trusts. These pass-through entities primarily have individuals as partners, shareholders, or beneficiaries, but may also have corporate partners. It is likely there is some double counting whereby both partnerships and partners are filing a Form 8621 for the same PFIC. C corporations constitute just over one percent of these filings. Nearly two percent of Forms 8621 do not identify the filing status of the filer.

Regardless of the number of small entities potentially affected by the final regulations, the Treasury Department and the IRS have concluded that there

is no significant economic impact on small entities as a result of the final regulations based on the following argument.

To provide a bound on the impact of these regulations on businesses, the Treasury Department and the IRS calculated the ratio of the PFIC regime tax to (gross) total income for 2013 through 2018 for C corporations that filed the Form 8621. Total income was determined by matching each C corporation filing the Form 8621 to its Form 1120. Ordinary QEF income, QEF capital gains, and mark-to-market income were assumed to be taxed at 35 percent (21 percent for 2018), and the

section 1291 tax and interest charge were included as reported. Only those corporations where a match was found and that had positive total income were included in the analysis. For the approximately 150 to 300 C corporations for which a match was available in a given year, the average annual ratio of the calculated tax to total income was never greater than 0.00035 percent. For the approximately 60 to 200 C corporations with total income of \$25 million or less for which a match was available, the average annual ratio was never greater than 1.08 percent.

	2013	2014	2015	2016	2017	2018
	(\$ millions)					
All C corporations						
Tax	5	12	14	8	22	42
Total Income	4,204,795	10,154,520	19,935,845	20,076,876	21,625,159	13,317,244
Tax to Total Income	0.000%	0.000%	0.000%	0.000%	0.000%	0.000%
C corporations with total income of \$25 million or less						
Tax	(*)	(*)	4	4	5	3
Total Income	463	563	627	573	460	741
Tax to Total Income	0.060%	0.014%	0.576%	0.689%	1.068%	0.400%

Source: RAAS, CDW.
* Indicates less than \$1 million.

The economic impact of the final regulations will generally be a small fraction of the calculated tax and thus considerably smaller than the effects reported in the table. Thus, the economic impact of the final regulations should not be regarded as significant under the Regulatory Flexibility Act.

A portion of the economic impact of the final regulations may derive from the collection of information requirements imposed by § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and § 1.1297–4(d)(5)(iii). The Treasury Department and the IRS have determined that the average burden is 1 hour per response. The IRS’s Research, Applied Analytics, and Statistics division estimates that the appropriate wage rate for this set of taxpayers is \$95 per hour. Thus, the annual burden per taxpayer from the collection of information requirement is \$95. These requirements apply only if a taxpayer chooses to make an election or rely on a favorable rule.

Accordingly, it is hereby certified that the final rule would not have a significant economic impact on a substantial number of small entities. Pursuant to section 7805(f), the proposed regulations preceding these final regulations (REG–105474–18) were

submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. The proposed regulations also solicited comments from the public on both the number of entities affected (including whether specific industries are affected) and the economic impact of this proposed rule on small entities. No comments were received.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled “Federalism”) prohibits an agency from

publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This final rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

VI. Congressional Review Act

Pursuant to the Congressional Review Act (5 U.S.C. 801 *et seq.*), the Office of Information and Regulatory Affairs designated this rule as not a ‘major rule’, as defined by 5 U.S.C. 804(2).

Statement of Availability of IRS Documents

IRS Revenue Procedures, Revenue Rulings, notices, and other guidance cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at www.irs.gov.

Drafting Information

The principal drafters of these regulations are Josephine Firehock and Christina Daniels of the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS also participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 is amended by adding entries for §§ 1.1297–1, 1.1297–2, 1.1297–4, 1.1297–5, 1.1297–6, 1.1298–2, and 1.1298–4 in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
Section 1.1297–1 also issued under 26 U.S.C. 1298(g).

Section 1.1297–2 also issued under 26 U.S.C. 1298(g).

* * * * *

Section 1.1297–4 also issued under 26 U.S.C. 1297(b)(2)(B) and 1298(g).

Section 1.1297–5 also issued under 26 U.S.C. 1297(b)(2)(B) and 1298(g).

Section 1.1297–6 also issued under 26 U.S.C. 1297(b)(2)(B) and 1298(g).

* * * * *

Section 1.1298–2 also issued under 26 U.S.C. 1298(b)(3) and (g).

Section 1.1298–4 also issued under 26 U.S.C. 1298(g).

* * * * *

■ **Par. 2.** Section 1.1291–0 is amended by:

■ 1. Redesignating the entry for § 1.1291–1(b)(8)(iv) as the entry for § 1.1291–1(b)(8)(v).

■ 2. Adding a new entry for § 1.1291–1(b)(8)(iv).

■ 3. Adding entries for newly redesignated § 1.1291–1(b)(8)(v)(A) and (B), (b)(8)(v)(A)(1) and (2), (b)(8)(v)(A)(2)(i) and (ii), (b)(8)(v)(B)(1) and (2), (b)(8)(v)(C), (b)(8)(v)(C)(1) and (2), (b)(8)(v)(D), (b)(8)(v)(D)(1) and (2).

The revisions and additions read as follows:

§ 1.1291–0 Treatment of shareholders of certain passive foreign investment companies; table of contents.

* * * * *

§ 1.1291–1 Taxation of U.S. persons that are shareholders of section 1291 funds.

* * * * *

(b) * * *

(8) * * *

(iv) Successive application.

(v) Examples.

(A) Example 1.

(1) Facts.

(2) Results.

(i) Treatment of DC.

(ii) Treatment of A.

(B) Example 2.

(1) Facts.

(2) Results.

(C) Example 3.

(1) Facts.

(2) Results.

(D) Example 4.

(1) Facts.

(2) Results.

* * * * *

■ **Par. 3.** Section 1.1291–1 is amended by:

■ 1. Redesignating paragraph (b)(8)(iv) as paragraph (b)(8)(v).

■ 2. Adding new paragraph (b)(8)(iv).

■ 3. Redesignating *Example 1* in newly redesignated paragraph (b)(8)(v) as paragraph (b)(8)(v)(A).

■ 4. Revising newly redesignated paragraph (b)(8)(v)(A).

■ 5. Adding paragraphs (b)(8)(v)(B), (C), and (D).

■ 6. Revising paragraph (j)(3).

■ 7. Adding paragraph (j)(4).

The revisions and additions read as follows:

§ 1.1291–1 Taxation of U.S. persons that are shareholders of section 1291 funds.

* * * * *

(b) * * *

(8) * * *

(iv) *Successive application.* Stock considered to be owned by a person by reason of paragraphs (b)(8)(ii) or (iii) of this section is, for purposes of applying such paragraphs, considered to be actually owned by such person. Subject to the limitations provided in section 1298(a) and paragraphs (b)(8)(ii) and (b)(8)(iii) of this section, this paragraph applies by successively considering a person as actually owning its proportionate share of stock or other equity interest directly held by an entity directly owned by the person. Paragraph (b)(8)(ii)(C)(2) of this section applies after the other subparagraphs of paragraph (b)(8) of this section.

(v) *Examples.* The rules of this paragraph (b)(8) are illustrated by the following examples:

(A) *Example 1—(1) Facts.* A is a United States person who owns 49% of the stock of FC1, a foreign corporation that is not a PFIC, and separately all of the stock of DC, a domestic corporation that is not an S corporation. DC, in turn, owns the remaining 51% of the stock of FC1, and FC1 owns 100 shares of stock in a PFIC that is not a controlled foreign corporation (CFC) within the meaning of

section 957(a). The remainder of the PFIC's shares are owned by unrelated foreign persons.

(2) *Results—(i) Treatment of DC.* Under paragraph (b)(8)(ii)(A) of this section, DC is considered to actually own 51 shares of the PFIC stock directly held by FC1 because DC directly owns 50% or more of the stock of FC1.

(ii) *Treatment of A.* In determining whether A is considered to own 50% or more of the value of FC1 for purposes of applying paragraphs (b)(8)(ii)(A) and (b)(8)(iv) of this section to the PFIC stock held through FC1, A is considered under paragraphs (b)(8)(ii)(C)(1) and (b)(8)(iv) of this section as indirectly owning all the stock of FC1 that DC directly owns, before the application of paragraph (b)(8)(ii)(C)(2) of this section. Because A also directly owns 49% of the stock of FC1, before the application of paragraph (b)(8)(ii)(C)(2) of this section A would be treated as owning all 100 shares of PFIC stock held by FC1. However, because 51 shares of the PFIC stock held by FC1 are indirectly owned by DC under paragraph (b)(8)(ii)(A) of this section, pursuant to the limitation imposed by paragraph (b)(8)(ii)(C)(2) of this section, only the remaining 49 shares of the PFIC stock are considered as indirectly owned by A under paragraph (b)(8) of this section.

(B) *Example 2—(1) Facts.* B, a United States citizen, owns 50% of the interests in Foreign Partnership, a foreign partnership treated as a partnership for U.S. federal income tax purposes, the remaining interests in which are owned by an unrelated foreign person. Foreign Partnership owns 100% of the stock of FC1 and 50% of the stock of FC2, the remainder of which is owned by an unrelated foreign person. Both FC1 and FC2 are foreign corporations that are not PFICs. FC1 and FC2 each own 50% of the stock of FC3, a foreign corporation that is a PFIC.

(2) *Results.* Under paragraphs (b)(8)(iii)(A) and (b)(8)(iv) of this section, for purposes of determining whether B is a shareholder of FC3, B is considered to actually own 50% (50% × 100%) of the stock of FC1 and 25% (50% × 50%) of the stock of FC2. Under paragraphs (b)(8)(ii)(A) and (b)(8)(iv) of this section, B is then considered to own 25% (50% × 100% × 50%) of the stock of FC3 indirectly through FC1, and thus is a shareholder of FC3 for purposes of the PFIC provisions. Because B is considered to own less than 50% of FC2, B is not considered to own any stock of FC3 indirectly through FC2.

(C) *Example 3—(1) Facts.* The facts are the same as in paragraph (b)(8)(v)(B)(1) of this section (the facts in

- (i) LTS stock.
(ii) LTS obligation.
(2) General rule for income test.
(i) LTS stock.
(ii) LTS obligation.
(3) Partnerships.
(4) Examples.
(i) Example 1.
(A) Facts.
(B) Results.
(1) LTS.
(2) TFC.
(ii) Example 2.
(A) Facts.
(B) Results.
(iii) Example 3.
(A) Facts.
(B) Results.
(iv) Example 4.
(A) Facts.
(B) Results.
(v) Example 5.
(A) Facts.
(B) Results.
(1) Asset test.
(2) Income test.
(3) Treatment of intangible and rental property.
(d) Related person determination for purposes of section 1297(b)(2)(C).
(1) General rule.
(2) Example.
(i) Facts.
(ii) Results.
(e) Treatment of activities of certain look-through subsidiaries and look-through partnerships for purposes of certain exceptions.
(1) General rule.
(2) Qualified affiliate.
(3) Examples.
(i) Example 1.
(A) Facts.
(B) Results.
(1) Qualified affiliates.
(2) FS1 and FS2.
(3) FS4.
(ii) Example 2.
(A) Facts.
(B) Results.
(iii) Example 3.
(A) Facts.
(B) Results.
(f) Gain on disposition of a look-through subsidiary or look-through partnership.
(1) [Reserved].
(2) Amount of gain taken into account from disposition of look-through subsidiary.
(3) Characterization of residual gain as passive income.
(4) Gain taken into account from disposition of 25%-owned partnerships and look-through partnerships.
(i) Section 954(c)(4) partnerships.
(ii) Look-through partnerships.
(5) Examples.
(i) Example 1.
(A) Facts.
(B) Results.
(ii) Example 2.
(A) Facts.
(B) Results.
(iii) Example 3.
(A) Facts.
(B) Results.
(g) Definitions.
- (1) Direct LTS obligation.
(2) Indirect LTS obligation.
(3) Look-through subsidiary.
(4) Look-through partnership.
(i) In general.
(ii) Active partner test.
(A) Partnership interest under asset test.
(B) Partnership income under income test.
(iii) Election.
(iv) Examples.
(A) Example 1.
(1) Facts.
(2) Results.
(i) Active partner test with respect to partnership interest.
(ii) Active partner test with respect to partnership income.
(iii) Qualification of look-through partnership.
(B) Example 2.
(1) Facts.
(2) Results.
(i) Active partner test with respect to partnership interest.
(ii) Active partner test with respect to partnership income.
(iii) Failure to qualify as look-through partnership.
(5) LTS debt.
(6) LTS lease.
(7) LTS license.
(8) LTS obligation.
(9) LTS stock.
(10) Qualified affiliate.
(11) Residual gain.
(12) TFC obligation
(13) Unremitted earnings.
(h) Applicability date.
- * * * * *
- § 1.1297-4 Qualifying insurance corporation.
(a) Scope.
(b) Qualifying insurance corporation.
(c) 25 percent test.
(d) Election to apply the alternative facts and circumstances test.
(1) In general.
(2) Predominantly engaged in an insurance business.
(i) In general.
(ii) Facts and circumstances.
(iii) Examples of facts indicating a foreign corporation is not predominantly engaged in an insurance business.
(3) Runoff-related circumstances.
(4) Rating-related circumstances.
(5) Election.
(i) In general.
(ii) Information provided by foreign corporation.
(iii) Time and manner for making the election.
(iv) Deemed election for small shareholders in publicly traded companies.
(A) In general.
(B) Publicly traded stock.
(v) Options.
(6) Stock ownership.
(e) Rules limiting the amount of applicable insurance liabilities.
(1) In general.
(2) General limitation on applicable insurance liabilities.
(3) Discounting.
(4) [Reserved].
- (5) [Reserved].
(f) Definitions.
(1) Applicable financial statement.
(i) GAAP statements.
(ii) IFRS statements.
(iii) Regulatory annual statement.
(iv) [Reserved].
(2) Applicable insurance liabilities.
(i) In general.
(ii) Amounts not specified in paragraph (f)(2)(i) of this section.
(3) Applicable insurance regulatory body.
(4) Applicable reporting period.
(5) Financial guaranty insurance company.
(6) Financial statements.
(i) In general.
(ii) [Reserved].
(iii) [Reserved].
(7) Generally accepted accounting principles or GAAP.
(8) Insurance business.
(9) International financial reporting standards or IFRS.
(10) Mortgage insurance company.
(11) Total assets.
(g) Applicability date.
§ 1.1297-5 [Reserved].
§ 1.1297-6 Exception from the definition of passive income for active insurance income.
(a) Scope.
(b) Exclusion from passive income of active insurance income.
(c) Exclusion of assets for purposes of the passive asset test under section 1297(a)(2).
(d) Treatment of income and assets of certain look-through subsidiaries and look through partnerships for purposes of the section 1297(b)(2)(B) exception.
(1) General rule.
(2) Limitation.
(3) Examples.
(i) Example 1: QIC holds all the stock of an investment subsidiary.
(A) Facts.
(B) Result.
(C) Alternative Facts.
(1) Facts.
(2) Result.
(ii) Example 2: QIC holds all the stock of an operating subsidiary.
(A) Facts.
(B) Result.
(e) Qualifying domestic insurance corporation.
(1) General rule.
(2) [Reserved].
(3) [Reserved].
(f) Applicability date.
- **Par. 5.** Sections 1.1297-1 and 1.1297-2 are added to read as follows:
- § 1.1297-1 **Definition of passive foreign investment company.**
(a) *Overview.* This section provides rules concerning the income test set forth in section 1297(a)(1) and the asset test set forth in section 1297(a)(2). Paragraph (b) of this section provides a rule relating to the definition of gross income with respect to certain dividends that are excluded from gross income under section 1502 for purposes of section 1297. Paragraph (c) of this

section provides rules relating to the definition of passive income for purposes of section 1297. Paragraph (d) of this section provides rules relating to the asset test of section 1297. See §§ 1.1297-2 and 1.1297-6 for additional rules concerning the treatment of the income and assets of a corporation subject to look-through treatment under section 1297(c). Paragraph (e) of this section provides rules relating to the determination of passive foreign investment company (PFIC) status for stapled entities. Paragraph (f) of this section provides definitions applicable for this section, and paragraph (g) of this section provides the applicability date of this section.

(b) *Dividends included in gross income*—(1) *General rule.* For purposes of section 1297, gross income includes dividends that are excluded from gross income under section 1502 and § 1.1502-13.

(2) *Example*—(i) *Facts.* USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 25% of the value of USS1, a domestic corporation. USS1 owns 80% of the value of USS2, a domestic corporation. USS1 and USS2 are members of an affiliated group (as defined in section 1504(a)) filing a consolidated return. USS2 distributes a dividend to USS1 that is excluded from USS1's income pursuant to § 1.1502-13 for purposes of determining the U.S. Federal income tax liability of the affiliated group of which USS1 and USS2 are members.

(ii) *Results.* Although the dividend received by USS1 from USS2 is excluded from USS1's income for purposes of determining the U.S. Federal income tax liability of the affiliated group of which USS1 and USS2 are members, pursuant to paragraph (b)(1) of this section, for purposes of section 1297, USS1's gross income includes the USS2 dividend. Accordingly, for purposes of section 1297, TFC's gross income includes 25% of the dividend received by USS1 from USS2 pursuant to section 1297(c) and § 1.1297-2(b)(2)(ii). See section 1298(b)(7) and § 1.1298-4 for rules concerning the characterization of the USS2 dividend.

(c) *Passive income*—(1) *Foreign personal holding company income*—(i) *General rule.* For purposes of section 1297(b)(1), except as otherwise provided in section 1297(b)(2), this section, and § 1.1297-6, the term *passive income* means income of a kind that would be foreign personal holding company income as defined under section 954(c).

For the purpose of this paragraph (c)(1)—

(A) The exceptions to foreign personal holding company income in section 954(c)(1), 954(c)(2)(A) (relating to active rents and royalties), 954(c)(2)(B) (relating to export financing income), and 954(c)(2)(C) (relating to dealers) are taken into account;

(B) The exceptions in section 954(c)(3) (relating to certain income received from related persons), 954(c)(6) (relating to certain amounts received from related controlled foreign corporations), and 954(i) (relating to entities engaged in the active conduct of an insurance business) are not taken into account;

(C) The rules in section 954(c)(4) (relating to sales of certain partnership interests) and 954(c)(5) (relating to certain commodity hedging transactions) are taken into account; and

(D) An entity is treated as a controlled foreign corporation within the meaning of section 957(a) for purposes of applying an exception to foreign personal holding company income in section 954(c)(1)(B)'s flush language, (1)(C)(ii), (1)(D), (4), and (5) and § 1.954-2 and for purposes of identifying whether a person is a related person with respect to such entity within the meaning of section 954(d)(3).

(ii) *Determination of gross income or gain on a net basis for certain items of foreign personal holding company income.* For purposes of section 1297, the excess of gains over losses from property transactions described in section 954(c)(1)(B), the excess of gains over losses from transactions in commodities described in section 954(c)(1)(C), the excess of foreign currency gains over foreign currency losses described in section 954(c)(1)(D), and positive net income from notional principal contracts described in section 954(c)(1)(F) are taken into account as gross income. The excess of gains over losses (or, with respect to notional principal contracts, positive net income) for a category of transactions is calculated by a tested foreign corporation taking into account individual items of gain or loss (or, with respect to notional principal contracts, net income or net deduction) recognized by the tested foreign corporation and those items of gain or loss (or, with respect to notional principal contracts, net income or net deduction) treated as recognized by the tested foreign corporation with respect to its look-through subsidiaries and look-through partnerships pursuant to section 1297(c) and § 1.1297-2(b)(2) or (3).

(iii) *Amounts treated as dividends.* For purposes of section 1297, the term

dividend includes all amounts treated as dividends for purposes of this chapter, including amounts treated as dividends pursuant to sections 302, 304, 356(a)(2), 964(e), and 1248.

(2) [Reserved].

(3) *Passive treatment of dividends and distributive share of partnership income.* For purposes of section 1297, a tested foreign corporation's share of dividends received from a corporation that is not a look-through subsidiary (as defined in § 1.1297-2(g)(3)) and distributive share of any item of income of a partnership that is not a look-through partnership (as defined in § 1.1297-2(g)(4)) with respect to a tested foreign corporation are treated as passive income, except to the extent that the item of income would not be treated as passive under section 1297(b)(2)(C) and paragraph (c)(4) of this section.

(4) *Exception for certain interest, dividends, rents, and royalties received from a related person*—(i) *In general.* For purposes of section 1297(b)(2)(C), interest, dividends, rents, or royalties actually received or accrued by a tested foreign corporation are considered received or accrued from a related person only if the payor of the interest, dividend, rent, or royalty is a related person (within the meaning of section 954(d)(3)) with respect to the tested foreign corporation, taking into account paragraph (c)(1)(i)(D) of this section. For rules determining when amounts received or accrued by a look-through subsidiary or look-through partnership (and treated as received directly by a tested foreign corporation pursuant to section 1297(c) and § 1.1297-2(b)(2) and (b)(3)) are treated as received from a related person, see § 1.1297-2(d).

(ii) *Ordering rule.* Gross income that is interest, a dividend, or a rent or royalty that is, in each case, received or accrued from a related person is allocated to income that is not passive under the rules of this paragraph (c)(4). If the related person is also a look-through subsidiary or a look-through partnership with respect to the tested foreign corporation, this paragraph (c)(4) applies after the application of the intercompany income rules of § 1.1297-2(c).

(iii) *Allocation of interest.* For purposes of section 1297(b)(2)(C), interest that is received or accrued, as applicable based on the recipient's method of accounting, from a related person is allocated to income of the related person that is not passive income in proportion to the ratio of the portion of the related person's non-passive gross income for its taxable year that ends with or within the taxable year of the recipient to the total amount of

the related person's gross income for the taxable year. If the related person does not have gross income for the taxable year that ends with or within the taxable year of the recipient, the interest is either allocated to income of the related person that is not passive income to the extent the related person's deduction for the interest would be allocable to non-passive income of the related person under the principles of §§ 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 section 1297(b)(2)(C) or, alternatively, at the election of the tested foreign corporation is treated as allocated entirely to passive income.

(iv) *Allocation of dividends*—(A) *In general.* For purposes of section 1297(b)(2)(C), the principles of § 1.316-2(a) apply in determining from what year's earnings and profits a dividend from a related person is treated as distributed. A dividend is considered to be distributed, first, out of the earnings and profits of the taxable year of the related person that includes the date the dividend is distributed (current earnings and profits) and that ends with or within the taxable year of the recipient; second, out of the earnings and profits accumulated for the immediately preceding taxable year of the related person; third, out of the earnings and profits accumulated for the second preceding taxable year of the related person; and so forth. For purposes of paragraph (c)(4)(iv) of this section, the principles of § 1.243-4(a)(6) apply with respect to a deficit in an earnings and profits account for a prior year.

(B) *Dividends paid out of current earnings and profits.* To the extent that a dividend is paid out of current earnings and profits of the related person for its taxable year that ends with or within the taxable year of the recipient, the dividend is treated as paid ratably out of earnings and profits attributable to passive income and to non-passive income. The portion of the current earnings and profits that is treated as paid out of non-passive income of the related person may be determined by multiplying the current earnings and profits by the ratio of the related person's non-passive gross income as determined under this section (including paragraph (c)(1)(ii) of this section) for the taxable year to its total gross income as determined under this section (including paragraph (c)(1)(ii) of this section) for that year.

(C) *Dividends paid out of accumulated earnings and profits.* To the extent that a dividend from a related person is treated as paid out of the

related person's accumulated earnings and profits, the dividend is treated as paid ratably out of accumulated earnings and profits of the related person for prior taxable years (beginning with the most recently accumulated) that are attributable to passive income and to non-passive income, which may be determined in the same manner as in paragraph (c)(4)(iv)(B) of this section. Alternatively, the accumulated earnings and profits may be allocated based on the ratio of accumulated earnings and profits that are attributable to passive income and to non-passive income during either the related party period or the three-year period. The related party period is the entire period during which the related person was related to the recipient. The three-year period is the three taxable years immediately preceding the related person's taxable year that ends with or within the current taxable year of the recipient. The three-year period may be used only if the related person has been related to the recipient for a period longer than the three taxable years immediately preceding the recipient's taxable year.

(v) *Allocation of rents and royalties.* For purposes of section 1297(b)(2)(C), rents and royalties that are received or accrued, as applicable based on the recipient's method of accounting, from a related person are allocable to income of the related person that is not passive income to the extent the related person's deduction for the rent or royalty is allocable to non-passive gross income of the related person under the principles of §§ 1.861-8 through 1.861-14T.

(vi) *Determination of whether amounts are received or accrued from a related person.* For purposes of section 1297(b)(2)(C), the determination of whether interest, dividends, rents, and royalties were received or accrued from a related person is made on the date of the receipt or accrual, as applicable based on the recipient's method of accounting, of the interest, dividend, rent, or royalty.

(vii) *Allocation of distributive share of income from related partnership.* For purposes of section 1297(a)(1), a tested foreign corporation includes its distributive share as provided in section 704 of the separate items of passive or non-passive income from a partnership that is a related person (and not a look-through partnership) with respect to the tested foreign corporation for the taxable year of the tested foreign corporation.

(d) *Asset test*—(1) *Calculation of average annual value (or adjusted bases)*—(i) *General rule.* For purposes of section 1297, the calculation of the average percentage of assets held by a tested foreign corporation during its

taxable year that produce passive income or that are held for the production of passive income is determined based on the average of the fair market values, or the average of the adjusted bases, as appropriate, of the passive assets and total assets held (including assets treated as held pursuant to section 1297(c) and § 1.1297-2(b)(2)(i) and (b)(3)) by the foreign corporation on the last day of each measuring period (*measuring date*) of the foreign corporation's taxable year. The average of the fair market values (or the average of the adjusted bases) of the foreign corporation's passive assets or total assets for the taxable year is equal to the sum of the values (or adjusted bases) of the passive assets or total assets, as applicable, on each measuring date of the foreign corporation's taxable year, divided by the number of measuring dates in the taxable year.

(ii) *Measuring period*—(A) *General rule.* Except as otherwise provided in paragraph (d)(1)(ii)(B) of this section, the measuring periods for a tested foreign corporation are the four quarters that make up the foreign corporation's taxable year.

(B) *Election to use alternative measuring period.* The average percentage of assets held by a tested foreign corporation during its taxable year that produce passive income or that are held for the production of passive income may be calculated using a period that is shorter than a quarter (such as a week or month). The same period must be used to measure the assets of the foreign corporation for the first year (including a short taxable year) that this alternative measuring period is used, and for any and all subsequent years, unless a revocation is made. An election to use an alternative measuring period or a revocation of such an election must be made in accordance with the rules of paragraph (d)(1)(iv) of this section.

(C) *Short taxable year.* For purposes of applying section 1297 to a tested foreign corporation that has a taxable year of less than twelve months (short taxable year), the average values (or adjusted bases) are determined based on the measuring dates of the foreign corporation's taxable year that fall within the short taxable year, and by treating the last day of the short taxable year as a measuring date.

(iii) *Adjusted basis election.* An election under section 1297(e)(2)(B) with respect to an eligible tested foreign corporation or a revocation of such an election may be made by the tested foreign corporation or alternatively by the owner (as defined in paragraph (d)(1)(iv) of this section). If made by the

owner, the election must be made in accordance with the rules of paragraph (d)(1)(iv) of this section.

(iv) *Time and manner of elections and revocations*—(A) *Elections*. An owner (as defined in this paragraph (d)(1)(iv)) of a foreign corporation makes an election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of this section for a taxable year in the manner provided in the Instructions to Form 8621 (or successor form), if the owner is required to file a Form 8621 (or successor form) with respect to the foreign corporation for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is made ends. If the owner is not required to file Form 8621 (or successor form) with respect to the foreign corporation for the taxable year, the owner makes such an election by filing a written statement providing for the election and attaching the statement to an original or amended Federal income tax return for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is made ends clearly indicating that such election has been made. An election can be made by an owner only if the owner's taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. Elections described in paragraphs (d)(1)(ii)(B) and (d)(1)(iii) of this section are not eligible for relief under § 301.9100-3 of this chapter. For purposes of this paragraph (d)(1)(iv), an owner of a foreign corporation is a United States person that is eligible under § 1.1295-1(d) to make a section 1295 election with respect to the foreign corporation, or would be eligible under § 1.1295-1(d) to make a section 1295 election if the foreign corporation were a PFIC.

(B) *Revocations and subsequent elections*. An election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of this section made pursuant to paragraph (d)(1)(iv)(A) of this section is effective for the taxable year of the foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by the Commissioner or the owner (as defined in paragraph (d)(1)(iv)(A) of this section) of the foreign corporation. The owner of a foreign corporation may revoke such an election at any time. If an election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of this section has been revoked under this paragraph (d)(1)(iv)(B), a new election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of

this section, as applicable, cannot be made until the sixth taxable year following the year for which the previous election was revoked, and such subsequent election cannot be revoked until the sixth taxable year following the year for which the subsequent election was made. The owner revokes the election for a taxable year in the manner provided in the Instructions to Form 8621 (or successor form), if the owner is required to file a Form 8621 (or successor form) with respect to the foreign corporation for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is revoked ends, or by filing a written statement providing for the revocation and attaching the statement to an original or amended Federal income tax return for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is revoked ends clearly indicating that such election has been revoked, if the owner is not required to file Form 8621 (or successor form) with respect to the foreign corporation for the taxable year.

(v) *Method of measuring assets*—(A) *Publicly traded foreign corporations*. For purposes of section 1297, the assets of a publicly traded foreign corporation as defined in paragraph (f)(7) of this section (including assets treated as held pursuant to section 1297(c) and § 1.1297-2(b)(2)(i) and (b)(3)(i), other than assets of a look-through subsidiary described in paragraph (d)(1)(v)(B) of this section) must be measured for all measuring periods of the taxable year on the basis of value.

(B) *Non-publicly traded controlled foreign corporation*—(1) *In general*. For purposes of section 1297, the assets of a controlled foreign corporation that is not described in paragraph (d)(1)(v)(A) of this section (including assets treated as held pursuant to section 1297(c) and § 1.1297-2(b)(2)(i) and (b)(3)(i), other than assets held by a look-through subsidiary described in paragraph (d)(1)(v)(A) of this section) must be measured for all measuring periods of the taxable year during which the foreign corporation is a controlled foreign corporation on the basis of adjusted basis.

(2) *Controlled foreign corporation determination*. For purposes of section 1297(e)(2)(A) and this paragraph (d)(1)(v), the term *controlled foreign corporation* has the meaning provided in section 957, determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock

which is owned by a person who is not a United States person.

(C) *Other foreign corporations*—(1) *In general*. Except as provided in paragraph (d)(1)(v)(C)(2) of this section, the assets of a foreign corporation that is not described in paragraphs (d)(1)(v)(A) or (d)(1)(v)(B) of this section (including assets treated as held pursuant to section 1297(c) and § 1.1297-2(b)(2)(i) and (b)(3)(i), other than assets held by a look-through subsidiary described in paragraphs (d)(1)(v)(A) or (d)(1)(v)(B) of this section) are measured for all measuring periods of the taxable year on the basis of value, unless a tested foreign corporation or a shareholder makes an election under section 1297(e)(2)(B) in accordance with paragraph (d)(1)(iii) of this section. In the case of a foreign corporation that is described in paragraph (d)(1)(v)(B) of this section for some but not all measuring periods during a taxable year, this paragraph (d)(1)(v)(C)(1) applies to the remaining measuring period or periods during that taxable year.

(2) *Lower-tier subsidiaries*—(i) *Lower-tier subsidiaries that are publicly traded foreign corporations*. For purposes of applying section 1297(a)(2) to the assets of a foreign corporation that is a lower-tier subsidiary of a foreign corporation that directly or indirectly owns all or part of the lower-tier subsidiary (a parent foreign corporation), if the lower-tier subsidiary is described in paragraph (d)(1)(v)(A), the rules of paragraph (d)(1)(v)(A) apply. The previous sentence applies both for purposes of applying section 1297(a)(2) to the lower-tier subsidiary as a tested foreign corporation, and for purposes of applying section 1297(a)(2) to a parent foreign corporation with respect to the assets of the lower-tier subsidiary.

(ii) *Lower-tier subsidiaries that are non-publicly traded controlled foreign corporations*. For purposes of applying section 1297(a)(2) to the assets of a foreign corporation that is a lower-tier subsidiary of a parent foreign corporation, if the lower-tier subsidiary is described in paragraph (d)(1)(v)(B), the rules of paragraph (d)(1)(v)(B) apply. The previous sentence applies both for purposes of applying section 1297(a)(2) to the lower-tier subsidiary as a tested foreign corporation, and for purposes of applying section 1297(a)(2) to a parent foreign corporation with respect to the assets of the lower-tier subsidiary.

(iii) *Other lower-tier subsidiaries*. For purposes of applying section 1297(a)(2) to a foreign corporation that is a lower-tier subsidiary of a parent foreign corporation, if the lower-tier subsidiary is not described in paragraphs

(d)(1)(v)(A) or (d)(1)(v)(B) of this section, the assets of the lower-tier subsidiary (including assets treated as held pursuant to section 1297(c) and § 1.1297-2(b)(2)(i) and (b)(3)(i)) must be measured under the rules of the same paragraph of this section (d)(1)(v) that applies to the parent foreign corporation. The previous sentence applies both for purposes of applying section 1297(a)(2) to the lower-tier subsidiary as a tested foreign corporation, and for purposes of applying section 1297(a)(2) to a parent foreign corporation. If a tested foreign corporation indirectly owns a lower-tier subsidiary that is not described in paragraphs (d)(1)(v)(A) or (d)(1)(v)(B) of this section through one or more other foreign corporations, the status of any parent foreign corporation in that chain of corporations that is described in paragraph (d)(1)(v)(A) of this section, or if there is no such parent foreign corporation then the status of any parent foreign corporation in that chain of corporations that is described in paragraph (d)(1)(v)(B) of this section, determines the basis on which the assets of the lower-tier subsidiary are measured. In the case of a foreign corporation that is a lower-tier subsidiary with respect to more than one parent foreign corporation, this rule applies separately to measure the assets of the lower-tier subsidiary with respect to each parent foreign corporation.

(D) [Reserved].

(E) *Examples.* The following examples illustrate the application of this paragraph (d)(1)(v).

(1) *Example 1—(i) Facts.* USP, a domestic corporation, owns 60% of TFC1, which is a foreign corporation. The remaining 40% of TFC1's stock is regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission and continues to be until September 1 of the taxable year, when USP acquires all of TFC1's stock pursuant to a tender offer. TFC1 owns 30% of the stock of FS1, a foreign corporation that is neither a publicly traded foreign corporation nor a controlled foreign corporation.

(ii) *Results.* TFC1 is a controlled foreign corporation with respect to USP. TFC1 also is a publicly traded foreign corporation until September 1 of the taxable year. For purposes of section 1297, the assets of TFC1 (including the assets of FS1 treated as held by TFC1 pursuant to section 1297(c) and § 1.1297-2(b)(2)(i)) must be measured on the basis of value for each measuring period ending before September 1, pursuant to paragraph (d)(1)(v)(A) of this section. For purposes of applying section 1297 to FS1 as a tested foreign

corporation with respect to USP, the assets of FS1 must be measured using the same method as is used for TFC1's assets, pursuant to paragraph (d)(1)(v)(C)(2) of this section.

(2) *Example 2—(i) Facts.* A, a United States person, owns 1% of the stock of TFC2, a foreign corporation that is neither a publicly traded foreign corporation nor a controlled foreign corporation. TFC2 owns 25% of the stock of FS2, a foreign corporation that is neither a publicly traded foreign corporation nor a controlled foreign corporation.

(ii) *Results.* For purposes of applying section 1297 to TFC2, the assets of TFC2 (including the assets of FS2 treated as held by TFC2 pursuant to section 1297(c) and § 1.1297-2(b)(2)(i)) are measured for all measuring periods of the taxable year on the basis of value, unless A or TFC2 makes an election under section 1297(e)(2)(B) in accordance with paragraph (d)(1)(iii) of this section, pursuant to paragraph (d)(1)(v)(C)(1) of this section. For purposes of applying section 1297 to FS2 as a tested foreign corporation with respect to A, the assets of FS2 must be measured using the same method as is used for TFC2's assets, pursuant to paragraph (d)(1)(v)(C)(2) of this section.

(3) *Example 3—(i) Facts.* The facts are the same as in paragraph (d)(1)(v)(E)(2)(i) (the facts in Example 2), except that the 75% of FS2's stock not owned by TFC2 is owned by TFC3, a publicly traded foreign corporation that is neither related to TFC2 nor to A. B, a United States person that is neither related to A nor to TFC2, owns 1% of the stock of TFC3.

(ii) *Results.* For purposes of applying section 1297 to TFC2, the results are the same as in paragraph (d)(1)(v)(E)(2)(ii) (the results in Example 2). For purposes of applying section 1297 to FS2 as a tested foreign corporation with respect to A, the assets of FS2 must be measured using the same method as is used for TFC2's assets, pursuant to paragraph (d)(1)(v)(C)(2) of this section. For purposes of applying section 1297 to TFC3, the assets of TFC3 must be measured by reference to value pursuant to paragraph (d)(1)(v)(A) because it is a publicly traded corporation. For purposes of applying section 1297 to FS2 as a tested foreign corporation with respect to B, the assets of FS2 must be measured by reference to value because TFC3 is a publicly traded foreign corporation, pursuant to paragraphs (d)(1)(v)(C)(2) and (d)(1)(v)(A) of this section.

(2) [Reserved].

(3) *Dual-character assets—(i) General rule.* Except as otherwise provided in

paragraph (d)(3)(ii) or (d)(3)(iii) of this section and in § 1.1297-2(c), for purposes of section 1297, an asset (or portion of an asset) that produces both passive income and non-passive income during a taxable year (dual-character asset), including stock and other assets that produce passive and non-passive income under section 1297(b)(2)(C) and paragraph (c)(4) of this section, is treated as two assets for each measuring period in the taxable year, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the dual-character asset is allocated between the passive asset and the non-passive asset in proportion to the relative amounts of passive income and non-passive income produced by the asset (or portion of an asset) during the taxable year. See paragraph (d)(3)(iii) of this section for a special rule concerning stock that has previously produced dividends subject to the exception provided in section 1297(b)(2)(C). For purposes of section 1297(b)(2)(C), a partnership interest in a partnership that is a related person to the tested foreign corporation is treated as producing passive or non-passive income in proportion to the tested foreign corporation's distributive share of partnership passive or non-passive income for the taxable year under paragraph (c)(4)(vii) of this section.

(ii) *Special rule when only part of an asset produces income.* For purposes of section 1297, when only a portion of an asset produces income during a taxable year or a portion of a taxable year, the asset is treated as two assets for that period, one of which is characterized as a passive asset or a non-passive asset based on the income that it produces, and one of which is characterized based on the income that it is held to produce. The value (or adjusted basis) of the asset is allocated between the two assets pursuant to the method that most reasonably reflects the uses of the property. In the case of real property, an allocation based on the physical use of the property generally is the most reasonable method.

(iii) *Special rule for stock that previously produced income that was excluded from passive income under section 1297(b)(2)(C).* Stock with respect to which no dividends are received during a taxable year, but with respect to which dividends were received during one or both of the prior two taxable years, is characterized based on the relative portion of the dividends received that was passive or non-passive. If the dividends were in whole excluded from passive income under section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section, the stock is

treated as a single non-passive asset. If the dividends were in part excluded from passive income under section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section, the stock is treated as two assets, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the stock is allocated between the two assets in proportion to the average percentage of aggregate dividends received in the prior two taxable years that were characterized as passive income and the average percentage of aggregate dividends received in the prior two years that were characterized as non-passive income, for the previous two taxable years pursuant to section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section. If the tested foreign corporation did not receive any dividends from the stock for the current taxable year or within either of the prior two taxable years of the tested foreign corporation, then the stock is treated as a passive asset.

(iv) *Example.* The following example illustrates the application of this paragraph (d)(3).

(A) *Facts.* (1) USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 20% of the value of FS1, a foreign corporation, and FP owns the remaining 80% of the value of FS1. FP, TFC, and FS1 are not controlled foreign corporations within the meaning of section 957(a), and each has a calendar year taxable year.

(2) In Year 1, FS1 had current earnings and profits of \$1000x, attributable to passive income of \$500x and non-passive income of \$500x, and paid \$300x of dividends to TFC. In Year 2, FS1 had current earnings and profits of \$1000x, attributable to passive income of \$100x and non-passive income of \$900x, and paid \$100x of dividends to TFC. In Year 3, FS1 has passive income of \$200x and non-passive income of \$800x and does not pay a dividend.

(3) Throughout Year 3, TFC holds an obligation of FS1 with respect to which FS1 pays \$100x of interest.

(4) In addition to the stock in FS1 and the FS1 obligation, TFC holds an office building, 40% of which is rented to FP throughout Year 3 for \$100x per quarter. During Year 3, FP has only passive income. The remaining 60% of the office building is leased throughout Year 3 to an unrelated person for \$300x per quarter, and TFC's own officers or staff of employees regularly perform active and substantial management and

operational functions while the property is leased.

(B) *Results.* (1) For purposes of section 1297(b)(2)(C), FP is a "related person" with respect to TFC because FP owns more than 50% of the vote or value of TFC, and FS1 is a "related person" with respect to TFC because FP owns more than 50% of the vote or value of both TFC and of FS1.

(2) Under paragraph (c)(4)(iv) of this section, the dividends paid by FS1 in Year 1 were characterized as 50% passive income (\$150x) and 50% non-passive income (\$150x). Under paragraph (c)(4)(iv) of this section, the dividends paid by FS1 in Year 2 were characterized as 10% passive income (\$10x) and 90% non-passive income (\$90x). Accordingly, the average percentage of dividends for the previous two taxable years that were characterized as passive income is 40% $((10\% \times \$100x) + (50\% \times \$300x)) / (\$100x + \$300x)$, and the average percentage of dividends characterized as non-passive income is 60% $((90\% \times \$100x) + (50\% \times \$300x)) / (\$100x + \$300x)$. Thus, under paragraph (d)(3)(iii) of this section, 60% of each share of stock of FS1 is characterized as a non-passive asset and 40% is characterized as a passive asset for each quarter of Year 3 for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(3) Under paragraph (c)(4)(iii) of this section, the interest received by TFC from FS1 is characterized as 20% $(\$200x / (\$200x + \$800x))$ passive income and thus 80% non-passive income for purposes of applying section 1297(a)(1) to determine whether TFC is a PFIC. Accordingly, under paragraph (d)(3)(i) of this section, 20% of the obligation of FS1 is characterized as a passive asset and 80% as a non-passive asset for each quarter of Year 3 for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(4) Under paragraph (c)(4)(v) of this section, the rent received from FP throughout Year 3 is characterized as 100% passive income. Under paragraph (c)(1)(i)(A) of this section and section 954(c)(2)(A), the rent received from the unrelated person is characterized as 100% non-passive income. Accordingly, under paragraph (d)(3)(i) of this section, the 40% of the office building rented to FP has a value of 25% $((\$100x \times 4) / ((\$100x \times 4) + (\$300x \times 4)))$ of the value of the office building and that 25% is a passive asset, and the 60% of the office building rented to the unrelated person has a value of 75% $((\$300x \times 4) / ((\$100x \times 4) + (\$300x \times 4)))$ of the value of the office building and is a non-passive asset for purposes of applying section

1297(a)(2) to determine whether TFC is a PFIC.

(4) *Passive treatment of stock and partnership interests.* For purposes of section 1297(a)(2), shares of stock in a corporation that is not a look-through subsidiary (as defined in § 1.1297-2(g)(3)) and partnership interests in a partnership that is not a look-through partnership (as defined in § 1.1297-2(g)(4)) with respect to a tested foreign corporation for a taxable year or portion thereof are treated as passive assets for the taxable year or relevant portion thereof, except to the extent the stock or partnership interest is treated as a dual-character asset under section 1297(b)(2)(C) and paragraph (d)(3) of this section because it produces both passive and non-passive income, or the stock or partnership interest produces solely non-passive income for the taxable year under section 1297(b)(2)(C) and paragraph (c)(4) of this section or under paragraph (d)(5) of this section.

(5) *Dealer property.* For purposes of section 1297(a)(2), an asset that produces, or would produce upon disposition, income or gain that is, or would be, excluded from passive income pursuant to section 954(c)(2)(C) is treated as a non-passive asset.

(e) *Stapled stock.* If a United States person that would be a shareholder (within the meaning of § 1.1291-1(b)(7) and (b)(8)) of a stapled entity (as defined in section 269B(c)(2)) owns stock in all entities that are stapled entities with respect to each other and the shares are stapled interests (as defined in section 269B(c)(3)), the United States person's interests in the stapled entities are treated as an interest in a single entity that holds all of the assets of the stapled entities, conducts all of the activities of the stapled entities, and derives all of the income of the stapled entities for all purposes of the PFIC regime.

(f) *Definitions.* The following definitions apply for purposes of this section and § 1.1297-2:

(1) *Measuring date.* The term *measuring date* has the meaning provided in paragraph (d)(1)(i) of this section.

(2) *Measuring period.* The term *measuring period* means a three-month period or an alternative measuring period, within the meaning provided in paragraph (d)(1)(ii) of this section.

(3) *Non-passive asset.* The term *non-passive asset* means an asset other than a passive asset.

(4) *Non-passive income.* The term *non-passive income* means income other than passive income.

(5) *Passive asset.* The term *passive asset* means an asset that produces passive income, or which is held for the

production of passive income, taking into account the rules in paragraphs (c) and (d) of this section.

(6) *Passive income.* The term *passive income* has the meaning provided in paragraph (c)(1) of this section.

(7) *Publicly traded foreign corporation.* The term *publicly traded foreign corporation* means a foreign corporation the stock of which is regularly traded on an exchange described in section 1297(e)(3), other than in de minimis quantities, for at least twenty trading days during a taxable year.

(8) *Related person.* For purposes of applying the rules with respect to section 1297(b)(2)(C), the term *related person* means a related person within the meaning of section 954(d)(3).

(9) *Tested foreign corporation.* The term *tested foreign corporation* means a foreign corporation the PFIC status of which is being tested under section 1297(a).

(g) *Applicability date*—(1) *In general.* Except as otherwise provided in paragraph (g)(2) of this section, the rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation, the shareholder consistently applies the provisions of this section (except that consistent treatment is not required with respect to paragraph (c)(1)(i)(A) of this section) and § 1.1291–1(b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) and §§ 1.1297–2, 1.1298–2, and 1.1298–4 for such year and all subsequent years.

(2) *Paragraph (d)(1)(v)(B)(2) of this section.* Paragraph (d)(1)(v)(B)(2) of this section applies to taxable years of shareholders ending on or after October 1, 2019. For taxable years of shareholders ending before October 1, 2019, a shareholder may apply paragraph (d)(1)(v)(B)(2) of this section to the last taxable year of a foreign corporation beginning before January 1, 2018, and each subsequent taxable year of the foreign corporation, provided that the shareholder and United States persons that are related (within the meaning of section 267 or 707) to the taxpayer consistently apply such paragraph with respect to all foreign corporations.

§ 1.1297–2 Special rules regarding look-through subsidiaries and look-through partnerships.

(a) *Overview.* This section provides rules concerning the treatment of income and assets of a look-through subsidiary (as defined in § 1.1297–

2(g)(3)) or look-through partnership (as defined in § 1.1297–2(g)(4)) for purposes of determining whether a tested foreign corporation (as defined in § 1.1297–1(f)(9)) is a passive foreign investment company (PFIC) under section 1297(a). Paragraph (b) of this section provides guidance for purposes of section 1297(c) on how to determine a tested foreign corporation's ownership in a corporation and how to determine a tested foreign corporation's proportionate share of a look-through subsidiary's or look-through partnership's assets and income. Paragraph (c) of this section provides rules that eliminate certain income and assets related to look-through subsidiaries and look-through partnerships for purposes of determining a tested foreign corporation's PFIC status. Paragraph (d) of this section provides a rule to determine whether certain income received or accrued by look-through subsidiaries and look-through partnerships is received or accrued from a related person for purposes of section 1297(b)(2)(C). Paragraph (e) of this section provides rules concerning the attribution of activities from qualified affiliates (as defined in § 1.1297–2(e)(2)) for purposes of characterizing the income and assets of a look-through subsidiary or look-through partnership. Paragraph (f) of this section provides rules for determining the amount of gain from the direct or indirect sale or exchange of stock of a look-through subsidiary or partnership interests in a partnership described in section 954(c)(4) that is taken into account under section 1297(a) and for determining the passive or non-passive character of gain from the sale of a look-through subsidiary. Paragraph (g) of this section provides definitions applicable for this section, and paragraph (h) of this section provides the applicability date of this section.

(b) *General rules*—(1) *Tested foreign corporation's ownership of a corporation.* For purposes of section 1297(c) and this section, the principles of section 958(a) and the regulations in this chapter under that section applicable to determining direct or indirect ownership by value apply to determine a tested foreign corporation's percentage ownership (by value) in the stock of another corporation. These principles apply whether an intermediate entity is domestic or foreign.

(2) *Tested foreign corporation's proportionate share of the assets and income of a look-through subsidiary*—(i) *Proportionate share of subsidiary assets.* For each measuring period (as defined

in § 1.1297–1(f)(2)), a tested foreign corporation is treated as if it held its proportionate share of each asset of a look-through subsidiary, determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section)) of the look-through subsidiary on the measuring date (as defined in § 1.1297–1(f)(1)). A tested foreign corporation's proportionate share of a look-through subsidiary's asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the hands of such look-through subsidiary under the rules of paragraph (b)(2)(ii) of this section.

(ii) *Proportionate share of subsidiary income*—(A) *General rule.* A tested foreign corporation is treated as if it received directly its proportionate share of each item of gross income or loss of a corporation for a taxable year if the corporation is a look-through subsidiary with respect to the tested foreign corporation for the taxable year of the tested foreign corporation. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income or loss is determined based on the corporation's average percentage ownership (by value) of the look-through subsidiary. The exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) that are based on whether income is derived in the active conduct of a business or whether a corporation is engaged in the active conduct of a business apply to such income only if the exception would have applied to exclude the income from passive income or foreign personal holding company income in the hands of the subsidiary, determined by taking into account only the activities of the subsidiary except as provided in paragraph (e) of this section. See paragraph (d) of this section for rules determining whether a person is a related person for purposes of applying section 1297(b)(2)(C) in the case of income received or accrued by a subsidiary that is treated as received directly by a tested foreign corporation pursuant to this paragraph (b)(2).

(B) *Partial year.* When a corporation is not a look-through subsidiary with respect to a tested foreign corporation for an entire taxable year of the tested foreign corporation, the tested foreign corporation may be treated as if it received directly its proportionate share of the gross income or loss of the first corporation for each measuring period in the year for which the first

corporation is a look-through subsidiary, if the conditions in paragraph (g)(3)(ii)(B) of this section are satisfied. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income or loss is determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section) of the look-through subsidiary on the relevant measuring date.

(iii) *Coordination of section 1297(c) with section 1298(b)(7)*. A tested foreign corporation is not treated under section 1297(c) and this paragraph (b) as holding its proportionate share of the assets of a domestic corporation, or receiving directly its proportionate share of the gross income or loss of the domestic corporation, if the stock of the domestic corporation is treated as an asset that is not a passive asset (as defined in § 1.1297-1(f)(5)) that produces income that is not passive income (as defined in § 1.1297-1(f)(6)) under section 1298(b)(7) (concerning the treatment of certain foreign corporations owning stock in certain 25-percent-owned domestic corporations). See § 1.1298-4 for rules governing the application of section 1298(b)(7).

(3) *Tested foreign corporation's proportionate share of the assets and income of a look-through partnership—*

(i) *Proportionate share of partnership assets*. For each measuring period (as defined in § 1.1297-1(f)(2)), a tested foreign corporation is treated as if it held its proportionate share of each asset of a look-through partnership, determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section) of the look-through partnership on the measuring date (as defined in § 1.1297-1(f)(1)). A tested foreign corporation's proportionate share of a look-through partnership's asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the hands of the partnership under the rules in paragraph (b)(3)(ii) of this section.

(ii) *Proportionate share of partnership income—(A) General rule*. A tested foreign corporation is treated as if it received directly its proportionate share of any item of gross income or loss of a partnership that is a look-through partnership with respect to the tested foreign corporation for the taxable year of the tested foreign corporation. The exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) that are based

on whether income is derived in the active conduct of a business or whether a corporation is engaged in the active conduct of a business apply to such income only if the exception would have applied to exclude the income from passive income or foreign personal holding company income in the hands of the partnership, determined by taking into account only the activities of the partnership except as provided in paragraph (e) of this section. See paragraph (d) of this section for rules determining whether a person is a related person for purposes of applying section 1297(b)(2)(C) in the case of income received or accrued by a partnership that is treated as received directly by a tested foreign corporation pursuant to this paragraph (b)(3).

(B) *Partial year*. When a partnership is not a look-through partnership with respect to a tested foreign corporation for an entire taxable year of the tested foreign corporation, the tested foreign corporation may be treated as if it received directly its proportionate share of the gross income of the partnership for each measuring period in the year for which the partnership is a look-through partnership, provided that the conditions set forth in paragraph (g)(3)(ii)(B) of this section would be satisfied if the partnership were a corporation.

(4) *Examples*. The following examples illustrate the rules of this paragraph (b). For purposes of these examples, USP is a domestic corporation; TFC, LTS, and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a); USP owns 30% of TFC; and LTS owns 25% of the only class of FS stock.

(i) *Example 1—(A) Facts*. TFC directly owns 80% of the only class of LTS stock for TFC's and LTS's entire taxable year.

(B) *Results—(1) LTS*. Under paragraph (b)(1) of this section and pursuant to the principles of section 958(a), LTS owns 25% of the value of FS. Under paragraph (b)(2)(i) and (ii) of this section, in determining whether LTS is a PFIC under section 1297(a), LTS is treated as if it held 25% of each of FS's assets on each of the measuring dates in its taxable year and received directly 25% of the gross income of FS for the taxable year.

(2) *TFC*. Under paragraph (b)(1) of this section and pursuant to the principles of section 958(a), TFC owns 80% of the value of LTS and indirectly owns 20% of the value of FS. Under paragraph (b)(2) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 80% of each of LTS's assets on each of the measuring dates in its taxable year and

received directly 80% of the gross income of LTS for the taxable year. However, because TFC indirectly owns less than 25% of FS, FS is not a look-through subsidiary with respect to TFC and, therefore, TFC is treated as if it held a 20% interest in the stock of FS (and not the assets of FS), and received 80% of any dividends paid from FS to LTS (and not any income of FS).

(ii) *Example 2—(A) Facts*. TFC directly owns 25% of the only class of LTS stock on the last day of each of the first three quarters of its taxable year but disposes of its entire interest in LTS during the fourth quarter of its taxable year.

(B) *Results*. Under paragraph (b)(1) and pursuant to the principles of section 958(a), on each of its first three measuring dates, TFC owns 25% of the value of LTS and indirectly owns 6.25% of the value of FS. Under paragraph (g)(3) of this section, if information about the gross income of LTS for each of the first three quarters of its taxable year is available to TFC, LTS is treated as a look-through subsidiary with respect to TFC for those quarters because TFC owned 25% of the value of LTS on the measuring dates with respect to those measuring periods. In that case, under paragraph (b)(2) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 25% of each of LTS's assets and received directly 25% of the gross income of LTS on each of the first three measuring dates in its taxable year. For each of its first three quarters, if LTS is treated as a look-through subsidiary with respect to TFC under paragraph (g)(3) of this section, then TFC is treated as if it held a 6.25% interest in the stock of FS (and not the assets of FS) and received 25% of any dividends paid from FS to LTS (and not any income of FS). Under paragraph (g)(3) of this section, if information about the gross income of LTS for each of the first three quarters of its taxable year is not available to TFC, then LTS is not a look-through subsidiary with respect to TFC.

(iii) *Example 3—(A) Facts*. TFC directly owns 100% of the only class of LTS stock for TFC's and LTS's entire taxable year. TFC sells one item of property described in section 954(c)(1)(B)(i) for a gain of \$25x and another for a loss of \$10x, and no exception from passive income applies to either amount. During the taxable year, FS sells one item of property described in section 954(c)(1)(B)(i) for a gain of \$50x and another for a loss of \$55x; no exception from passive income applies to either amount.

(B) *Results.* Under paragraph (b)(1) of this section and pursuant to the principles of section 958(a), TFC owns 100% of the value of LTS, and TFC indirectly owns 25% of the value of FS. Under paragraph (b) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 100% of LTS's assets on each of the measuring dates in its taxable year and received directly 100% of the gross income of LTS for the taxable year. Furthermore, TFC is treated as if it held 25% of each of FS's assets and received directly 25% of the gross income of FS. Pursuant to § 1.1297-1(c)(1)(ii), the excess of gains over losses from property transactions described in section 954(c)(1)(B) is taken into account as gross income for purposes of section 1297, and items of gain or loss of look-through subsidiaries are treated as recognized by a tested foreign corporation. Accordingly, TFC takes into account the net \$5x loss from the sales of property by FS. TFC's income from its own sales of property constitutes passive income pursuant to § 1.1297-1(c) and section 954(c)(1)(B), although, pursuant to § 1.1297-1(c)(1)(ii), only the excess of gains over losses, \$15x (\$25x - \$10x), is taken into account as gross income for purposes of section 1297. As a result, TFC's income (including the \$5x loss from FS), all of which is passive income, equals \$10x (\$15x - \$5x) of gross income.

(c) *Elimination of certain intercompany assets and income—(1) General rule for asset test—(i) LTS stock.* For purposes of section 1297(a)(2), a tested foreign corporation does not take into account the value (or adjusted basis) of stock of a look-through subsidiary (*LTS stock*), including LTS stock that the tested foreign corporation is treated as owning on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section. Furthermore, for purposes of section 1297(a)(2), a tested foreign corporation does not take into account the value (or adjusted basis) of its own stock that it is treated as owning on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section.

(ii) *LTS obligation.* For purposes of section 1297(a)(2), a tested foreign corporation does not take into account the value (or adjusted basis) of its proportionate share of a direct LTS obligation, an indirect LTS obligation or a TFC obligation that it is treated as owning on a measuring date. The term *direct LTS obligation* means a debt obligation of, lease to, or license to a look-through subsidiary (*LTS debt*, *LTS lease*, and *LTS license*, respectively, and

LTS obligation collectively) from the tested foreign corporation that the tested foreign corporation owns on a measuring date, and the term *indirect LTS obligation* means a LTS obligation from a look-through subsidiary that the tested foreign corporation is treated as owning on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section. The term *TFC obligation* means a debt obligation of, lease to, or a license to the tested foreign corporation from a look-through subsidiary that the tested foreign corporation is treated as owning on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section. The tested foreign corporation's proportionate share of a LTS obligation or a TFC obligation is the value (or adjusted basis) of the item multiplied by the tested foreign corporation's percentage ownership (by value) in each relevant look-through subsidiary. For purposes of section 1297(a)(2) and § 1.1297-1(d) as applied to a tested foreign corporation, property subject to a LTS lease or LTS license or a lease or license to the tested foreign corporation is characterized as either producing passive income or non-passive income (or both) by taking into account the activities of the qualified affiliates (as defined in paragraph (e)(2) of this section) of the entity that owns the property. For this purpose, the activities of the entity that owns the property that is subject to the lease or license are not taken into account to the extent that they relate to the lease or license.

(2) *General rule for income test—(i) LTS stock.* For purposes of section 1297(a)(1), a tested foreign corporation does not take into account dividends derived with respect to LTS stock, including dividends that the tested foreign corporation is treated as receiving on a measuring date pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section; provided that, notwithstanding the foregoing, a tested foreign corporation takes into account dividends that are attributable to income that was not treated as received directly by the tested foreign corporation pursuant to paragraph (b)(2) of this section. For this purpose, the rules of § 1.1297-1(c)(4)(iv)(A) apply to determine the earnings and profits from which a dividend is paid, substituting the term "look-through subsidiary" for "related person."

(ii) *LTS obligation.* For purposes of section 1297(a)(1), a tested foreign corporation does not take into account its proportionate share of interest, rents, or royalties derived with respect to direct or indirect LTS obligations or

TFC obligations. The tested foreign corporation's proportionate share of interest, rents, or royalties is the amount of the item multiplied by the tested foreign corporation's percentage ownership (by value) in each relevant look-through subsidiary.

(3) *Partnerships.* For purposes of section 1297(a)(1) and (a)(2), the principles of paragraphs (c)(1) and (2) of this section apply with respect to ownership interests in, debt of, and leases or licenses to a look-through partnership (as defined in paragraph (g)(4) of this section), and with respect to distributions and the distributive shares of income from a look-through partnership and interest, rents, or royalties derived with respect to the debt, leases or licenses of a look-through partnership.

(4) *Examples.* The following examples illustrate the rules of this paragraph (c). For purposes of these examples, USP is a domestic corporation; USP owns 30% of TFC; TFC, LTS, LTS1, LTS2, and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a); FPS is a foreign partnership; and TFC, LTS1, and LTS2 measure assets for purposes of section 1297(a)(2) based on value.

(i) *Example 1—(A) Facts.* TFC directly owns 80% of the only class of LTS stock for TFC's and LTS's entire taxable year, and LTS is a look-through subsidiary (as defined in paragraph (g)(3) of this section) with respect to TFC. LTS owns 25% of the only class of FS stock, and FS is a look-through subsidiary with respect to LTS. Pursuant to the principles of section 958(a), TFC owns 80% of the value of LTS, LTS owns 25% of the value of FS, and TFC indirectly owns 20% of the value of FS. During the first quarter of the taxable year, LTS received a \$20x dividend from FS.

(B) *Results—(1) LTS.* Under paragraph (c)(1)(i) of this section, for purposes of applying section 1297(a)(2) to LTS, LTS's assets do not include the stock of FS. Under paragraph (c)(2)(i) of this section, for purposes of applying section 1297(a)(1) to LTS, LTS's income does not include the \$20x dividend from FS.

(2) *TFC.* Under paragraph (c)(1)(i) of this section, for purposes of applying section 1297(a)(2) to TFC, TFC's assets do not include the stock of LTS. Under paragraph (b)(2)(ii)(A) of this section, for purposes of applying section 1297(a)(1) to TFC, TFC is treated as receiving directly the income of LTS. Because TFC indirectly owns less than 25% of FS, FS is not a look-through subsidiary with respect to TFC and, therefore, TFC's assets include the value of TFC's 20% interest in the stock of FS and do not include 20% of FS's assets.

Similarly, TFC is treated as if it received \$16x (80% × \$20x) of the \$20x dividend paid from FS to LTS (and not any income of FS). Because the dividend constitutes gross income to LTS (although it is eliminated for purposes of applying section 1297(a)(1) to LTS), TFC is treated as receiving the dividend from FS directly under paragraph (b)(2)(ii)(A) of this section. Because the dividend is from a subsidiary that is not a look-through subsidiary with respect to TFC, paragraph (c)(2)(i) of this section does not apply to eliminate the \$16x dividend for purposes of section 1297(a).

(ii) *Example 2—(A) Facts.* TFC directly owns 40% of the value of LTS1 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 40% of LTS1's assets on each of the measuring dates. TFC's assets include a loan to LTS1 with a balance of \$1,000x on each of the measuring dates. During the first quarter of the taxable year, TFC received \$20x of dividends from LTS1, which were attributable to income of LTS1 treated as received directly by TFC pursuant to paragraph (b)(2) of this section, and \$30x of interest on the loan, both of which were paid in cash.

(B) *Results.* Under paragraph (c)(1)(i) of this section, for purposes of applying section 1297(a), TFC's assets do not include the stock of LTS1, and TFC's income does not include the \$20x of dividends received from LTS1 pursuant to paragraph (c)(2)(i) of this section. Similarly, under paragraph (c)(1)(ii) of this section TFC's assets include only \$600x (\$1,000x loan – (40% × \$1,000x)) of the loan to LTS1, and under paragraph (c)(2)(ii) of this section, TFC's income includes only \$18x (\$30x interest – (40% × \$30x)) of the interest from LTS1. However, TFC's assets include the entire \$50x of cash (\$20x of dividends and \$30x of interest) received from LTS1.

(iii) *Example 3—(A) Facts.* The facts are the same as in paragraph (c)(4)(ii)(A) of this section (the facts in *Example 2*), except that TFC also directly owns 30% of the value of LTS2 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 30% of LTS2's assets, and LTS1's assets also include a loan to LTS2 with a balance of \$200x on each of the measuring dates. During the first quarter of the taxable year, LTS1 received \$5x of interest on the loan, which was paid in cash.

(B) *Results.* The results are the same as in paragraph (c)(4)(i)(B) of this section (the results in *Example 1*), except that TFC's assets also do not include the stock of LTS2. Similarly,

although TFC would be treated under paragraph (b)(2) of this section as owning \$80x (40% × \$200x) of the LTS1 loan to LTS2, under paragraph (c)(1)(ii) of this section TFC does not take into account its proportionate share of an indirect LTS obligation and accordingly, TFC does not take into account \$24x (30% × \$80x) of the loan to LTS2. As a result, TFC's assets include only \$56x (\$80x – \$24x) of the LTS1 loan to LTS2. Furthermore, although TFC would be treated under paragraph (b)(2) of this section as receiving \$2x (40% × \$5x) of the interest received by LTS1 from LTS2, under paragraph (c)(2)(ii) of this section TFC does not take into account its proportionate share of interest with respect to an indirect LTS obligation and thus, TFC does not take into account \$0.60x (30% × \$2x) of the interest received by LTS1. Accordingly, TFC's income includes only \$1.40x (\$2x – \$0.60x) of the interest from LTS2. Furthermore, TFC's assets include \$2x (40% × \$5x) of LTS1's cash received from LTS2.

(iv) *Example 4—(A) Facts.* TFC directly owns 80% of the value of LTS1 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 80% of LTS1's assets on each of the measuring dates. TFC also directly owns 50% of the value in FPS on each of the measuring dates. LTS1's assets include the remaining 50% of the value in FPS and a loan to FPS with a balance of \$500x on each of the measuring dates. FPS's assets include a loan to TFC with a balance of \$1000x on each of the measuring dates. During the first measuring period of the taxable year, FPS received \$30x of interest from TFC, and LTS1 received \$15x of interest from FPS, both of which were paid in cash. During the last measuring period of the taxable year, FPS received \$80x of income from an unrelated person in cash and distributed \$60x of such income in cash to TFC and LTS1 in proportion to their interests in FPS.

(B) *Results.* Under paragraph (c)(1)(i) and (ii) of this section, for purposes of applying section 1297(a), TFC's assets do not include the stock of LTS1, the interests in FPS owned by TFC directly and through LTS1, any of the loan by FPS to TFC, or any of the loan by LTS1 to FPS. Similarly, under paragraph (c)(2)(i) and (ii) of this section, TFC's income does not include any of the \$30x of interest received by FPS from TFC, any of the \$15x of interest received by LTS1 from FPS, or any of the \$60x of distributions received by TFC and LTS1 from FPS. However, on each of the measuring dates, TFC's assets include \$27x ((50% × \$30x) + (80% × 50% ×

\$30x)) of the \$30 of cash received by FPS from TFC and \$12x (80% × \$15x) of the \$15x of cash received by LTS1 from FPS. Moreover, on the last measuring date of the taxable year, TFC's assets include \$18x ((50% × \$20x) + (80% × 50% × \$20x)) of the \$20x (\$80x – \$60x) of cash received by FPS from the unrelated person and retained by FPS and \$54x ((50% × \$60x) + (80% × 50% × \$60x)) of the \$60x cash received by FPS from the unrelated person and distributed. Furthermore, TFC's income includes \$72x ((50% × \$80x) + (80% × 50% × \$80x)) of the \$80x of income received by FPS from an unrelated person.

(v) *Example 5—(A) Facts.* TFC directly owns 80% of the value of the stock of LTS1 and 60% of the value of the stock of LTS2 on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 80% of LTS1's assets and 60% of LTS2's assets on each of the measuring dates. TFC's assets include a license for the use of its intangible property by LTS1 with a value of \$5,000x on each of the measuring dates, LTS1's assets include a sub-license of such license to LTS2 with a value of \$2,000x on each of the measuring dates, and LTS2's assets include a lease of its building to LTS1 with a value of \$4,000x on each of the measuring dates. LTS1 and LTS2 each use the intangible property that is the subject of the license and sub-license in its respective trade or business, and LTS1 uses the building in its trade or business. During the last quarter of the taxable year, TFC received a royalty of \$500x from LTS1 with respect to the license, and LTS1 received a royalty of \$200x from LTS2 with respect to the sub-license, both of which were paid in cash. LTS2 received \$100x of rent paid in cash from LTS1 during each quarter of the taxable year with respect to the building lease.

(B) *Results—(1) Asset test.* Under paragraph (c) of this section, for purposes of applying section 1297(a)(2) to TFC's final measuring period, the following analysis applies. TFC's assets do not include the stock of LTS1 and LTS2. Similarly, TFC's assets include only \$1,000x (\$5,000x license – (80% × \$5,000x)) of the license to LTS1. However, TFC's assets include the entire \$500x of cash it received from LTS1 as a result of the royalty. Moreover, although TFC would be treated under paragraph (b)(2) of this section as owning \$1,600x (80% × \$2,000x) of the LTS1 sub-license to LTS2, under paragraph (c)(1)(ii) of this section TFC does not take into account its proportionate share of an indirect LTS obligation, and accordingly TFC

does not take into account \$960x (60% × \$1,600x) of LTS1's sub-license to LTS2. As a result, TFC's assets include \$640x (\$1,600x – \$960x) of the sub-license. In addition, TFC's assets include \$160x (80% × \$200x) of LTS1's cash received from LTS2 as a result of the royalty to LTS1. Similarly, although TFC would be treated under paragraph (b)(2) of this section as owning \$2,400x (60% × \$4,000x) of the LTS2 lease to LTS1, under paragraph (c)(1)(ii) of this section TFC does not take into account \$1,920x (80% × \$2,400x) of the LTS2 building lease, and accordingly, its assets include \$480x (\$2,400x – \$1,920x) of the lease. TFC's assets also include \$240x (60% × \$100x × 4) of LTS2's cash received from LTS1 as a result of the rental payment to LTS2.

(2) *Income test.* Under paragraph (c)(2)(ii) of this section, because TFC does not take into account its proportionate share of a direct LTS obligation, TFC's income includes only \$100x (\$500x royalty – (80% × \$500x)) of the royalties from LTS1. Furthermore, although TFC would be treated under paragraph (b)(2) of this section as receiving \$160x (80% × \$200x) of the royalty received by LTS1 from LTS2, under paragraph (c)(2)(ii) of this section TFC does not take into account its proportionate share of royalties derived with respect to an indirect LTS obligation, and accordingly TFC does not take into account \$96x (60% × \$160x) of the royalty received by LTS1. As a result, TFC's income includes only \$64x (\$160x – \$96x) of the royalty from LTS2. Similarly, although TFC would be treated under paragraph (b)(2) of this section as receiving \$240x (60% × \$100x × 4) of the rent received by LTS2 from LTS1, under paragraph (c)(2)(ii) of this section TFC does not take into account its proportionate share of rent derived with respect to an indirect LTS obligation, and accordingly TFC does not take into account \$192x (80% × \$240) of the rent received by LTS2. Therefore, TFC's income includes only \$48 (\$240x – \$192x) of the rent received from LTS1.

(3) *Treatment of intangible and rental property.* For purposes of determining whether the intangible property that TFC owns and the building that TFC is treated as owning under paragraph (b)(2) of this section is held in the production of passive income, the activities performed by TFC and its qualified affiliates with respect to the property are taken into account under paragraphs (c)(1)(ii) and (e) of this section. Because TFC is the common parent of the affiliated group (as determined under paragraph (e)(2) of this section) that includes LTS1 and

LTS2, LTS1 and LTS2 are qualified affiliates of TFC and the activities of their officers and employees with respect to the intangible property and building are taken into account to determine whether the building and intangible property would be treated as passive assets.

(d) *Related person determination for purposes of section 1297(b)(2)(C)*—(1) *General rule.* For purposes of section 1297(b)(2)(C), interest, dividends, rents or royalties received or accrued by a look-through subsidiary (and treated as received directly by a tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) of this section) are considered received or accrued from a related person only if the payor of the interest, dividend, rent or royalty is a related person (within the meaning of section 954(d)(3)) with respect to the look-through subsidiary, taking into account § 1.1297–1(c)(1)(i)(D). Similarly, for purposes of 1297(b)(2)(C), interest, dividends, rents or royalties received or accrued by a look-through partnership (and treated as received directly by a tested foreign corporation pursuant to paragraph (b)(3) of this section) are considered received or accrued from a related person only if the payor of the interest, dividend, rent or royalty is a related person (within the meaning of section 954(d)(3)) with respect to the look-through partnership, taking into account § 1.1297–1(c)(1)(i)(D).

(2) *Example.* The following example illustrates the rule of this paragraph (d).

(i) *Facts.* USP is a domestic corporation that owns 30% of TFC. TFC directly owns 30% of the value of FS1 stock, and thus under paragraph (b) of this section is treated as owning 30% of FS1's assets and earning 30% of FS1's gross income. The remaining FS1 stock is owned by an unrelated foreign person. FS1 directly owns 60% of the vote of FS2 stock and 20% of the value of FS2 stock. The remaining vote and value of FS2 stock are owned by an unrelated foreign person. TFC, FS1, and FS2 are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a). FS1 receives a \$100x dividend from FS2.

(ii) *Results.* Pursuant to section 1297(c) and paragraph (b)(2) of this section, TFC is treated as receiving directly \$30x of the dividend income received by FS1. FS2 is a related person (within the meaning of section 954(d)(3)) with respect to FS1 for purposes of section 1297(b)(2)(C) because FS1 owns more than 50% of the vote of FS2. FS2 is not a related person (within the meaning of section 954(d)(3)) with respect to TFC for purposes of section 1297(b)(2)(C)

because TFC indirectly does not own more than 50% of the vote or value of the FS2 stock. Under paragraph (d)(1) of this section, for purposes of determining whether the dividend income received by FS1 is subject to the exception in section 1297(b)(2)(C) for purposes of testing the PFIC status of TFC, the dividend is treated as received from a related person because FS1 and FS2 are related persons within the meaning of section 1297(b)(2)(C). Therefore, to the extent the dividend income received by FS1 would be properly allocable to income of FS2 that is not passive income, the dividend income that TFC is treated as receiving under section 1297(c) and paragraph (b)(2)(ii) of this section is treated as non-passive income (as defined in § 1.1297–1(f)(4)).

(e) *Treatment of activities of certain look-through subsidiaries and look-through partnerships for purposes of certain exceptions*—(1) *General rule.* An item of income received by a tested foreign corporation (including an amount treated as received or accrued pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section) that would be passive income in the hands of the entity that actually received or accrued it is not passive if the item would be excluded from foreign personal holding company income under the following exceptions contained in section 954(c) that are based on whether the entity is engaged in the active conduct of a trade or business, 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 any qualified affiliate of the tested foreign corporation—

(i) Section 954(c)(1)(B) and § 1.954–2(e)(1)(ii) and (3)(ii), (iii) and (iv);

(ii) Section 954(c)(1)(C) and § 1.954–2(f)(1)(ii) and (2)(iii)(D);

(iii) Section 954(c)(1)(D) and § 1.954–2(g)(2)(ii);

(iv) Section 954(c)(2)(A) and § 1.954–2(b)(6), (c), and (d);

(v) Section 954(c)(2)(B) and § 1.954–2(b)(2); and

(vi) Section 954(c)(2)(C) and § 1.954–2(h)(3)(ii).

(2) *Qualified affiliate.* The term *qualified affiliate* means a corporation or a partnership that is included in an affiliated group that includes the tested foreign corporation. For purposes of this paragraph (e), the term *affiliated group* has the meaning provided in section 1504(a), except that—

(i) The affiliated group is determined without regard to sections 1504(a)(2)(A), (b)(2) and (b)(3);

(ii) Subject to paragraph (e)(2)(iii) of this section, a partnership is treated as an includible corporation;

(iii) The common parent of the affiliated group is not a domestic corporation or domestic partnership;

(iv) Section 1504(a)(2)(B) is applied by substituting “more than 50 percent” for “at least 80 percent”;

(v) A foreign corporation or foreign partnership must be the common parent of the affiliated group;

(vi) Subject to paragraph (e)(2)(vii) of this section, a partnership is included as a member of the affiliated group if more than 50 percent of the value of its capital interests or profits interests is owned by one or more corporations or partnerships that are included in the affiliated group; and

(vii) A corporation or a partnership that is not the common parent of an affiliated group is included in the affiliated group only if it would be a look-through subsidiary or look-through partnership, as applicable, of the common parent if the common parent were a tested foreign corporation.

(3) *Examples.* The following examples illustrate the rule of this paragraph (e).

(i) *Example 1—(A) Facts.* USP is a domestic corporation that directly owns 20% of the outstanding stock of FS1.

The remaining 80% of the outstanding stock of FS1 is directly owned by a foreign person that is not related to USP.

FS1 directly owns 100% of the value of the outstanding stock of FS2 and directly owns 80% of the value of the outstanding stock of FS3. The remaining 20% of the value of the outstanding stock of FS3 is directly owned by a foreign person that is not related to USP.

FS2 directly owns 80% of the value of the outstanding stock of FS4. The remaining 20% of the value of the outstanding stock of FS4 is directly owned by a foreign person that is not related to USP.

FS1, FS2, FS3 and FS4 are all organized in Country A and are not controlled foreign corporations within the meaning of section 957(a).

FS4 owns real property that is leased to a person that is not a related person, but does not perform any activities. FS1 and FS2 also do not perform any activities.

Officers and employees of FS3 in Country A perform activities with respect to the real property of FS4 that, if performed by officers or employees of FS4, would allow the rental income in the hands of FS4 to qualify for the exception from foreign personal holding company income in section 954(c)(2)(A) and § 1.954-2(b)(6) and (c)(1)(ii).

(B) *Results—(1) Qualified affiliates.* FS1 is the common parent of the affiliated group (as determined under paragraph (e)(2) of this section) that

includes FS2, FS3, and FS4 because (i) FS1 owns more than 50% by value of FS2 and FS3, (ii) FS2 owns more than 50% by value of FS4, and (iii) FS2, FS3, and FS4 would be look-through subsidiaries with respect to FS1 if FS1 were the tested foreign corporation.

Accordingly, each of FS1, FS2, FS3 and FS4 are qualified affiliates (as determined under paragraph (e)(2) of this section) with respect to the other members of the group for purposes of determining whether FS1, FS2, FS3, or FS4 is a PFIC.

(2) *FS1 and FS2.* Under this paragraph (e), for purposes of determining whether the rental income actually received by FS4 with respect to the real property owned and rented by FS4 and treated under section 1297(c) and paragraph (b)(2) of this section as received directly by FS1 or by FS2, respectively, is passive income for purposes of section 1297, the activities of FS3 are taken into account because FS3 is a qualified affiliate of FS1 and FS2, respectively. Thus, the exception in section 954(c)(2)(A) would apply, and the rental income treated as received by FS1 or by FS2, respectively, would be treated as non-passive income for purposes of determining whether FS1 or FS2 is a PFIC.

(3) *FS4.* Under this paragraph (e), for purposes of determining whether the rental income received by FS4 with respect to the real property owned and rented by FS4 is passive income for purposes of section 1297, the activities of FS3 are taken into account, because FS3 is a qualified affiliate of FS4. Thus, the exception in section 954(c)(2)(A) would apply, and the rental income received by FS4 would be treated as non-passive income for purposes of determining whether FS4 is a PFIC.

(ii) *Example 2—(A) Facts.* The facts are the same as in paragraph (e)(3)(i)(A) of this section (the facts in *Example 1*), except that FS2 also owns real property that is leased to a person that is not a related person, and the officers and employees of FS2 in Country A engage in activities that would allow rental income received by FS2 with respect to its real property to qualify for the exception in section 954(c)(2)(A) and § 1.954-2(b)(6) and (c)(1)(iv), relying on the rule in § 1.954-2(c)(2)(ii) that provides that an organization is substantial in relation to rents if active leasing expenses equal or exceed 25% of adjusted leasing profit. However, the active leasing expenses of FS1 are less than 25% of its adjusted leasing profit, which includes the rental income of FS4 treated as received directly by FS1 as well as the rental income of FS2 treated as received directly by FS1.

(B) *Results.* Because FS2's rental income constitutes non-passive income as a result of the application of § 1.1297-1(c)(1)(i)(A) and section 954(c)(2)(A), it is treated as non-passive income that FS1 is treated as receiving directly under section 1297(c) and paragraph (b)(2) of this section for purposes of determining whether FS1 is a PFIC, and accordingly, it is not necessary to rely on paragraph (e) of this section.

(iii) *Example 3—(A) Facts.* The facts are the same as in paragraph (e)(3)(i)(A) of this section (the facts in *Example 1*), except that USP directly owns 60% of the outstanding stock of FS1.

(B) *Results.* Under paragraph (e)(2)(iii) of this section, USP cannot be the common parent of an affiliated group for purposes of paragraph (e)(2) of this section because it is a domestic corporation. Because FS1 is a foreign corporation, FS1 may be the common parent of an affiliated group for purposes of paragraph (e)(2) of this section. The results therefore are the same as in paragraph (e)(3)(i)(B) of this section (the results in *Example 1*).

(f) *Gain on disposition of a look-through subsidiary or look-through partnership—(1) [Reserved].*

(2) *Amount of gain taken into account from disposition of look-through subsidiary.* For purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298-2, the amount of gain that is taken into account by a tested foreign corporation from the tested foreign corporation's direct disposition of stock of a look-through subsidiary, or an indirect disposition resulting from the disposition of stock of a look-through subsidiary by other look-through subsidiaries or by look-through partnerships, is the residual gain. The residual gain equals the total gain recognized by the tested foreign corporation (including gain treated as recognized by the tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section) from the disposition of the stock of the look-through subsidiary reduced (but not below zero) by unremitted earnings. *Unremitted earnings* are the excess (if any) of the aggregate income (if any) taken into account by the tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) or (b)(3) of this section with respect to the stock of the disposed-of look-through subsidiary (including with respect to any other look-through subsidiary, to the extent it is owned by the tested foreign corporation indirectly through the disposed-of look-through subsidiary) over the aggregate dividends (if any)

received by the tested foreign corporation from the disposed-of look-through subsidiary with respect to the stock, determined without regard to paragraph (c)(2)(i) of this section. For purposes of this paragraph (f)(2), the amount of gain derived from the disposition of stock of a look-through subsidiary and income of and dividends received from the look-through subsidiary is determined on a share-by-share basis under a reasonable method.

(3) *Characterization of residual gain as passive income.* For purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298–2, the residual gain from the direct or indirect disposition of stock of a look-through subsidiary is characterized as passive income or non-passive income based on the relative amounts of passive assets and non-passive assets (as defined in § 1.1297–1(f)(5) and (3), respectively) 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 on the date of the disposition of the look-through subsidiary. For the purpose of this paragraph (f)(3), the relative amounts of passive assets and non-passive assets held by the look-through subsidiary are measured under the same method (value or adjusted bases) used to measure the assets of the tested foreign corporation for purposes of section 1297(a)(2).

(4) *Gain taken into account from disposition of 25%-owned partnerships and look-through partnerships—(i) Section 954(c)(4) partnerships.* The amount of gain derived from a tested foreign corporation's direct or indirect (through a look-through subsidiary or look-through partnership) disposition of partnership interests in a partnership described in section 954(c)(4) (treating the tested foreign corporation as if it were a controlled foreign corporation) that is taken into account by the tested foreign corporation for purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298–2 is determined under section 954(c)(4).

(ii) *Look-through partnerships.* In the case of a look-through partnership that is not described in paragraph (f)(4)(i) of this section, the principles of paragraphs (f)(2) and (f)(3) of this section apply to determine the amount and characterization of gain derived from a tested foreign corporation's direct or indirect (through a look-through subsidiary or look-through partnership) disposition of partnership interests of the look-through partnership that is taken into account by the tested foreign corporation for purposes of

section 1297(a)(1), section 1298(b)(3), and § 1.1298–2.

(5) *Examples.* The following examples illustrate the rules of this paragraph (f). For purposes of the examples in this paragraph (f)(5), USP is a domestic corporation, TFC and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a), and USP, TFC, and FS each has a single class of stock with 100 shares outstanding and a calendar taxable year.

(i) *Example 1—(A) Facts.* USP owned 30% of the outstanding stock of TFC throughout Years 1, 2, 3, and 4. In Year 1, TFC purchased 5 shares of FS stock, representing 5% of the stock of FS, from an unrelated person. On the first day of Year 3, TFC purchased 20 shares of FS stock, representing 20% of the stock of FS, from an unrelated person. TFC owned 25% of the outstanding stock of FS throughout Years 3 and 4. Before Year 3, TFC did not include any amount in income with respect to FS under section 1297(c)(2). During Years 3 and 4, for purposes of section 1297(a)(1), TFC included in income, in the aggregate, \$40x of income with respect to FS under section 1297(c) and paragraph (b)(2) of this section. TFC did not receive dividends from FS during Year 1, 2, 3, or 4. For purposes of section 1297(a)(2), TFC measures its assets based on their fair market value as provided under section 1297(e). On the last day of Year 4, TFC recognizes a loss with respect to the sale of 5 shares of FS stock, and a \$110x gain with respect to the sale of 20 shares of FS stock. On the date of the sale, FS owns non-passive assets with an aggregate fair market value of \$150x, and passive assets with an aggregate fair market value of \$50x.

(B) *Results.* For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must take into account \$78x of residual gain, as provided by paragraph (f)(2) of this section, which equals the amount by which the \$110x gain recognized on the sale of 20 shares in FS exceeds the aggregate pro rata share of \$32x income ($\$40x \times 20/25$) taken into account by TFC with respect to the 20 shares in FS under section 1297(c) and paragraph (b)(2) of this section during Years 3 and 4. There is zero residual gain on the sale of 5 shares of FS stock because they were sold at a loss. Under paragraph (f)(3) of this section, \$58.50x of the residual gain is non-passive income ($\$78x \times (\$150x/\$200x)$) and \$19.50x is passive income ($\$78x \times (\$50x/\$200x)$).

(ii) *Example 2—(A) Facts.* The facts are the same as in paragraph (f)(5)(i)(A) of this section (the facts in *Example 1*), except that in Year 1, TFC purchased 15

shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the first day of Year 3, TFC purchased an additional 15 shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the last day of Year 4, TFC recognizes gain of \$10x of the sale of 15 shares of FS stock purchased in Year 1, and gain of \$60x on the sale of the other 15 shares of FS stock purchased in Year 3.

(B) *Results.* For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must take into account \$40x of residual gain with respect to the 15 shares acquired in Year 3, as provided by paragraph (f)(2) of this section, which equals the amount by which the \$60x gain recognized on the sale of those 15 shares exceeds the aggregate pro rata share of \$20x income ($\$40x \times 15/30$) taken into account by TFC with respect to those 15 shares in FS under section 1297(c)(2) during Years 3 and 4. There is zero residual gain on the sale of the 15 shares of FS stock acquired in Year 1 because the \$10x of gain does not exceed the aggregate pro rata share of \$20x income taken into account by TFC with respect to those 15 shares of FS under section 1297(c) and paragraph (b)(2) of this section. Under paragraph (f)(3) of this section, \$30x of the residual gain is non-passive income ($\$40x \times (\$150x/\$200x)$) and \$10x is passive income ($\$40x \times (\$50x/\$200x)$).

(iii) *Example 3—(A) Facts.* The facts are the same as in paragraph (f)(5)(ii)(A) of this section (the facts in *Example 2*), except that TFC received, in the aggregate, \$20x of dividends from FS during Year 2.

(B) *Results.* The results are the same as in paragraph (f)(5)(ii)(B) of this section (the results in *Example 2*) with respect to the 15 shares acquired in Year 3 (\$40x of residual gain attributable to the 15 shares acquired in Year 3). For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must also take into account \$10x of residual gain with respect to the 15 shares acquired in Year 1. As provided by paragraph (f)(2) of this section, the residual gain equals the amount by which the \$10x gain recognized on the sale of those 15 shares exceeds the unremitted earnings with respect to those shares. The unremitted earnings with respect to the 15 shares acquired in Year 1 are \$0x, the amount by which the pro rata share of aggregate income (\$20x) taken into account by TFC with respect to those 15 shares of FS stock under section 1297(c) and paragraph (b)(2) of this section in Years 3 and 4 exceeds the aggregate pro rata amount of dividends with respect to those 15 shares of FS stock (\$20x)

received by TFC from FS in Year 2. Total residual gain therefore is \$50x (\$40x + \$10x). Under paragraph (f)(3) of this section, \$37.50x of the residual gain is non-passive income ($\$50x \times (\$150x / \$200x)$) and \$12.50x is passive income ($\$50x \times (\$50x / \$200x)$).

(g) *Definitions.* The following definitions apply for purposes of § 1.1297-1 and this section:

(1) *Direct LTS obligation.* The term *direct LTS obligation* has the meaning provided in paragraph (c)(1)(ii) of this section.

(2) *Indirect LTS obligation.* The term *indirect LTS obligation* has the meaning provided in paragraph (c)(1)(ii) of this section.

(3) *Look-through subsidiary.* The term *look-through subsidiary* means, with respect to a tested foreign corporation, a corporation as to which the asset test of paragraph (g)(3)(i) and the income test of paragraph (g)(3)(ii) of this section are satisfied on each measuring date during the taxable year of a tested foreign corporation. If a corporation satisfies both the asset test of paragraph (g)(3)(i) and the income test of paragraph (g)(3)(ii)(B) for some but not all measuring periods within the taxable year of a tested foreign corporation, the subsidiary is treated as a look-through subsidiary only for those measuring periods in which both tests are satisfied.

(i) For purposes of section 1297(a)(2) and paragraph (b)(2)(i) of this section, a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation on the measuring date (as defined in § 1.1297-1(f)(1));

(ii) For purposes of section 1297(a)(1), either—

(A) For the taxable year, a corporation with respect to which the average percentage ownership (which is equal to the percentage ownership (by value) (as determined under paragraph (b)(1) of this section) on each measuring date during the taxable year, divided by the number of measuring dates in the year) by the tested foreign corporation during the tested foreign corporation's taxable year is at least 25 percent; or

(B) For a measuring period (as defined in § 1.1297-1(f)(2)), a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation on the measuring date, provided all items of gross income of the corporation for each of the measuring periods in the taxable year for which the tested foreign corporation owns at least 25 percent of the value (as determined under paragraph (b)(1) of this section) on the

relevant measuring dates can be established; and

(iii) For purposes of paragraph (f) of this section and § 1.1298-2, a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation immediately before the disposition of stock of the corporation.

(4) *Look-through partnership—(i) In general.* The term *look-through partnership* means, with respect to a tested foreign corporation—

(A) A partnership that would be a look-through subsidiary (as defined in paragraph (g)(3) of this section) if such partnership were a corporation; or

(B) A partnership that is not described in paragraph (g)(4)(i)(A) of this section, if the tested foreign corporation satisfies both of the active partner tests set forth in paragraphs (g)(4)(ii)(A) and (B) of this section on the measurement date or for the taxable year, as applicable, unless an election is made under paragraph (g)(4)(iii) of this section.

(ii) *Active partner test—(A) Partnership interest under asset test.* For purposes of paragraph (b)(3)(i) of this section, paragraph (g)(4)(i)(B) of this section applies for the measuring period only if the tested foreign corporation would not be a PFIC if section 1297(a)(1) and (2) and the regulations thereunder were applied to the tested foreign corporation without regard to any partnership interest owned by the tested foreign corporation that is not a partnership described in paragraph (g)(4)(i)(A) of this section. For purposes of the preceding sentence, the active partner test is applied on the measurement date (as defined in § 1.1297-1(f)(1)).

(B) *Partnership income under income test.* For purposes of paragraph (b)(3)(ii) of this section, paragraph (g)(4)(i)(B) of this section applies for the taxable year of the tested foreign corporation or for a measuring period (as defined in § 1.1297-1(f)(2)), as applicable, only if the tested foreign corporation would not be a PFIC if section 1297(a)(1) and (2) and the regulations thereunder were applied to the tested foreign corporation without regard to any partnership interest owned by the tested foreign corporation that is not a partnership described in paragraph (g)(4)(i)(A) of this section. For purposes of the preceding sentence, the active partner test is applied on the measuring date (as defined in § 1.1297-1(f)(1)) or for the taxable year, as applicable using the same period that was used under paragraph (g)(3)(ii) of this section.

(iii) *Election.* For any taxable year, an election may be made with respect to a

partnership described in paragraph (g)(4)(i)(B) of this section to not apply the provisions of this paragraph (g)(4) to such partnership.

(iv) *Examples.* The following examples illustrate the rules of this paragraph (g)(4). For purposes of the examples in this paragraph (g)(4)(iv), TFC is a foreign corporation that is not a controlled foreign corporation; FC1 and FC2 are foreign corporations that are not controlled foreign corporations; FPS is a foreign partnership; TFC owns 100% of the single class of stock of FC1 and FC2; FC2 owns 10% of the value of FPS, and the remaining 90% of FPS is owned by an unrelated foreign person; and TFC, FC1, FC2, and FPS are all calendar year taxpayers.

(A) *Example 1—(1) Facts.* During Year 1, FC1 generated \$100x of non-passive income, FC2 generated \$150x of non-passive income, and FPS generated \$50x of income. On all of the measurement dates in Year 1, FC1 has assets with a value of \$1000x that FC1 uses in its trade or business generating non-passive income, FC2 has assets with a value of \$1500x that FC2 uses in its trade or business generating non-passive income, and FPS has assets with a value of \$500x.

(2) *Results—(i) Active partner test with respect to partnership interest.* Pursuant to section 1297(c) and § 1.1297-2(b)(2), TFC is treated as holding directly the assets held by FC1 and FC2. For purposes of the active partner test under paragraph (g)(4)(ii)(B) of this section, TFC does not take into account its interest in FPS to determine whether it would be a PFIC. Because 100% ($\$2500x / \$2500x$) of the assets of FC1 and FC2 that TFC is treated as directly holding, without taking into account the interest in FPS, generates non-passive income, TFC satisfies the active partner test in paragraph (g)(4)(ii)(B) of this section.

(ii) *Active partner test with respect to partnership income.* Pursuant to section 1297(c) and paragraph (b)(2) of this section, TFC is treated as if it received directly its proportionate share of income of FC1 and FC2. For purposes of the active partner test under paragraph (g)(4)(ii)(A) of this section, TFC does not take into account its interest in FPS to determine whether it would be a PFIC. Because 100% ($\$250x / \$250x$) of the income of FC1 and FC2 that TFC is treated as directly receiving, without taking into account the interest in FPS, is non-passive income, TFC satisfies the active partner test in paragraph (g)(4)(ii)(A) of this section with respect to the income of FPS.

(iii) *Qualification of look-through partnership.* For purposes of paragraph

(b)(3) of this section, FPS qualifies as a look-through partnership because TFC satisfies the active partner tests of both paragraphs (g)(4)(i)(A) and (B) of this section. Unless an election is made not to treat FPS as a look-through partnership under paragraph (g)(4)(iii) of this section, TFC is treated as receiving directly \$5x of income (10% × \$50x), TFC's pro rata share of the income of FPS, the character of which is determined at the level of FPS for purposes of section 1297. In addition, TFC is treated as holding directly \$50x of FPS's assets (10% × \$500x), TFC's proportionate share of the assets held by FPS. The character of those assets as passive or non-passive is determined in the hands of FPS for purposes of section 1297.

(B) *Example 2—(1) Facts.* During Year 1, FC1 generated \$50x of passive income, FC2 earned \$175x of non-passive income, and FPS generated \$50x of income. On all of the measurement dates in Year 1, FC1 has assets with a value of \$1100x that produce passive income, and FC2 has assets with a value of \$900x that FC2 uses in its trade or business generating non-passive income. The value of FPS is \$1000x taking into account its assets and liabilities.

(2) *Results—(i) Active partner test with respect to partnership interest.* Pursuant to section 1297(c) and § 1.1297-2(b)(2), TFC is treated as holding directly the assets held by FC1 and FC2. For purposes of the active partner test under paragraph (g)(4)(ii)(B) of this section, TFC does not take into account its interest in FPS to determine whether it would be a PFIC. Accordingly, 55% (\$1100x/\$2000x) of the assets that TFC is treated as directly holding, without taking into account the interest in FPS, generate passive income.

(ii) *Active partner test with respect to partnership income.* Pursuant to section 1297(c) and § 1.1297-2(b)(2), TFC is treated as if it received directly its proportionate share of income of FC1 and FC2. For purposes of the active partner test under paragraph (g)(4)(ii)(A) of this section, TFC does not take into account its interest in FPS to determine whether it would be a PFIC. Accordingly, 77.8% (\$175x/\$225x) of the income that TFC is treated as directly receiving, without taking into account the interest in FPS, is non-passive income.

(iii) *Failure to qualify as look-through partnership.* TFC satisfies the active partner test in paragraph (g)(4)(ii)(A) of this section but does not satisfy the active partner test in paragraph (g)(4)(ii)(B) of this section. Therefore, FPS does

not qualify as a look-through partnership. Under paragraph (b)(3)(iii) of this section, TFC's share of income with respect to FPS is treated as passive income for purposes of section 1297 and TFC's \$100x interest (10% × \$1000x) in FPS is treated as a passive asset for purposes of section 1297.

(5) *LTS debt.* The term *LTS debt* has the meaning provided in paragraph (c)(1)(ii) of this section.

(6) *LTS lease.* The term *LTS lease* has the meaning provided in paragraph (c)(1)(ii) of this section.

(7) *LTS license.* The term *LTS license* has the meaning provided in paragraph (c)(1)(ii) of this section.

(8) *LTS obligation.* The term *LTS obligation* has the meaning provided in paragraph (c)(1)(ii) of this section.

(9) *LTS stock.* The term *LTS stock* has the meaning provided in paragraph (c)(1)(i) of this section.

(10) *Qualified affiliate.* The term *qualified affiliate* has the meaning provided in paragraph (e)(2) of this section.

(11) *Residual gain.* The term *residual gain* has the meaning provided in paragraph (f)(2) of this section.

(12) *TFC obligation.* The term *TFC obligation* has the meaning provided in paragraph (c)(1)(ii) of this section.

(13) *Unremitted earnings.* The term *unremitted earnings* has the meaning provided in paragraph (f)(2) of this section.

(h) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation, the shareholder consistently applies the provisions of § 1.1291-1(b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) and §§ 1.1297-1 (except that consistent treatment is not required with respect to § 1.1297-1(c)(1)(i)(A)), 1.1298-2, and 1.1298-4 for such year and all subsequent years.

■ **Par. 6.** Sections 1.1297-4, 1.1297-5, and 1.1297-6 are added to read as follows:

§ 1.1297-4 Qualifying insurance corporation.

(a) *Scope.* This section provides rules for determining whether a foreign corporation is a qualifying insurance corporation for purposes of section 1297(f). Paragraph (b) of this section provides the general rule for determining whether a foreign corporation is a qualifying insurance corporation. Paragraph (c) of this section describes the 25 percent test in section

1297(f)(1)(B). Paragraph (d) of this section contains rules for applying the alternative facts and circumstances test in section 1297(f)(2). Paragraph (e) of this section contains rules limiting the amount of applicable insurance liabilities for purposes of the 25 percent test described in paragraph (c) of this section and the alternative facts and circumstances test described in paragraph (d) of this section. Paragraph (f) of this section provides definitions that apply for purposes of this section. Paragraph (g) of this section provides the applicability date of this section.

(b) *Qualifying insurance corporation.* For purposes of section 1297(b)(2)(B), this section, and §§ 1.1297-5 and 1.1297-6, with respect to a U.S. person, a qualifying insurance corporation (QIC) is a foreign corporation that—

(1) Is an insurance company as defined in section 816(a) that would be subject to tax under subchapter L if the corporation were a domestic corporation; and

(2) Satisfies—

(i) The 25 percent test described in paragraph (c) of this section; or

(ii) The requirements for an election to apply the alternative facts and circumstances test as described in paragraph (d) of this section and a United States person has made an election as described in paragraph (d)(5) of this section.

(c) *25 percent test.* A foreign corporation satisfies the 25 percent test if the amount of its applicable insurance liabilities exceeds 25 percent of its total assets. This determination is made on the basis of the applicable insurance liabilities and total assets reported on the corporation's applicable financial statement for the applicable reporting period.

(d) *Election to apply the alternative facts and circumstances test—(1) In general.* A United States person that owns stock in a foreign corporation that fails to qualify as a QIC solely because of the 25 percent test may elect to treat the stock of the corporation as stock of a QIC if the foreign corporation—

(i) Is predominantly engaged in an insurance business as described in paragraph (d)(2) of this section;

(ii) Failed to satisfy the 25 percent test solely due to runoff-related circumstances, as described in paragraph (d)(3) of this section, or rating-related circumstances, as described in paragraph (d)(4) of this section; and

(iii) Reports an amount of applicable insurance liabilities that is at least 10 percent of the amount of the total assets on the corporation's applicable financial

statement for the applicable reporting period.

(2) *Predominantly engaged in an insurance business*—(i) *In general.* A foreign corporation is not considered predominantly engaged in an insurance business in any taxable year unless more than half of the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. This determination is made based on the character of the business actually conducted in the taxable year. The fact that a foreign corporation has been holding itself out as an insurer for a long period is not determinative of whether the foreign corporation is predominantly engaged in an insurance business.

(ii) *Facts and circumstances.* Facts and circumstances to consider in determining whether a foreign corporation is predominantly engaged in an insurance business include (but are not limited to)—

(A) Claims payment patterns for the current year and prior years;

(B) The foreign corporation's loss exposure as calculated for a regulator or for a credit rating agency, or, if those are not calculated, for internal pricing purposes;

(C) The percentage of gross receipts constituting premiums for the current and prior years; and

(D) The number and size of insurance contracts issued or taken on through reinsurance by the foreign corporation.

(iii) *Examples of facts indicating a foreign corporation is not predominantly engaged in an insurance business.* Examples of facts that may indicate a foreign corporation is not predominantly engaged in an insurance business include (but are not limited to)—

(A) A small overall number of insured risks with low likelihood but large potential costs;

(B) Employees and agents of the foreign corporation focused to a greater degree on investment activities than underwriting activities; and

(C) Low loss exposure.

(3) *Runoff-related circumstances.* During the annual reporting period covered by the applicable financial statement, a foreign corporation fails to satisfy the 25 percent test solely due to runoff-related circumstances only if the corporation—

(i) Was engaged in the process of terminating its pre-existing, active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)) under the supervision of its applicable insurance regulatory body

or pursuant to any court-ordered receivership proceeding (liquidation, rehabilitation, or conservation) and fails to satisfy the 25 percent test because the corporation is required to hold additional assets due to its business being in runoff;

(ii) Has no plan or intention to enter into, and did not issue or enter into, any insurance, annuity, or reinsurance contract, other than a contractually obligated renewal of an existing insurance contract or a reinsurance contract pursuant to and consistent with the termination of its active conduct of an insurance business; and

(iii) Made payments during the annual reporting period covered by the applicable financial statement as required to satisfy claims under insurance, annuity, or reinsurance contracts.

(4) *Rating-related circumstances.* A foreign corporation fails to satisfy the 25 percent test solely due to rating-related circumstances only if—

(i) The 25 percent test is not met due to capital and surplus amounts that a generally recognized credit rating agency considers necessary for the foreign corporation to obtain a public rating with respect to its financial strength, and the foreign corporation maintains such capital and surplus in order to obtain the minimum credit rating necessary for the annual reporting period by the foreign corporation to be able to write the business in its regulatory or board supervised business plan. This paragraph (c)(4)(i) applies only if the foreign corporation is a mortgage insurance company (as defined in paragraph (f)(10) of this section) or if more than half of the foreign corporation's net written premiums for the annual reporting period (or the average of the net written premiums for the foreign corporation's annual reporting period and the two immediately preceding annual reporting periods) are from insurance coverage against the risk of loss from a catastrophic loss event (that is, a low frequency but high severity loss event); or

(ii) The foreign corporation is a financial guaranty insurance company (as defined in paragraph (f)(5) of this section).

(5) *Election*—(i) *In general.* A United States person may make the election under section 1297(f)(2) for its taxable year if the foreign corporation directly provides the United States person a statement, signed by a responsible officer of the foreign corporation or an authorized representative of the foreign corporation, or the foreign corporation (or its foreign parent corporation on its

behalf) makes a publicly available statement (such as in a public filing, disclosure statement, or other notice provided to United States persons that are shareholders of the foreign corporation) that it satisfied the requirements of section 1297(f)(2) and paragraph (d)(1) of this section during the foreign corporation's applicable reporting period. However, a United States person may not rely upon any statement by the foreign corporation (or its foreign parent corporation) to make the election under section 1297(f)(2) if the shareholder knows or has reason to know based on reasonably accessible information that the statement made by the foreign corporation (or its foreign parent corporation) was incorrect.

(ii) *Information provided by foreign corporation.* In addition to a statement that the foreign corporation satisfied the requirements of section 1297(f)(2) and paragraph (d)(1) of this section, the statement described in paragraph (d)(5)(i) of this section also must include:

(A) The ratio of applicable insurance liabilities to total assets for the applicable reporting period; and

(B) A statement indicating whether the failure to satisfy the 25 percent test described in paragraph (c) of this section was the result of runoff-related or rating-related circumstances, along with a brief description of those circumstances.

(iii) *Time and manner for making the election.* Except as provided in paragraph (d)(5)(iv), the election described in paragraph (d)(1) of this section may be made by a United States person who owns stock in the foreign corporation by completing the appropriate part of Form 8621 (or successor form) for each taxable year of the United States person in which the election applies. A United States person must attach the Form 8621 (or successor form) to its original or amended Federal income tax return for the taxable year of the United States person to which the election relates. A United States person can attach the Form 8621 (or successor form) to an amended return for the taxable year of the United States person to which the election relates if the United States person can demonstrate the reason for not filing the form with its original return was due to reasonable cause.

(iv) *Deemed election for small shareholders in publicly traded companies*—(A) *In general.* A United States person who owns publicly traded stock in a foreign corporation will be deemed to make the election under section 1297(f)(2) with respect to the foreign corporation and its subsidiaries

if the following requirements are satisfied:

(1) The stock of the foreign corporation that is owned by the United States person (including stock owned indirectly) has a value of \$25,000 or less (\$50,000 or less in the case of a joint return) on the last day of the United States person's taxable year and on any day during the taxable year on which the United States person disposes of stock of the foreign corporation; and

(2) If the United States person owns stock of the foreign corporation indirectly through a domestic partnership, domestic trust, domestic estate, or S corporation (a *domestic pass-through entity*), the stock of the foreign corporation that is owned by the domestic pass-through entity has a value of \$25,000 or less on the last day of the taxable year of the domestic pass-through entity that ends with or within the United States person's taxable year and on any day during the taxable year of the domestic pass-through entity on which it disposes of stock of the foreign corporation.

(B) *Publicly traded stock.* For the purpose of paragraph (d)(5)(iv)(A) of this section, stock is publicly traded if it would be treated as marketable stock within the meaning of section 1296(e) and § 1.1296-2 (without regard to § 1.1296-2(d)) if the election under section 1297(f)(2) is not made.

(v) *Options.* If a United States person is considered to own stock in a foreign corporation by reason of holding an option, the United States person may make the election under section 1297(f)(2) (or may be deemed to make an election under paragraph (d)(5)(iv) of this section) with respect to the foreign corporation or its subsidiaries in the same manner as if the United States person owned stock in the foreign corporation.

(6) *Stock ownership.* For purposes of this section, ownership of stock in a foreign corporation means either direct ownership of such stock or indirect ownership determined using the rules specified in § 1.1291-1(b)(8).

(e) *Rules limiting the amount of applicable insurance liabilities—(1) In general.* For purposes of determining whether a foreign corporation satisfies the 25 percent test described in paragraph (c) of this section or the 10 percent test described in paragraph (d)(1)(iii) of this section, the rules of this paragraph (e) apply to limit the amount of applicable insurance liabilities of the foreign corporation.

(2) *General limitation on applicable insurance liabilities.* The amount of applicable insurance liabilities may not exceed any of the amounts described in

paragraphs (e)(2)(i) to (iii) of this section. This paragraph (e)(2) applies after applying paragraph (e)(3) of this section.

(i) The amount of applicable insurance liabilities of the foreign corporation shown on any financial statement that the foreign corporation filed or was required to file with its applicable insurance regulatory body for the financial statement's applicable reporting period;

(ii) If the foreign corporation's applicable financial statement is prepared on the basis of either GAAP or IFRS, the amount of the foreign corporation's applicable insurance liabilities determined on the basis of its applicable financial statement, whether or not the foreign corporation files the statement with its applicable insurance regulatory body; or

(iii) The amount of applicable insurance liabilities required for the foreign corporation by the applicable law or regulation of the jurisdiction of the applicable insurance regulatory body at the end of the applicable reporting period (or a lesser amount of applicable insurance liabilities, if the foreign corporation is holding a lesser amount as a permitted practice of the applicable regulatory body).

(3) *Discounting.* If an applicable financial statement or a financial statement described in paragraph (e)(2) of this section is prepared on the basis of an accounting method other than GAAP or IFRS and does not discount applicable insurance liabilities on an economically reasonable basis, the amount of applicable insurance liabilities may not exceed the amount of applicable insurance liabilities on the financial statement reduced by applying the discounting methods that would apply under either GAAP or IFRS to the insurance or annuity contracts to which the applicable insurance liabilities at issue relate. The foreign corporation may choose whether to apply either GAAP or IFRS discounting methods for this purpose.

(4) [Reserved].

(5) [Reserved].

(f) *Definitions.* The following definitions apply for purposes of this section.

(1) *Applicable financial statement.* The term *applicable financial statement* means the foreign corporation's financial statement prepared for financial reporting purposes, listed in paragraphs (f)(1)(i) through (iii) of this section, and that has the highest priority. The financial statements are, in order of descending priority—

(i) *GAAP statements.* A financial statement that is prepared in accordance with GAAP;

(ii) *IFRS statements.* A financial statement that is prepared in accordance with IFRS; or

(iii) *Regulatory annual statement.* A financial statement required to be filed with the applicable insurance regulatory body.

(iv) [Reserved].

(2) *Applicable insurance liabilities—*
(i) *In general.* The term *applicable insurance liabilities* means, with respect to any life or property and casualty insurance business—

(A) Reported losses (which are expected payments to policyholders for sustained losses related to insured events under an insurance contract that have occurred and have been reported to, but not paid by, the insurer as of the financial statement end date), and incurred but not reported losses (which are expected payments to policyholders for sustained losses relating to insured events under an insurance contract that have occurred but have not been reported to the insurer as of the financial statement end date);

(B) Unpaid loss adjustment expenses (including reasonable estimates of anticipated loss adjustment expenses) associated with investigating, defending, settling, and adjusting paid losses, unpaid reported losses, and incurred but not reported losses (of the type described in paragraph (f)(2)(i)(A) of this section) as of the financial statement end date; and

(C) The aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held as of the financial statement end date to mature or liquidate potential, future claims for death, annuity, or health benefits that may become payable under contracts providing, at the time the reserve is computed, coverage for mortality or morbidity risks;

(D) Provided, however, that—

(1) No item or amount shall be taken into account more than once in determining applicable insurance liabilities;

(2) The applicable insurance liabilities eligible to be taken into account in applying this paragraph (f)(2) include only the applicable insurance liabilities of the foreign corporation whose QIC status is being determined; and

(3) [Reserved].

(ii) *Amounts not specified in paragraph (f)(2)(i) of this section.* Amounts not specified in paragraph (f)(2)(i) of this section are not applicable insurance liabilities. For example, the term *applicable insurance liability* does

not include any amount held by an insurance company as a deposit liability that is not an insurance liability, such as a funding agreement, a guaranteed investment contract, premium or other deposit funds, structured settlements, or any other substantially similar contract issued by an insurance company. The term applicable insurance liabilities also does not include the amount of any reserve for a life insurance or annuity contract the payments of which do not depend on the life or life expectancy of one or more individuals.

(3) *Applicable insurance regulatory body.* The term *applicable insurance regulatory body* means the entity that has been established by law to license or authorize a corporation to engage in an insurance business, to regulate insurance company solvency, and, in the case of an applicable financial statement described in paragraph (f)(1)(iii), is the entity to which the applicable financial statement is provided.

(4) *Applicable reporting period.* The term *applicable reporting period* is the last annual reporting period for a financial statement ending with or within the taxable year of a U.S. person owning stock in a foreign corporation, within the meaning of paragraph (d)(6) of this section.

(5) *Financial guaranty insurance company.* The term *financial guaranty insurance company* means any insurance company whose sole business is to insure or reinsure only the type of business written by, or that would be permitted to be written by a company licensed under, and compliant with, a U.S. state law, modeled after the Financial Guaranty Insurance Guideline as established by National Association of Insurance Companies, that specifically governs the licensing and regulation of financial guaranty insurance companies.

(6) *Financial statements*—(i) *In general.* The term *financial statement* means a statement prepared for a legal entity for a reporting period in accordance with the rules of a financial accounting or statutory accounting standard that includes a complete balance sheet, statement of income, and a statement of cash flows (or equivalent statements under the applicable reporting standard).

(ii) [Reserved].

(iii) [Reserved].

(7) *Generally accepted accounting principles or GAAP.* The term *generally accepted accounting principles or GAAP* means United States generally accepted accounting principles described in standards established and

made effective by the Financial Accounting Standards Board.

(8) *Insurance business.* For purposes of this section, § 1.1297–5, and § 1.1297–6, *insurance business* means the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support (or are substantially related to) insurance, annuity, or reinsurance contracts issued or entered into by the foreign corporation.

(9) *International financial reporting standards or IFRS.* The term *international financial reporting standards or IFRS* means accounting standards established and made effective by the International Accounting Standards Board.

(10) *Mortgage insurance company.* For purposes of this section, *mortgage insurance company* means any insurance company whose sole business is to insure or reinsure against a lender's loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor.

(11) *Total assets.* For purposes of section 1297(f) and this section, a foreign corporation's *total assets* are the aggregate value of the real property and personal property that the foreign corporation reports on its applicable financial statement as of the financial statement end date.

(g) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning after December 31, 2017 and before January 14, 2021, provided that, with respect to a tested foreign corporation, it consistently applies the provisions of this section and § 1.1297–6 for such year and all subsequent years.

§ 1.1297–5 [Reserved].

§ 1.1297–6 Exception from the definition of passive income for active insurance income.

(a) *Scope.* This section provides rules pertaining to the exception from passive income under section 1297(b)(2)(B) for income derived in the active conduct of an insurance business and rules related to certain income of a qualifying domestic insurance corporation. Paragraph (b) of this section provides a general rule that excludes from passive income certain income of a qualifying insurance corporation (QIC), as defined in § 1.1297–4(b), and certain income of a qualifying domestic insurance

corporation. Paragraph (c) of this section provides rules excluding certain assets for purposes of the passive asset test under section 1297(a)(2). Paragraph (d) of this section provides rules concerning the treatment of income and assets of certain look-through subsidiaries and look-through partnerships of a QIC. Paragraph (e) of this section provides rules relating to qualifying domestic insurance corporations. Paragraph (f) of this section provides the applicability date of this section.

(b) *Exclusion from passive income of active insurance income.* For purposes of section 1297 and § 1.1297–1, passive income does not include—

(1) Income that a QIC derives in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)); and

(2) Income of a qualifying domestic insurance corporation.

(c) *Exclusion of assets for purposes of the passive asset test under section 1297(a)(2).* For purposes of section 1297 and § 1.1297–1, passive assets (as defined in § 1.1297–1(f)(5)), do not include—

(1) Assets of a QIC available to satisfy liabilities of the QIC related to its insurance business (as defined in § 1.1297–4(f)(8)), if the QIC is engaged in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)); and

(2) Assets of a qualifying domestic insurance corporation.

(d) *Treatment of income and assets of certain look-through subsidiaries and look-through partnerships for purposes of the section 1297(b)(2)(B) exception—*

(1) *General rule.* For purposes of applying paragraphs (b)(1) and (c)(1) of this section, a QIC is treated as receiving the income or holding the assets of a look-through subsidiary or look-through partnership to the extent provided in section 1297(c) and § 1.1297–2(b)(2) or § 1.1297–2(b)(3). Subject to the limitation of paragraph (d)(2) of this section, a QIC's proportionate share of the income or assets of a look-through subsidiary or look-through partnership may be treated as earned or held directly by the QIC, and thus as non-passive under paragraphs (b)(1) and (c)(1) of this section, if the requirements of those paragraphs are satisfied.

(2) *Limitation.* A QIC that is engaged in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)) may not treat its proportionate share of the income or assets of a look-through subsidiary or look-through partnership as non-passive to the extent that it exceeds the greater of—

(i) The QIC's proportionate share of the income or assets, respectively, of the look-through subsidiary or look-through partnership multiplied by a fraction, the numerator of which is the net equity value of the interests held by the QIC in the look-through subsidiary or look-through partnership, and the denominator of which is the value of the QIC's proportionate share of the assets of the look-through subsidiary or look-through partnership; and

(ii) The QIC's proportionate share of the income or assets, respectively, of the look-through subsidiary or look-through partnership that are treated as non-passive in the hands of the look-through subsidiary or look-through partnership.

(3) *Examples.* The following examples illustrate the rules of this section.

(i) *Example 1: QIC holds all the stock of an investment subsidiary—(A) Facts.*

(1) F1 is a foreign corporation. In Year 1, F1 meets the definition of a QIC under section 1297(f) and § 1.1297-4 and is engaged in the active conduct of an insurance business within the meaning of section 1297(b)(2)(B). Throughout Year 1, F1 owns all the stock of F2, a foreign corporation that is not a QIC and is engaged solely in the investment of passive assets. The stock of F2 is an asset that is available to satisfy liabilities of F1 related to its insurance business within the meaning of paragraph (c)(1) of this section. The assets of F1 are measured on the basis of value under § 1.1297-1(d)(1)(v)(C).

(2) Throughout Year 1, F2 owns assets with a value of \$1,000x and adjusted bases of \$500x, all of which are treated as passive in the hands of F2. F2 has outstanding debt with a principal amount of \$250x. On the financial statement end date of F1's applicable financial statement, the net equity value of the F2 stock held by F1 is \$750x. In Year 1, F2 earned \$100x of income that is treated as passive in the hands of F2.

(B) *Result—(1)* Because F1 owns all of the stock of F2, F2 is a look-through subsidiary of F1 within the meaning of § 1.1297-2(g)(3). Under section 1297(c) and § 1.1297-2(b)(2), F1 is treated as if it held 100% of the assets of F2 and received directly 100% of the income of F2. Under paragraph (d)(1) of this section, because F1 is engaged in the active conduct of an insurance business and the stock of F2 is an asset that is available to satisfy the insurance liabilities of F1, F1 treats its proportionate share of the income and assets of F2 as non-passive. The amount of income and assets that is treated as non-passive is subject to the limitation of paragraph (d)(2) of this section.

(2) Under paragraph (d)(2) of this section, the amount of F1's

proportionate share of F2's income that is treated as non-passive cannot exceed the greater of two amounts: \$75x, which is F1's proportionate share of F2's income (\$100x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is \$750x, divided by the value of F1's proportionate share of F2's assets, which is \$1,000x); and zero, which is F1's proportionate share of the income of F2 that is treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of F2's income, \$75x is treated as non-passive, and \$25x is treated as passive.

(3) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that is treated as non-passive cannot exceed the greater of two amounts: \$750x, which is F1's proportionate share of F2's assets (\$1,000x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is \$750x, divided by the value of F1's proportionate share of F2's assets, which is \$1,000x); and zero, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2, \$750x is treated as non-passive, and \$250x is treated as passive.

(C) *Alternative facts—(1) Facts.* The facts are the same as in paragraph (d)(3)(i)(A) of this section (paragraph (A) of this Example 1), except that the assets of F1 are measured on the basis of adjusted basis under § 1.1297-1(d)(1)(v)(C) pursuant to a valid election under § 1.1297-1(d)(1)(iii).

(2) *Result.* The result with respect to F1's proportionate share of the income of F2 is the same as in paragraph (d)(3)(i)(B)(2) of this section (paragraph (B)(2) of this Example 1). Because the assets of F1 are measured on the basis of adjusted basis under § 1.1297-1(d)(1)(v)(C), F1's proportionate share of the passive assets of F2 is equal to \$500x (100% of \$500x adjusted bases). Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that may be treated as non-passive cannot exceed the greater of two amounts: \$375x, which is F1's proportionate share of F2's passive assets (\$500x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is \$750x, divided by the value of F1's proportionate share of F2's assets, which is \$1,000x); and zero, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2,

\$375x is treated as non-passive, and \$125x is treated as passive.

(ii) *Example 2: QIC holds all the stock of an operating subsidiary—(A) Facts.*

(1) F1 is a foreign corporation. In Year 1, F1 meets the definition of a QIC under section 1297(f) and § 1.1297-4 and is engaged in the active conduct of an insurance business within the meaning of section 1297(b)(2)(B). Throughout Year 1, F1 owns all the stock of F2, a foreign corporation engaged in a manufacturing business that is not a QIC. The stock of F2 is an asset that is available to satisfy liabilities of F1 related to its insurance business within the meaning of paragraph (c)(1) of this section. The assets of F1 are measured on the basis of value under § 1.1297-1(d)(1)(v)(C).

(2) Throughout Year 1, F2 owns assets with a value of \$1,200x, of which \$1,000x is treated as non-passive and \$200x is treated as passive in the hands of F2. F2 has outstanding debt of \$600x. On the financial statement end date of F1's applicable financial statement, the net equity value of the F2 stock held by F1 is \$600x. In Year 1, F2 earned \$120x of income, of which, in the hands of F2, \$100x is treated as non-passive and \$20x is treated as passive.

(B) *Result—(1)* Because F1 owns all the stock of F2, F2 is a look-through subsidiary of F1 within the meaning of § 1.1297-2(g)(3). Under section 1297(c) and § 1.1297-2(b)(2), F1 is treated as if it held 100% of the assets of F2 and received directly 100% of the income of F2. Under paragraph (d)(1) of this section, because F1 is engaged in the active conduct of an insurance business and the stock of F2 is an asset that is available to satisfy the insurance liabilities of F1, F1 treats its proportionate share of the income and assets of F2 as non-passive. The amount of income and assets that is treated as non-passive is subject to the limitation of paragraph (d)(2) of this section.

(2) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's income that is treated as non-passive cannot exceed the greater of two amounts: \$60x, which is F1's proportionate share of F2's income (\$120x) multiplied by 50% (the net equity value of the F2 stock held by F1, which is \$600x, divided by the value of F1's proportionate share of F2's assets, which is \$1,200x); and \$100x, which is F1's proportionate share of the income of F2 that is treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of F2's income, \$100x is treated as non-passive, and \$20x is treated as passive.

(3) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that is treated as non-passive cannot exceed the greater of two amounts: \$600x, which is F1's proportionate share of F2's income (\$1,200x) multiplied by 50% (the net equity value of the F2 stock held by F1, which is \$600x, divided by the value of F1's proportionate share of F2's assets, which is \$1,200x); and \$1,000x, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2, \$1,000x is treated as non-passive, and \$200x is treated as passive.

(e) *Qualifying domestic insurance corporation*—(1) *General rule.* A domestic corporation (or a foreign corporation that is treated as a domestic corporation pursuant to a valid section 953(d) election and that computes its reserves as a domestic insurance company would under subchapter L) is a qualifying domestic insurance corporation if it is—

- (i) Subject to tax as an insurance company under subchapter L of the Internal Revenue Code;
- (ii) Subject to federal income tax on its net income; and
- (iii) A look-through subsidiary of a tested foreign corporation.

- (2) [Reserved].
- (3) [Reserved].

(f) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning after December 31, 2017 and before January 14, 2021, provided that, with respect to a tested foreign corporation, it consistently applies the provisions of this section and § 1.1297-4, for such year and all subsequent years.

■ **Par. 7.** Section 1.1298-0 is amended by:

- 1. Revising the introductory text.
- 2. Adding entries for §§ 1.1298-2 and 1.1298-4 in numerical order.

The revision and additions read as follows:

§ 1.1298-0 Passive foreign investment company—table of contents.

This section contains a listing of the paragraph headings for §§ 1.1298-1, 1.1298-2, 1.1298-3, and 1.1298-4.

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§ 1.1298-2 Rules for certain corporations changing businesses.

- (a) Overview.
- (b) Change of business exception.
- (c) Special rules.

(d) Disposition of stock in a look-through subsidiary or partnership interests in a look-through partnership.

(e) Application of change of business exception.

- (f) Examples.
 - (1) Example 1.
 - (i) Facts.
 - (ii) Results.
 - (2) Example 2.
 - (i) Facts.
 - (ii) Results.
- (g) Applicability date.

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1.1298-4 Rules for certain foreign corporations owning stock in 25-percent-owned domestic corporations.

- (a) Overview.
- (b) Treatment of certain foreign corporations owning stock in a 25-percent-owned domestic corporation.

- (1) General rule.
- (2) Qualified stock and second-tier domestic corporation.

(c) Indirect ownership of stock through a partnership.

- (d) Section 531 tax.
 - (1) Subject to section 531 tax.
 - (2) Waiver of treaty benefits.

(i) Tested foreign corporation that files, or is required to file, a Federal income tax return.

(ii) Tested foreign corporation that is not required to file a Federal income tax return.

- (e) Anti-abuse rule.
 - (1) General rule.
 - (2) [Reserved].
 - (3) [Reserved].
- (f) Applicability date.

■ **Par. 8.** Section 1.1298-2 is added to read as follows:

§ 1.1298-2 Rules for certain corporations changing businesses.

(a) *Overview.* This section provides rules under section 1298(b)(3) and 1298(g) that apply to certain foreign corporations that dispose of one or more active trades or businesses for purposes of determining whether a foreign corporation is treated as a passive foreign investment company (PFIC). Paragraph (b) of this section provides a rule that applies to certain foreign corporations that dispose of one or more active trades or businesses. Paragraph (c) of this section provides special rules. Paragraph (d) of this section provides a rule for the treatment of the disposition of the stock of a look-through subsidiary (as defined in § 1.1297-2(g)(3)) or partnership interests in a look-through partnership (as defined in § 1.1297-2(g)(4)). Paragraph (e) of this section provides guidance on when a tested foreign corporation can apply the change of business exception. Paragraph (f) provides examples illustrating the application of the rules in this section. Paragraph (g) provides the applicability date for this section.

(b) *Change of business exception.* A corporation is not treated as a PFIC for a taxable year if—

(1) Neither the corporation (nor any predecessor) was a PFIC for any prior taxable year;

(2) Either—

(i) Substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses; or

(ii) Following the disposition of one or more active trades or businesses, substantially all of the passive assets of the corporation on each of the measuring dates that occur during the taxable year and after the disposition are attributable to proceeds from the disposition; and

(3) The corporation reasonably does not expect to be and is not a PFIC for either of the first two taxable years following the taxable year.

(c) *Special rules.* The rules in this paragraph (c) apply for purposes of section 1298(b)(3) and this section.

(1) Income is attributable to proceeds from the disposition of one or more active trades or businesses to the extent the income is derived from the investment of the proceeds from the disposition of assets used in the active trades or businesses.

(2) Assets are attributable to proceeds from the disposition of one or more active trades or businesses only to the extent the assets are the proceeds of the disposition of assets used in the active trades or businesses, or are derived from the investment of the proceeds.

(3) The determination of the existence of an active trade or business and whether assets are used in an active trade or business is made under § 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). However, if activities performed by the officers and employees of a look-through subsidiary of a corporation (including a look-through subsidiary with respect to which paragraph (d) of this section applies) or of a look-through partnership would be taken into account by the corporation pursuant to § 1.1297-2(e) if it applied, such activities are taken into account for purposes of the determination of the existence of an active trade or business and the determination of whether assets are used in an active trade or business.

(4) In the case of a corporation that satisfies the condition in paragraph (b)(2)(ii) of this section, the condition in paragraph (b)(3) of this section is deemed to be satisfied if the corporation

completely liquidates by the end of the taxable year following the year with respect to which the tested foreign corporation applies the exception in paragraph (b) of this section.

(d) *Disposition of stock of a look-through subsidiary or partnership interests in a look-through partnership.* For purposes of paragraph (b) of this section, the proceeds from a tested foreign corporation's disposition of the stock of a look-through subsidiary or of partnership interests in a look-through partnership are treated as proceeds from the disposition of a proportionate share of the assets held by the look-through subsidiary or look-through partnership on the date of the disposition, based on the method (value or adjusted bases) used to measure the assets of the tested foreign corporation for purposes of section 1297(a)(2). The proceeds attributable to assets used by the look-through subsidiary or look-through partnership in an active trade or business are treated as proceeds attributable to the disposition of an active trade or business.

(e) *Application of change of business exception.* A tested foreign corporation can apply the exception in paragraph (b) of this section with respect to a taxable year of a disposition of an active trade or business or an immediately succeeding taxable year, but cannot apply the exception with respect to more than one taxable year for a disposition.

(f) *Examples.* The following examples illustrate the rules of this section. For purposes of these examples: USP is a domestic corporation; TFC and FS are foreign corporations that are not controlled foreign corporations (within the meaning of section 957(a)); each corporation has outstanding a single class of stock; USP has owned its interest in TFC since the formation of TFC; each of USP, TFC, and FS have a calendar taxable year; and for purposes of section 1297(a)(2), TFC measures the amount of its assets based on value.

(1) *Example 1—(i) Facts.* (A) USP owns 15% of the outstanding stock of TFC. TFC owns 30% of the outstanding stock of FS. FS operates an active trade or business and 100% of its assets are used in the active trade or business. The value of FS's non-passive assets (as defined in § 1.1297-1(f)(3)) is \$900x; the value of FS's passive assets (which include cash and cash equivalents) is \$100x. TFC has not been treated as a PFIC for any taxable year before Year 1 and has no predecessor. In addition to holding the FS stock, TFC directly conducts its own active trade or business. The value of TFC's non-passive assets (other than FS stock) is

\$50x; the value of TFC's passive assets (other than FS stock and assets received during Year 1) is \$30x. TFC earns \$1x of non-passive income (as defined in § 1.1297-1(f)(4)) from its directly conducted active trade or business.

(B) On January 1, Year 1, TFC sells all of its FS stock for \$300x. The residual gain computed under § 1.1297-2(f)(1) on the sale of the FS stock is \$10x. Under § 1.1297-2(f)(3), \$9x of residual gain is characterized as non-passive income and \$1x of residual gain is characterized as passive income. TFC earned \$5x of passive income from the investment of the proceeds from the disposition of the FS stock during each quarter of Year 1, and TFC maintained those earnings (\$20x in total) as well as the disposition proceeds in cash for the remainder of the year. TFC reinvests the proceeds of the FS stock sale in an active trade or business during Year 2, and, thus, TFC is not a PFIC in Year 2 and Year 3. Less than 75% of TFC's gross income in Year 1 is passive income ($(\$20x + \$1x)/(\$10x + \$20x + \$1x) = 68\%$). However, subject to the application of section 1298(b)(3) and this section, TFC would be a PFIC in Year 1 under section 1297(a)(2) because the proceeds from the sale of the FS stock (\$300x) together with TFC's other passive assets exceed 50% of TFC's total assets on each quarterly measuring date. For example, on the first quarterly measuring date TFC's ratio of passive assets to total assets is $(\$300x + \$30x + \$5x)/(\$300x + \$30x + \$5x + \$50x)$ and on the fourth quarterly measuring date TFC's ratio of passive assets to total assets is $(\$300x + \$30x + \$20x)/(\$300x + \$30x + \$20x + \$50x)$, each of which exceeds 87%. Therefore, TFC chooses to apply the change of business exception in paragraph (b) of this section to Year 1.

(ii) *Results.* (A) Under paragraph (d) of this section, for purposes of applying section 1298(b)(3)(B)(i) in Year 1, TFC's proceeds from the disposition of the stock of FS that are attributable to assets used by FS in an active trade or business are considered as from the disposition of an active trade or business. Because 100% of FS's assets are used in its active trade or business, all of TFC's proceeds are considered as from the disposition of an active trade or business. Therefore, under paragraph (c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is \$20x (from investment of disposition proceeds). Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of section 1298(b)(3)

and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(i) of this section, because the 95% ($\$20x/(\$20x + \$1x)$) of TFC's passive income for Year 1 that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive income.

(B) TFC would also not be treated as a PFIC in Year 1 by reason of section 1298(b)(3) and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, because the over 91% of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets. For example, on the first quarterly measuring date TFC's ratio of passive assets attributable to the proceeds of the disposition of FS's active trade or business to its total passive assets is 91% ($\$305x/(\$305x + \$30x)$), and the same ratio for the fourth quarterly measuring date is 91.4% ($\$320x/(\$320x + \$30x)$).

(C) Under paragraph (e) of this section, TFC cannot claim the section 1298(b)(3) exception in relation to the income attributable to the proceeds of the FS stock sale in Year 2 because TFC already claimed the exception for Year 1.

(2) *Example 2—(i) Facts.* The facts are the same as in paragraph (f)(1)(i) of this section (the facts in *Example 1*), except that during the first quarter of Year 1, TFC earned only \$4x of passive income (\$1x per quarter) from the investment of the proceeds from the disposition of the FS stock and earned \$12x of passive income (\$3x per quarter) from its other passive assets and maintained such earnings in cash for the remainder of the year.

(ii) *Results.* The results are the same as in paragraph (f)(1)(ii) of this section (the facts in *Example 1*), except that under paragraph (c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is \$4x (from investment of disposition proceeds). Because 24% ($\$4x/(\$4x + \$12x + \$1x)$) of TFC's passive income for Year 1 is attributable to proceeds of the disposition of FS's active trade or business, and 24% does not constitute substantially all of TFC's passive income for Year 1, TFC does not qualify for the exception from treatment as a PFIC in section 1298(b)(3) and paragraph (b)(2)(i) of this section for Year 1. However, under paragraphs (b)(2)(ii) and (d) of this section, more

than \$300x (\$300x disposition proceeds + amounts earned from investment of disposition proceeds) of TFC's passive assets held on each quarterly measuring date after the disposition is considered attributable to the disposition of an active trade or business. Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, assuming that the average 89% of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets.

(g) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning before January 14, 2021, provided that, with respect to the tested foreign corporation, the shareholder consistently applies the provisions of this section and § 1.1291-1(b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) and §§ 1.1297-1 (except that consistent treatment is not required with respect to § 1.1297-1(c)(1)(i)(A)), 1.1297-2, and 1.1298-4 for such year and all subsequent years.

■ **Par. 9.** Section 1.1298-4 is added to read as follows:

§ 1.1298-4 Rules for certain foreign corporations owning stock in 25-percent-owned domestic corporations.

(a) *Overview.* This section provides rules under section 1298(b)(7) that apply to certain foreign corporations that own stock in 25-percent-owned domestic corporations (as defined in paragraph (b) of this section) for purposes of determining whether a foreign corporation is a passive foreign investment company (PFIC). Paragraph (b) of this section provides the general rule. Paragraph (c) of this section provides rules concerning ownership of 25-percent-owned domestic corporations or qualified stock (as defined in paragraph (b)(2) of this section) through partnerships. Paragraph (d) of this section provides rules for determining whether a foreign corporation is subject to the tax imposed by section 531 (the section 531 tax) and for waiving treaty benefits that would prevent the imposition of such tax. Paragraph (e) of this section provides an anti-abuse rule for the application of section 1298(b)(7). Paragraph (f)

provides the applicability date for this section.

(b) *Treatment of certain foreign corporations owning stock in a 25-percent-owned domestic corporation—*
(1) *General rule.* Except as otherwise provided in paragraph (e) of this section, when a tested foreign corporation (as defined in § 1.1297-1(f)) is subject to the section 531 tax (or waives any benefit under any treaty that would otherwise prevent the imposition of the tax), and owns (directly or indirectly under the rules in paragraph (c) of this section) at least 25 percent (by value) of the stock of a domestic corporation (a 25-percent-owned domestic corporation), for purposes of determining whether the foreign corporation is a PFIC, any qualified stock held directly or indirectly under the rules in paragraph (c) of this section by the 25-percent-owned domestic corporation is treated as an asset that does not produce passive income (and is not held for the production of passive income), and any amount included in gross income with respect to the qualified stock is not treated as passive income.

(2) *Qualified stock and second-tier domestic corporation.* For purposes of this section, the term *qualified stock* means any stock in a C corporation that is a domestic corporation and that is not a regulated investment company or real estate investment trust and the term *second-tier corporation* means the corporation.

(c) *Indirect ownership of stock through a partnership.* For purposes of paragraph (b)(1) of this section, a tested foreign corporation that is a partner in a partnership is considered to own its proportionate share of any stock of a domestic corporation held by the partnership, and a domestic corporation that is a partner in a partnership is considered to own its proportionate share of any qualified stock held by the partnership. An upper-tier partnership's attributable share of the stock of a domestic corporation or of qualified stock held by a lower-tier partnership is treated as held by the upper-tier partnership for purposes of applying the rule in this paragraph (c).

(d) *Section 531 tax—*(1) *Subject to section 531 tax.* For purposes of paragraph (b) of this section, a tested foreign corporation is considered subject to the section 531 tax regardless of whether the tax is imposed on the corporation and of whether the requirements of § 1.532-1(c) are met.

(2) *Waiver of treaty benefits—*(i) *Tested foreign corporation that files, or is required to file, a Federal income tax return.* For purposes of paragraph (b) of

this section, a tested foreign corporation that files, or is required to file, a Federal income tax return waives the benefit under a treaty that would otherwise prevent the imposition of the section 531 tax by attaching to its original or amended return for the taxable year for which section 1298(b)(7) and paragraph (b)(1) of this section are applied or any prior taxable year a statement that it irrevocably waives treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years, provided the taxable year for which the return is filed and all subsequent taxable years are not closed by the period of limitations on assessments under section 6501.

(ii) *Tested foreign corporation that is not required to file a Federal income tax return.* For purposes of paragraph (b) of this section, a tested foreign corporation that is not required to file a Federal income tax return waives the benefit under a treaty that would otherwise prevent the imposition of the section 531 tax by a date no later than nine months following the close of the taxable year for which section 1298(b)(7) and paragraph (b)(1) of this section are applied by—

(A) Adopting a resolution or similar governance document that confirms that it has irrevocably waived any treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years, and maintaining a copy of the resolution (or other governance document) in its records; or

(B) In the case of a tested foreign corporation described in section 1297(e)(3), including in its public filings a statement that it irrevocably waives treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years.

(e) *Anti-abuse rule—*(1) *General rule.* Paragraph (b) of this section does not apply with respect to qualified stock in a second-tier domestic corporation owned by a 25-percent-owned domestic corporation if a principal purpose for the formation of, acquisition of, or holding of stock of the 25-percent-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 (as defined in § 1.1297-1(f)(5)) through the second-tier domestic corporation to avoid classification of the tested foreign corporation as a PFIC.

(2) [Reserved].

(3) [Reserved].

(f) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after

January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation, the shareholder consistently applies the provisions of this section and § 1.1291-

1(b)(8)(iv) and (b)(8)(v)(A), (B), (C), and (D) and §§ 1.1297-1 (except that consistent treatment is not required with respect to § 1.1297-1(c)(1)(i)(A)),

1.1297-2, and 1.1298-2 for such year and all subsequent years.

Sunita Lough,

Deputy Commissioner for Services and Enforcement.

Approved: November 19, 2020.

David J. Kautter,

Assistant Secretary of the Treasury (Tax Policy).

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