October 9, 2019

Hon. Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Proposed Regulations Under Sections 1291, 1297 and 1298 Regarding PFICs

Dear Commissioner Rettig:

Enclosed please find comments on Proposed Regulations under Sections 1291, 1297 and 1298 of the Internal Revenue Code regarding PFICs. These comments are submitted on behalf of the Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section of Taxation would be pleased to discuss these comments with you or your staff.

Sincerely,

Tom Callahan
Chair, Section of Taxation

Enclosure

cc: Hon. David Kautter, Assistant Secretary (Tax Policy), Department of the Treasury
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These comments ("Comments") are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Ethan Atticks and Charles Markham, with contributions and comments from Kevin Cunningham, Beverly Katz, Grace Kim, Chris Ocasal, John Owsley, Jason Tulis, Lori Hellkamp, and Amie Colwell Breslow. They were reviewed by Edward Tanenbaum of the Committee on Government Submissions and Eric B. Sloan, Vice Chair – Government Relations for the Tax Section.

Although members of the Section may have clients who might be affected by the federal tax principles addressed by these Comments, no member who has been engaged by a client (or is a member of a firm or other organization that has been engaged by a client) to make a government submission with respect to, or otherwise to influence the development or outcome of one or more of the specific issues addressed by these Comments has participated in the preparation of the portion (or portions) of these Comments addressing those issues. Additionally, while the Section’s diverse membership includes government officials, no such official was involved in any part of the drafting or review of these Comments.

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Date:  October 9, 2019
I. EXECUTIVE SUMMARY

The Department of Treasury ("Treasury") and the Internal Revenue Service (the "Service"), on July 11, 2019, released proposed regulations under sections 1291, 1297, and 1298 (the "Proposed Regulations"),¹ which address a number of long-standing questions arising under the Passive Foreign Investment Company ("PFIC") regime regarding the proper application of the PFIC ownership attribution rules, the PFIC asset and income tests (the “Asset Test” and the “Income Test,” respectively), and the PFIC look-through rules.² The Proposed Regulations also provide guidance regarding the status of a foreign corporation as a qualifying insurance corporation ("QIC") under section 1297(f) and the amount of income that is excluded from its passive income pursuant to section 1297(b)(2)(B) (the “PFIC Insurance Exception”), as amended by the Public Law 115-97 enacted on December 22, 2017 (the “Act”).³ In addition, on June 21, 2019, Treasury and the Service released proposed regulations under section 958 (the "Section 958 Proposed Regulations"), together with proposed and final regulations under section 951A, that would treat a domestic partnership as an aggregate of its partners for purposes of determining the subpart F inclusions of its partners (thereby potentially causing the controlled foreign corporation ("CFC") to be treated as a PFIC with respect to U.S. partners that are not themselves U.S. shareholders entitled to CFC/PFIC overlap protection under section 1297(d)).⁴

We commend Treasury and the Service for the issuance of the Proposed Regulations, which provide needed guidance on several long-standing questions related to the fundamental exercise of determining PFIC status. In addition, we recommend that certain issues be clarified or addressed as part of final PFIC and section 958 Regulations. In this regard, we have identified certain issues under the Proposed Regulations and the Section 958 Proposed Regulations that have significant and immediate impact on taxpayers and with respect to which we respectfully submit the following comments and recommendations. These Comments do not address provisions in the Proposed Regulations that relate specifically to the PFIC Insurance Exception.

The following is a summary of the issues and recommendations discussed in these Comments:

A. Elimination of double counting under section 1297(c) with respect to rents and royalties (and related assets)

- Recommendation: Modify Proposed Regulation section 1.1297-2(c) so as to provide for the elimination of intercompany rental and royalty income, and the

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2 Unless otherwise indicated, all “section” or “§” references are to the Internal Revenue Code of 1986, as amended (the “Code” or “I.R.C.”), and all “Reg. §,” “Temp. Reg. §,” and “Prop. Reg. §” references are to the final, temporary, and proposed regulations, respectively, promulgated under the Code (collectively, the “Regulations”).

3 An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018, 131 Stat. 2054 (2017).

corresponding lease and license agreements, in applying the Income Test and the Asset Test, respectively, to a tested foreign corporation (“TFC”) with Look-Through Subsidiaries and Look-Through Partnerships (defined below) in proportion to the TFC’s direct and indirect ownership in the Look-Through Subsidiary or Partnership.

B. **Maintenance of the foreign personal holding company income (“FPHCI”) exception for banking and financing income under section 954(h) after final Regulations under section 1297(b)(2)(A) are issued**

- **Recommendation:** Because the FPHCI active financing exception of section 954(h) applies to a different range of financing entities engaged in active businesses than the PFIC Banking Exception of section 1297(b)(2)(A), preserve the FPHCI active financing exception for PFIC testing purposes even after Regulations under section 1297(b)(2)(A) are finalized.

C. **Clarification of the manner of making PFIC elections and non-application of section 1297(d) at the domestic partnership level once the Section 958 Proposed Regulations become effective**

- **Recommendation:** Clarify that, once the Section 958 Proposed Regulations become effective, while the overlap rule under section 1297(d) (the “Overlap Rule”) no longer applies at the partnership level, elections and income inclusions under the PFIC rules continue to be handled at the partnership (rather than partner) level.

D. **Clarification of the treatment of stapled entities as a single entity for PFIC election and income inclusion purposes**

- **Recommendation:** Clarify how stapled entities that are treated as a single entity for purposes of determining their PFIC status should be treated for election and income inclusion purposes (i.e., if they are still viewed as a single entity or, once their PFIC status is determined, they are then treated as separate entities).

E. **Application of section 1297(b)(2)(C) when the related payor has no current income or earnings and profits (“E&P”) and treatment of stock of a related person with respect to which no dividends are received or accrued for the taxable year**

- **Recommendation:** With respect to interest payments, modify Proposed Regulation section 1.1297-1(c)(3)(i) to provide that, at the election of the TFC, or if the related party payor has no gross income in the current year, the interest is treated as allocable to passive and non-passive income of the related person under the principles of Temporary Regulation section 1.861-9T.

- **Recommendation:** With respect to dividend payments, because dividends paid during a taxable year are not necessarily sourced solely from current E&P but may
also be sourced out of accumulated E&P of the related person, modify Proposed Regulation section 1.1297-1(e)(3)(ii) to provide that a TFC should allocate dividend income (i) based on both current and accumulated E&P to which such dividend is attributable and (ii) by using, for purposes of such allocation, the method provided under section 316 (i.e., a last-in-first-out (“LIFO”) approach).

- **Recommendation:** Modify Proposed Regulation section 1.1297-1(d)(2)(iii) to provide that the value of stock of a related person with respect to which no dividends are received or accrued during a taxable year should be apportioned between passive and non-passive asset characterization in proportion to the average percentage of dividends that were characterized as passive and non-passive, respectively, for the last two years in which dividends were actually paid by the related person. If the TFC has never received any dividend payments with respect to the stock of the related person, the value of such stock should be apportioned between passive and non-passive in proportion to the average percentage of the related person’s undistributed earnings that were characterized as passive and non-passive, respectively, for the last two years in which the related person actually generated any earnings. If the related person has never generated any earnings, the value of the stock should be apportioned between passive and non-passive in proportion to the amount of passive and non-passive earnings reasonably expected to be generated in the reasonably foreseeable future.

**F. Adoption of an aggregate approach with respect to partnership interests, regardless of ownership threshold, for PFIC testing purposes**

- **Recommendation:** Modify Proposed Regulation section 1.1297-2(c) to provide that, regardless of a TFC’s ownership percentage interest in the partnership, the partnership should be treated as a Look-Through Partnership (defined below) and the TFC should be treated (i) as receiving directly its share of partnership income and (ii) as holding its proportionate share of partnership assets (the “aggregate approach”).

- **Recommendation:** If insufficient information is available to make a determination under the aggregate approach, only then characterize a minority partnership interest and the corresponding income as per se passive.

**G. Elimination of the new limitations on the Domestic Subsidiary Look-Through Rule under section 1298(b)(7), including for purposes of the section 1298(a)(2) ownership attribution rules**

- **Recommendation:** Eliminate the anti-abuse rules of Proposed Regulation section 1.1298-4(f).
• **Recommendation:** Eliminate Proposed Regulation section 1.1298-4(e) so as to permit the Domestic Subsidiary Look-Through Rule under section 1298(b)(7) to continue to be taken into account in determining PFIC status for section 1298(a)(2) ownership attribution purposes.

II. **Detailed Discussion**

A. **Elimination of double counting under section 1297(c) with respect to rents and royalties (and related assets)**

1. **The Proposed Regulations**

Under section 1297(c), a TFC is treated as earning its proportionate share of the income and holding its proportionate share of the assets of any 25% or greater owned (determined by value) subsidiary corporation (a “Look-Through Subsidiary”) for purposes of applying the Income Test and Asset Test to the TFC (the “General Look-Through Rule”). This approach would potentially double count assets and income if, for example, the shares of the Look-Through Subsidiary (and dividends paid with respect to the Look-Through Subsidiary’s stock) were not eliminated.

The Proposed Regulations therefore provide that intercompany payments of dividends and interest between a Look-Through Subsidiary and the TFC, as well as the stock and debt receivables, are eliminated in applying the Income Test and the Asset Test, respectively.\(^5\) To qualify for elimination in the case of dividends, the payment must be attributable to income of a Look-Through Subsidiary that was included in gross income by the TFC for purposes of determining its PFIC status.\(^6\)

The Proposed Regulations also extend this treatment to (i) intercompany payments between two Look-Through Subsidiaries of a TFC and the associated stock and debt receivables and (ii) stock and debt investments in a lower-tier Look-Through Subsidiary for purposes of applying the Income Test and Asset Test to the TFC.

In the case of a TFC that owns less than 100% of a Look-Through Subsidiary, the Proposed Regulations provide that debt receivables and interest are eliminated in proportion to the shareholder’s direct and indirect ownership (by value) in the Look-Through Subsidiary, while stock and dividends are eliminated in their entirety.

The Proposed Regulations also provide for eliminating partnership interests in and distributions from a “Look-Through Partnership” (defined as a partnership in which the TFC owns at least

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\(^5\) Prop. Reg. § 1.1297-2(c)(1) and (2).

\(^6\) Prop. Reg. § 1.1297-2(c)(2).
25% of the value on the relevant date), as well as eliminating intercompany debt receivables and interest paid or accrued thereon between a TFC and a Look-Through Partnership.

Treasury and the Service requested comments regarding whether rents, royalties, or any other types of intercompany income, and any related assets, also should be eliminated (as well as comments on how to effectuate the elimination of such income and assets).

2. Comment

As highlighted in the preamble to the Proposed Regulations, the legislative history to section 1297(c) provides that, for PFIC testing purposes, because section 1297(c) disregards the separate corporate existence of the Look-Through Subsidiary (and, instead, treats the income and assets of the Look-Through Subsidiary as earned and held directly by the TFC), “amounts such as interest and dividends received from foreign or domestic subsidiaries” (i.e., Look-Through Subsidiaries) should be ignored, as should the stock and debt investments in the Look-Through Subsidiaries.

The elimination of income received by the tested entity and the assets held by the tested entity that are attributable to the Look-Through Subsidiary prevents the so-called “double counting” of income and assets at the TFC level. That is, the income received by the Look-Through Subsidiary (which the TFC is deemed to receive directly) would presumably support the dividend or interest payment that the Look-Through Subsidiary makes to the TFC. Similarly, the value of the Look-Through Subsidiary stock is attributable to the value of the assets held by the Look-Through Subsidiary. Thus, regarding these items of income and assets at both the Look-Through Subsidiary and the TFC levels could give rise to double counting and character distortion issues for purposes of the PFIC tests by increasing the proportion of active or passive income and assets of the TFC by magnifying the impact of the items derived from the Look-Through Subsidiary. Such double counting issues were first acknowledged by the Joint Committee on Taxation in its General Explanation of the Tax Reform Act of 1986.

Therefore, the elimination of intercompany payments of dividends and interest between a Look-Through Subsidiary or Partnership and the TFC, or between two Look-Through Subsidiaries of a TFC, as well as stock and debt receivables, in applying the PFIC tests is a welcome provision that furthers Congressional intent.

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8 Prop. Reg. § 1.1297-2(c)(3).
9 The 1986 Bluebook stated, “Under this look-through rule, amounts such as interest and dividends received from foreign or domestic subsidiaries are to be eliminated from the recipient’s income in applying the Act’s income test and the shareholder’s stock investment is to be eliminated from its assets in applying the Act’s asset use test.” Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (1987) at 1026 (the “1986 Blue Book”).
10 In 1988, Congress amended section 1297(c) by adding the parenthetical “(directly or indirectly)” to clarify that the look-through rule may apply to multiple tiers of Look-Through Subsidiaries.
However, intercompany rent and royalty payments (and the corresponding lease and license agreements) raise the same double counting concern present in the context of dividends and interest payments (and stock and debt receivables) and, thus, we believe should be similarly eliminated for the purpose of determining whether the TFC is a PFIC. For example, when a Look-Through Subsidiary pays royalties to a sister Look-Through Subsidiary, the gross income of the payor that is used to fund the payment could be double counted by the TFC – once when earned by the payor, and a second time when the amount of the royalty is received by the payee – which could distort the application of the PFIC tests to the TFC in the same way that an interest payment could.

The elimination of rent and royalty payments (and related assets) is also consistent with the legislative history under section 1297(c), which suggests that the exclusion of interest and dividend amounts (and related assets) are not intended as exclusive examples of payments between a Look-Through Subsidiary and the TFC that may cause an undesired double counting result. The use of the phrase “such as” in describing the exclusion of such items for PFIC testing purposes makes clear that Congress thought it may be appropriate to eliminate other items of income (and related assets) in applying the PFIC tests with respect to a TFC with Look-Through Subsidiaries.

Therefore, we recommend that Treasury and the Service modify Proposed Regulation section 1.1297-2(c) to provide for the elimination of such rent and royalty income, and the corresponding lease and license agreements, in applying the Income Test and the Asset Test, respectively, to a TFC with Look-Through Subsidiaries and Look-Through Partnerships in proportion to the TFC’s direct and indirect ownership (by value) in the Look-Through Subsidiary or Partnership.

B. Maintenance of the FPHCI exception for banking and financing income under section 954(h) after final regulations under section 1297(b)(2)(A) are issued

1. The Proposed Regulations

Under the Income Test, a TFC will be treated as a PFIC if 75% or more of its gross income for the taxable year is “passive income.” Passive income for this purpose is defined in section 1297(b)(1) as any income of a kind that would be FPHCI, as defined in section 954(c).

The “Present Law” sections of the Congressional reports accompanying the 1988 Act, the committees provided:

Under this look-through rule, a foreign corporation that owns at least 25 percent of the stock of another corporation is treated as owning a proportionate part of the other corporation’s assets and income. Thus, amounts such as interest and dividends received from foreign or domestic subsidiaries are eliminated from the shareholder’s income in applying the income test and the stock or debt investment is eliminated from the shareholder’s assets in applying the asset test. (Emphasis added.) H.R. Rep. No. 100-795 at 268 (1988); and S. Rep. No. 100-445 at p. 282 (1988).
The Code includes a number of exceptions to the definition of FPHCI for subpart F purposes (i.e., exceptions in section 954(c), (h) and (i)), and there has been uncertainty as to whether those exceptions also apply in determining “passive income” for purposes of the Income Test.

The Proposed Regulations provide that the definition of “passive income” is determined by reference to the items of income listed in section 954(c)(1), subject only to certain exceptions of section 954, including the one provided under section 954(h), which provides for an exception to the definition of FPHCI for income derived by a CFC in the active conduct of a banking, financing, or similar business (the “FPHCI active financing exception”). According to the preamble to the Proposed Regulations, “given that no final regulations under the PFIC regime provide rules concerning an exclusion of active banking and financing income, these proposed regulations provide that the FPHCI exception for banking and financing income under section 954(h) applies for purposes of determining PFIC status.”

Comments were requested on whether the FPHCI active financing exception of section 954(c)(h) should continue to apply for PFIC testing purposes once regulations under section 1297(b)(2)(A) (the “PFIC Banking Exception,” described below), are finalized.

2. Comment

The PFIC Banking Exception of section 1297(b)(2)(A) provides an express exception to “passive income” for PFIC testing purposes for income derived in the 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 the Regulations, by any other corporation. In Notice 89-81 (the “Foreign Banking Notice”), the Service provided guidance on the characterization of income derived in a banking business by a foreign bank that is not licensed to do business as a bank in the United States, and in 1995, Treasury issued proposed regulations that would apply the PFIC Banking

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11 The Proposed Regulations provide that the definition of “passive income” is subject to the exceptions found in sections 954(c)(1), 954(c)(2)(A) (active business exception), 954(c)(2)(B) (export financing interest exception), 954(c)(2)(C) (dealer exception), 954(c)(4) (sales of certain partnership interests), 954(c)(5) (certain commodity hedging transactions), and 954(h) (active banking, financing, or similar business exception). See Prop. Reg. § 1.1297-1(c)(1)(i)(A) and (C). The Proposed Regulations do not incorporate the exceptions to FPHCI under sections 954(c)(3) (same-county exception), 954(c)(6) (CFC look-through exception), and 954(i) (active insurance exception). See Prop. Reg. § 1.1297-1(c)(1)(i)(B).


13 1988-1 C.B. 489.

14 The Foreign Banking Notice stated that the rules set forth therein would be incorporated in future Regulations and that taxpayers could rely on the notice until such Regulations were published. The Foreign Banking Notice has not been withdrawn and is still in force.

15 See Prop. Reg. § 1.1296-4, Notice of Proposed Rulemaking, Exceptions to Passive Income Characterization for Certain Foreign Banks and Securities Dealers, 60 Fed. Reg. 20,922 (Apr. 28, 1995). The 1995 Banking Proposed Regulations were proposed to be effective for taxable years beginning after 1994, but stated that they would allow taxpayers to apply the rules contained therein to a taxable year beginning after 1986, provided that the taxpayer consistently applied such rules to all subsequent years. (The 1995 Banking Proposed Regulations were proposed before the PFIC Code sections were renumbered in 1997.)
Exception for foreign corporations engaged in a banking business (the “1995 Banking Proposed Regulations”). These proposed regulations, which have never been finalized and therefore are not effective, generally would adopt the guidelines in the Foreign Banking Notice, but liberalize some of the tests therein.

The FPHCI active financing exception of section 954(h) excludes “qualified banking or financing income” of an eligible CFC from FPHCI treatment. An “eligible” CFC is one that (i) is predominantly engaged in the active conduct of a banking, financing, or similar business and (ii) conducts substantial activity with respect to such business. Broadly, in relevant part, a CFC is predominantly engaged in the active conduct of a banking, financing, or similar business if more than 70% of its gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with customers which are not related persons. A lending or finance business includes the business of making loans.

Accordingly, although the PFIC and subpart F exceptions may overlap in many circumstances, the PFIC Banking Exception – which generally does not apply to non-banking financing companies (e.g., entities that otherwise “actively” make loans to customers but rely on their own capital, rather than deposits, for funding) – is narrower than the FPHCI active financing exception, which extends the subpart F exception beyond banks to other active finance businesses. If the FPHCI active financing exception were made inapplicable for PFIC purposes, several active non-bank financing businesses across various industries – such as leasing companies, brokers or dealers in securities, credit unions, mortgage lenders and servicers, and securities clearinghouses – could be treated as PFICs. Thus, the maintenance of the FPHCI active financing exception for PFIC purposes, even after the finalization of the Regulations under section 1297(b)(2)(A), is critical in cases where an active financing company does not satisfy the narrow PFIC Banking Exception (because, e.g., it is a foreign bank that does not take sufficient deposits or an active financing company that is not a licensed bank). In such cases, section 954(h) would provide such financing company another avenue (i.e., under the FPHCI active financing exception) for treating its income as active for PFIC testing purposes. We believe retaining the section 954(h) exception is appropriate because section 1297 cross-references FPHCI under section 954(c) to define “passive income.” Active financing income contemplated

16 Under the 1995 Banking Proposed Regulations (i) banking income earned by an “active bank” is non-passive income, and (ii) a foreign bank is an “active bank” if it meets a licensing requirement and it actively conducts, within the meaning of Temporary Regulation section 1.367(a)-2T(b)(3), a banking business that is a trade or business within the meaning of Temporary Regulation section 1.367(a)-2T(b)(2). Prop. Reg. § 1.1296-4(b)(2). (Former Temporary Regulation sections 1.367(a)-2T(b)(2) and (3) were finalized as Regulation section 1.367(a)-2(d)(2) and (3), respectively. See Final Regulations, Treatment of Certain Transfers of Property to Foreign Corporations, 81 Fed. Reg. 91,012 (Dec. 16, 2016).) In addition, in order for the business conducted by a foreign corporation to be considered a banking business for these purposes, the foreign corporation must also meet certain deposit-taking requirements and lending requirements.

17 For example, regarding the deposit-taking test, Proposed Regulation section 1.1296-4(d) provides that a foreign corporation satisfies such test if, among other things, the amount of deposits accepted in the ordinary course of its trade or business and shown on the corporation’s balance sheet is substantial, which is determined based on all the facts and circumstances. The test in the 1995 Banking Proposed Regulations is more flexible than the Foreign Banking Notice requirement that deposits constitute at least 50% of the total liabilities of the bank.
by section 954(h) is not FPHCI within the meaning of section 954(c). Accordingly, absent a showing of Congressional intent to carve out this otherwise applicable exception to the definition of FPHCI, we believe the better interpretation is that this exception should be taken into account.

Further, the requirements for meeting the exception under section 954(h) (e.g., the foreign corporation must derive 70% of its gross income from the active conduct of a lending or finance business from transactions with unrelated persons and generally must conduct substantially all activities necessary to run the business through its own employees) are designed to ensure that the foreign corporation is engaging in real business activity. As such, it seems appropriate to apply the FPHCI active financing exception in the PFIC context since it applies to foreign corporations that are predominantly engaged in active businesses.

Therefore, because the FPHCI active financing exception of section 954(h) applies to a wider range of financing entities engaged in active businesses than those contemplated by the PFIC Banking Exception, we recommend that the FPHCI active financing exception be preserved for PFIC testing purposes even after regulations under section 1297(b)(2)(A) are finalized.

C. Clarification of the manner of making PFIC elections and non-application of section 1297(d) at the domestic partnership level once the Section 958 Proposed Regulations become effective

1. The Proposed Regulations

On June 21, 2019, Treasury and the Service released proposed and final regulations under section 951A related to implementing the global intangible low-tax income (“GILTI”) rules. Under these regulations, a domestic partnership is treated as an aggregate of its partners for purposes of determining its partners’ GILTI inclusions and for purposes of any other provision that applies by reference to section 951A or the regulations thereunder (e.g., sections 959, 960, and 961). And to ensure consistent treatment across the GILTI and subpart F regimes, the Section 958 Proposed Regulations (issued the same day as the proposed and final Regulations under section 951A) extended to subpart F the aggregate approach applicable to GILTI, providing that “for purposes of section 951 and section 951A, and for purposes of any other provision that applies by reference to section 951 or section 951A, a domestic partnership is not treated as owning stock of a foreign corporation within the meaning of section 958(a).”

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18 Reg. § 1.951A-1(e)(1).
20 Prop. Reg. § 1.958-1(d)(1). The Section 958 Proposed Regulations are effective for tax years of foreign corporations beginning on or after the finalization date. See Prop. Reg. § 1.958-1(d)(4). However, taxpayers may apply and rely on the Section 958 Proposed Regulations for tax years beginning after December 31, 2017, provided they do so consistently. Id.

Under both the final GILTI Regulations and the Section 958 Proposed Regulations, the aggregate rule for domestic partnerships does not apply for purposes of determining whether a U.S. person is a U.S. shareholder, whether a U.S. shareholder is a controlling domestic shareholder (as defined in Regulation section 1.964-1(c)(5)), and whether a foreign corporation is a CFC. Reg. § 1.951A-1(e)(2); Prop. Reg. § 1.958-1(d).
Treasury and the Service requested comments with respect to the application of the PFIC regime after finalization of the Section 958 Proposed Regulations, and specifically,

whether elections (including elections under sections 1295 and 1296) and income inclusions under the PFIC rules are more appropriately made at the level of the domestic partnership or at the level of the partners. Specifically, the Treasury Department and the IRS are considering the operation of the PFIC regime where U.S. persons are partners of a domestic partnership that owns stock of a foreign corporation that is a PFIC, some of those partners might themselves be U.S. shareholders of the foreign corporation, and the foreign corporation might not be treated as a PFIC with respect to such U.S. shareholders under section 1297(d) if the foreign corporation is also a CFC. (Emphasis added.)

2. Comment

The proposed aggregate treatment of a domestic partnership for subpart F purposes raises questions as to (i) how the Overlap Rule of section 1297(d) (discussed below) applies to U.S. persons that own through a domestic partnership stock of a foreign corporation that is treated as a CFC based on the domestic partnership’s ownership, (ii) whether any such U.S. persons that are not U.S. shareholders of the CFC are subject to the PFIC rules, and (iii) how a qualified electing fund (“QEF”) election is made with respect to such shareholders.21

According to section 1297(d), a corporation is not treated as a PFIC with respect to a shareholder during the qualified portion of such shareholder’s holding period with respect to the stock in such corporation (i.e., the Overlap Rule). “Qualified portion” is defined as a shareholder’s holding period which is after December 31, 1997, and during which the shareholder is a U.S. shareholder (as defined in section 951(b)) of the corporation and the corporation is a CFC.22

Based on the language of the statute, in order for the Overlap Rule to apply, (i) the shareholder must be a U.S. shareholder (as defined in section 951(b)) and (ii) the PFIC must be a CFC (as defined in section 957(a)) – but there is no statutory requirement that the U.S. shareholder be subject to subpart F inclusions under section 951. The Section 958 Proposed Regulations treat a domestic partnership as an aggregate for purposes of determining subpart F inclusions (thus causing the partnership not to be subject to subpart F inclusions and looking instead through to the U.S. partners that qualify as U.S. shareholders under section 951(b) to determine potential subpart F inclusions). The Section 958 Proposed Regulations do, however, retain the treatment

21 In two private letter rulings (“PLRs”), the Service interpreted the Overlap Rule to mean that if a domestic partnership owned ten percent or more of a foreign corporation that was both a CFC and a PFIC, the domestic partnership itself would receive overlap protection under section 1297(d). As a result, less than ten percent shareholders of such a CFC through the domestic partnership were generally not subject to the PFIC rules. See, e.g., PLR 201106003 (Feb. 11, 2011); PLR 200943004 (Oct. 23, 2009). However, those PLRs were issued before the issuance of the Section 958 Proposed Regulations. Because partners that own less than ten percent of a CFC held through a partnership would no longer be subject to subpart F inclusions under the Section 958 Proposed Regulations (as a result of the aggregate treatment to domestic partnerships), it does not seem that the position taken by the IRS in such PLRs would continue to apply with respect to such partners.

22 I.R.C. § 1297(d)(2).
of a domestic partnership as an entity for purposes of determining whether a U.S. person is a U.S. shareholder and whether a foreign corporation is a CFC (with the effect that a domestic partnership can still be a U.S. shareholder of a CFC under section 951(b), even if it will not have inclusions).

This treatment – whereby a domestic partnership can be a U.S. shareholder of a CFC yet it and (some or all of) its partners are not subject to subpart F inclusions – raises the question as to whether a domestic partnership would still be subject to the Overlap Rule as a U.S. shareholder of a CFC, and/or whether its U.S. partners should benefit from Overlap Rule protection instead.

Moreover, to the extent any U.S. partners are not subject to the Overlap Rule (i.e., because they do not separately qualify as U.S. shareholders under section 951(b)) and instead are subject to the PFIC rules with respect to the CFC once the Section 958 Proposed Regulations become effective, it also raises the question of how a QEF election should be made. Currently, the partnership (rather than the partners) must make the QEF (or mark-to-market (“MTM”)) election for PFIC stock held by a domestic partnership.23 One might assume that the U.S. partners (and not the domestic partnership) would be required to make a QEF election, because they generally would be the relevant persons with inclusion requirements under either the PFIC or subpart F and GILTI rules once the Section 958 Proposed Regulations become effective.24

The legislative history under section 1297(d) makes clear Congress’s intent to protect a shareholder that may be subject to current inclusion under both the subpart F and the PFIC regimes: “a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the PFIC provisions with respect to the same stock.”25 However, according to Congress, “[t]he PFIC provisions continue to apply in the case of a PFIC that is also a CFC to shareholders that are not subject to subpart F…”26

Because the domestic partners, not the domestic partnership, would take into account subpart F income under the Section 958 Proposed Regulations, it would no longer be necessary to provide overlap protection to the domestic partnership under section 1297(d). In contrast, the U.S. partners that are ten percent U.S. shareholders of the CFC under section 951(b) and subject to subpart F inclusions may independently qualify for overlap protection, which is necessary to ensure they are not concurrently subject to both the PFIC regime and subpart F inclusions on the same income. It would be helpful therefore if final Regulations confirmed that, after the Section 958 Proposed Regulations become effective (i) the PFIC rules still will not apply with respect to a U.S. shareholder partner since such partner’s share of subpart F income will be reported directly by the partner, and (ii) section 1297(d) disregards the holding period in PFIC stock of

23 Reg. § 1.1295-1(d)(2)(i).
26 Id.
any partner that is not a U.S. shareholder for section 1291 purposes during the period such partner included its share of the partnership’s subpart F income.

While the Section 958 Proposed Regulations and final GILTI Regulations have shifted to an aggregate approach for purposes of the subpart F and GILTI regimes such that there would be a logical consistency to also pushing PFIC inclusions and elections up to the partner level, we believe continuing to require QEF elections and inclusions at the partnership level is the better option for the practical reason of administrability. As a practical matter, it is often far more administratively feasible for a partnership to make the election on behalf of all partners. For any partners that are (also) U.S. shareholders with respect to a CFC owned by the partnership, the Overlap Rule would nevertheless operate at the partner level to exclude any otherwise applicable PFIC inclusion. Placing the burden of making and reporting elections and inclusions on all partners of a domestic partnerships holding stock in a PFIC (except for the U.S. shareholder that would instead be subject to the CFC rules) could be avoided if a partnership were permitted to continue to make a QEF election (as well as presumably collateral purging elections or MTM elections) on behalf of its partners. Further, taking this approach and removing overlap protection for the domestic partnership (such that it would clearly apply instead at the partner level) would be consistent with the existing rule that the domestic partnership makes the QEF election in the case of investments in non-CFC foreign corporations.27

We acknowledge this approach results in at least some conceptual inconsistency in the approach taken between the PFIC regime on the one hand and the subpart F and GILTI regimes on the other hand. It also adds at least some complexity in the sense that U.S. shareholder partners of a partnership that is itself a U.S. shareholder partners of a subpart F and GILTI inclusions at the partner level, while the partners that are not U.S. shareholders would have PFIC inclusions at the partnership level allocated to them.28 On balance, however, we feel this is still more workable, as a practical matter, than pushing the PFIC obligations and inclusions out to each partner.

Accordingly, we recommend that Treasury and the Service clarify that, when the Section 958 Proposed Regulations become effective, the Overlap Rule under section 1297(d) no longer applies to domestic partnerships, that elections (including elections under sections 1295 and 1296),29 resulting income inclusions, and reporting obligations under the PFIC rules should be made at the level of the domestic partnership (and not at the level of its partners), and that any

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27 In the case of a U.S. person that indirectly Invests in a PFIC through a domestic partnership, the domestic partnership generally must make the QEF election. See Reg. § 1.1295-1(d)(2)(i)(A) (“[a] domestic partnership that holds an interest in stock of a PFIC makes the section 1295 election with request to that PFIC”).

28 Appropriate adjustments to capital accounts and outside bases will be required.

29 Regarding the elections provided under the PFIC rules, while Regulation section 1.1295-1(d)(2)(i)(A) is clear in the sense that a domestic partnership through which a U.S. person indirectly invests in a PFIC must make the QEF election under section 1295, there is no such rule regarding the MTM election under section 1296, thus creating some uncertainty as to whether a domestic partnership must also make such election as a threshold matter. Although this issue is outside the scope of the Proposed Regulations (and, thus, of these Comments), we suggest that Treasury and the Service align the rules for QEF, purge and MTM elections to provide that these elections are all made at the domestic partnership level.
U.S. partners that separately qualify as U.S. shareholders with respect to a CFC held by the
domestic partnership are not subject to any QEF inclusions taken into account by the domestic
partnership.

D. Clarification of the treatment of stapled entities as a single entity for PFIC
election and income inclusion purposes

1. The Proposed Regulations

Under section 269B(c)(2), entities generally are considered “stapled” if over 50% in value of the
beneficial ownership in each entity consists of “stapled interests” – that is, if, in connection with
the transfer of one such interest, the other interest is also transferred or is required to be
transferred by reason of form of ownership, restrictions on transfer, or other similar terms or
conditions. The Proposed Regulations provide that when equity interests in two or more foreign
together the meaning of section 269B(c)(2), for purposes of applying the Asset
Test and Income Test, stapled entities are treated as one entity, that is, as a single entity that
holds all of the assets, conducts all of the activities, and derives all of the income of the stapled
entities.30

According to the preamble, such an approach is consistent with the treatment under section
269B(a)(3) for purposes of determining whether a stapled entity is a regulated investment
company (“RIC”) or real estate investment trust (“REIT”).

2. Comment

As noted above, the Proposed Regulations provide that, for purposes of determining PFIC status,
foreign stapled entities are treated as a single entity and, accordingly, the assets, activities, and
income of the stapled entities are collectively taken into account to determine their PFIC status.
Thus, a foreign stapled entity may be treated as a PFIC, even though its assets and income, if
viewed on an independent basis, would have otherwise failed the PFIC tests.

It is not completely clear, however, how foreign stapled entities that are collectively
determined to be a PFIC under the Proposed Regulations are then treated for PFIC taxation purposes (i.e., for
purposes of income inclusions under sections 1291, 1295, and 1296). Specifically, when one
stapled entity on its own would not be treated as a PFIC under the Income or Asset Tests, but
such entity is so treated when viewed as a single unit along with another stapled entity, are the
stapled entities treated as one PFIC for election and income inclusion purposes? Or, once their
PFIC status is determined, are they again treated as separate entities such that an election can be
made with respect to one of the stapled entities but not the other? It is also somewhat unclear
how to treat stapled entities for these purposes when not all of the equity of both entities is
stapled – for example, with respect to a holder of a non-stapled interest in an entity that, on a
stand-alone basis, would get a different PFIC result.

We respectfully request that Treasury and the Service clarify how stapled entities that are treated
as a single entity for purposes of determining PFIC status should be treated for election and

30 Prop. Reg. § 1.1297-1(e).
income inclusion purposes (i.e., whether they continue to be viewed as one single entity or, once their PFIC status is determined, they are then treated as separate entities).

E. Application of section 1297(b)(2)(C) when the related payor has no current income or E&P and treatment of stock of a related person with respect to which no dividends are received or accrued for the taxable year

1. The Proposed Regulations

Section 1297(b)(2)(C) (the “Related Person Look-Through Rule”) characterizes dividends, interest, rents and royalties (which, with certain exceptions, generally are treated as passive income) 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 income.

The Proposed Regulations give further guidance on such allocations by providing that, for purposes of the Related Person Look-Through Rule: (i) interest is properly allocable to income of the related person (payor) that is not passive income based on the relative portion of such related person’s income for its taxable year that ends in or with the taxable year of the recipient that is not passive income31 and (ii) dividends are treated as properly allocable to income of the related person (payor) that is not passive income based on the relative portion of such related person’s current-year E&P that is attributable to non-passive income for its taxable year that ends in or with the taxable year of the recipient.32

The Proposed Regulations do not expressly provide a general rule for characterizing the assets that give rise to income subject to the Related Person Look-Through Rule for purposes of the Asset Test. However, the Proposed Regulations provide an example that implies that such assets are characterized on a look-through basis in proportion to the respective amounts of passive and non-passive income they generate.33 In addition, the Proposed Regulations contain a specific rule for characterizing 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)34 – which likewise implies that assets that give rise to income subject to the Related Person Look-Through Rule are generally characterized on a look-through basis based on how the relevant income is characterized. In this respect, the Proposed Regulations generally adopt the approach taken in

33 See Prop. Reg. § 1.1297-1(d)(2)(iv), Example. A passive asset is defined as an asset that produces passive income, or is held for the production of passive income, “taking into account” the rules in Proposed Regulation section 1.1297-1(c) and (d). Prop. Reg. § 1.1297-1(f)(6). Proposed Regulation section 1.1297-1(c)(3) provides rules for characterizing payments from related persons. Characterizing assets on such a look-through basis is consistent with the legislative history of section 1297(b)(2)(C), which states that, as a corollary to the Related-Person Look-Through Rule, “the characterization of the assets that generate the income will follow the characterization of the income so that, for example, a loan to a related person will be treated as a non-passive asset if the interest on the loan is treated as non-passive income.” H.R. Rep. No. 100-795, at 272 (1988).
Notice 88-22 ("Notice 88-22")\(^{35}\) regarding "dual-character assets" (i.e., assets that produce both passive and non-passive income during a tax year) and provide that such assets are viewed as two separate assets for purposes of the Asset Test: one of which is non-passive and one of which is passive. Following such an approach, stock of a related person for which no dividends are received or accrued during the tax year but that previously generated non-passive income is treated, under the Proposed Regulations, as two assets (one of which is non-passive and the other passive), and the value is apportioned between these two assets in proportion to the average percentage of dividends that were characterized as passive income and non-passive income, respectively, for the previous two taxable years.\(^{36}\)

Comments were requested as to possible alternative methods of determining the portion of dividends treated as properly allocable to income of a related person (including if the payor has no current E&P), including by reference to accumulated E&P.

2. Comment

The characterization of interest and dividend income received from a related person between passive and non-passive income based on an allocation of the character (as passive or non-passive) of the payor’s income and E&P is a welcome clarification that is consistent with the purpose of section 1297(b)(2)(C), which is to provide a look-through exception for certain types of income that might otherwise be treated as passive income but that is not allocable to passive income of the related payor.\(^{37}\) We recommend, however, that the rule providing for the characterization of interest and dividend payments as passive or non-passive solely based on the related payor’s income and E&P for the current taxable year should be clarified to address situations in which such an allocation must be made for a taxable year during which the related person has no income or current-year E&P.

With respect to interest payments, we recommend that Proposed Regulation section 1.1297-1(c)(3)(i) be modified to provide that if the related party payor has no gross income in the current year, the interest is treated as allocable to passive and non-passive income of the related person under the principles of Temporary Regulation section 1.861-9T. We would further recommend that use of these principles be made available as an alternative method at the election of the TFC. This approach would generally give precedence to the more easily administered gross income approach, while providing a backup approach for special cases that is consistent with interest expense allocation under the general expense allocation and foreign tax credit look-through rules familiar to taxpayers and practitioners.

Regarding dividend payments, because dividends paid during a taxable year are not necessarily sourced solely from current E&P but may also be sourced from accumulated E&P of the related payor, we also recommend that, if Treasury and the Service decide to utilize an E&P approach,

\(^{35}\) 1988-1 C.B. 489. Notice 88-22 has been expanded on and modified by Notice 89-81, 1989-2 C.B. 399.

\(^{36}\) Prop. Reg. § 1.1297-1(d)(2)(iii).

\(^{37}\) The legislative history to section 1297(b)(2)(C) states that, in the case of payments of interest, rents, or royalties, the amount treated as passive will be the amount that is allocated against the passive income of the payor. H.R. Rep. No. 100-795, at 272 (1988).
Proposed Regulation section 1.1297-1(c)(3)(ii) be modified to provide that, for purposes of the Related Person Look-Through Rule, a TFC should allocate dividend income based on both current and accumulated E&P to which such dividend is attributable by applying the principles of section 316 (i.e., a LIFO approach). The computation of dividend income under section 316 as a general matter requires shareholders to determine the amount of a corporation’s current and accumulated earnings. Therefore, shareholders may be expected to have or be able to obtain information relating to a corporation’s prior year earnings, at least in the context of section 954(d)(3) related parties.

Regarding the rule that bifurcates stock of a related person with respect to which no dividends are received or accrued during the tax year but that had previously generated non-passive income into two assets (one of which is non-passive and the other passive) based on the dividends paid or accrued from the two prior years, we note there may be cases in which a related person has not paid dividends in more than two years. To address these cases, we recommend that Proposed Regulation section 1.1297-1(d)(2)(iii) be modified to provide that the value of stock of a related person with respect to which no dividends are received or accrued during a taxable year should be apportioned between passive and non-passive in proportion to the average percentage of dividends that were characterized as passive and non-passive, respectively, for the last two years in which dividends were actually paid by the related person. Furthermore, we recommend that: (i) to the extent that the TFC has never received any dividend payments with respect to the stock of the related person, the value of such stock should be apportioned between passive and non-passive in proportion to the average percentage of the related person’s undistributed earnings that were characterized as passive and non-passive, respectively, for the last two years in which the related person actually generated any earnings; and (ii) to the extent that the related person has never generated any earnings, the value of the stock should be apportioned between passive and non-passive in proportion to the amount of passive and non-passive earnings reasonably expected to be generated in the reasonably foreseeable future.

In addition, it would be helpful if the final regulations expressly stated the general rule (implied by the rules noted above) that assets that give rise to income subject to the Related Person Look-Through Rule are characterized based on the relative amounts of such income that are treated as passive and non-passive income for the year in question.

F. Adoption of an aggregate approach with respect to partnership interests, regardless of ownership threshold, for PFIC testing purposes

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38 Section 316 defines the term “dividend” to mean any distribution of property made by a corporation to its shareholders (1) out of its E&P accumulated after February 28, 1913, or (2) out of its E&P of the tax year, without regard to the amount of the E&P at the time the distribution was made. Except as otherwise provided, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. See section 316(a) (flush language).

39 We acknowledge this will not always be the case as a practical matter and shareholders may sometimes have difficulty obtaining this information.

1. The Proposed Regulations

Prior to the issuance of the Proposed Regulations, there was not express guidance on how partnership interests should be treated for purposes of applying the Income and Asset Tests. The Proposed Regulations provide that, for a partnership in which a TFC owns, directly or indirectly, at least 25% of the value (a Look-Through Partnership), the TFC is treated as (i) receiving directly its share of any item of income of the Look-Through Partnership and (ii) holding its proportionate share of the assets of the partnership. Additionally, for a Look-Through Partnership, the exceptions to passive income in section 1297(b)(2) and the relevant exceptions to FPHCI in section 954(c) and (h) are applied with respect to the partnership by taking into account only the activities of a Look-Through Partnership. For a partnership in which a TFC owns, directly or indirectly, less than 25% of the value, on the other hand, its interest in the partnership is treated as a passive asset, and the TFC’s distributive share of partnership income is treated as passive income (regardless of whether such income could have been excluded from FPHCI by virtue of the partnership’s activities).

The preamble to the Proposed Regulations explains that three different approaches were considered for determining when to treat the income and assets of a partnership as earned or held directly by the TFC: (i) apply no ownership threshold (i.e., similar to the treatment under the subpart F regime, a proportionate share – based on the foreign corporation’s capital or profits interest in the partnership – of the income and assets of the partnership would be considered as earned or held directly by the TFC, regardless of its ownership percentage in the partnership); (ii) apply a ten percent ownership threshold (i.e., a proportionate amount of the income and assets of the partnership would be considered as earned or held directly by the TFC, regardless of its ownership percentage in the partnership); (iii) apply the same 25% ownership threshold to partnership interests as is applied to interests in corporations under section 1297(c).

The first alternative was rejected in the Proposed Regulations based on the arguments that (i) an ownership interest of less than ten percent is unlikely to give the TFC significant control over the partnership activities so as to represent an active business interest; (ii) perceived differing policies underlying the subpart F regime and the PFIC regime would warrant different rules for partnerships; and (iii) providing a threshold for partnership interests that is lower than the one applicable to corporate interests would create incentives for foreign corporations to hold minority interests in partnerships rather than corporations solely for U.S. tax purposes (i.e., the classification of the entity as a partnership, as opposed to a corporation, would be driven solely by U.S. tax reasons). The second alternative was also dismissed because, according to Treasury and the Service, it would lead to differing treatment of minority interests in subsidiary corporations as opposed to partnerships, creating economic distortions. Therefore, the third

41 Prop. Reg. § 1.1297-1(c)(2)(i).
43 Id.
45 Prop. Reg. § 1.1297-1(c)(2)(ii).
approach was adopted by the Proposed Regulations to “maintain parity between the treatment of minority interests in corporations and partnership interest for PFIC testing purposes.”

Comments were requested on, among other things, whether a 25% threshold for the TFC’s percentage ownership in the partnership is the appropriate threshold, or whether an alternative threshold should be considered.

2. Comment

While confirmation of an aggregate approach for PFIC testing purposes, at least with respect to 25% or greater owned partnerships, is certainly welcome, we believe that such treatment should not be limited to TFCs that own 25%.

Congress found it appropriate to apply look-through treatment to a 25% owned corporation under section 1297(c), presumably because such an express look-through rule is required with respect to an otherwise opaque corporate entity. In contrast, no similar rule was codified with respect to partnerships, presumably because Congress considered look-through treatment as a given for partnerships, which are already transparent entities for general income tax purposes. Indeed, partnerships are pass-through entities treated as aggregates for many purposes of the Code.

Not only would the application of the aggregate approach to partnerships for PFIC testing purposes independent of an ownership threshold be consistent with the fundamental pass-through nature of partnerships and the aggregate theory of partnership taxation, it also would be consistent with the principles for determining subpart F income derived from holding an interest in a partnership. In general, in determining whether a CFC partner’s distributive share of an item of income of a partnership is FPHCI – a concept expressly imported by Congress into the PFIC regime – the FPHCI exceptions look to the activities of, and property owned by, the partnership, not the partners.46 Similarly, in characterizing a CFC’s distributive share of partnership income, Regulation section 1.952-1(g) treats a partnership as an aggregate of its partners and provides that “[a] [CFC’s] distributive share of any item of income of a partnership is income that falls within a category of subpart F income described in section 952(a) to the extent the item of income would have been income in such category if received by the [CFC] directly.” In both cases, these rules apply without regard to the CFC partner’s ownership percentage in the partnership.

Further, we note that a partner’s level of control or involvement in a partnership’s business is not generally relevant for purposes of characterizing the partner’s distributive share of partnership income for subpart F or other international tax purposes. According to the preamble, control over an entity is required to ensure that an interest in such an entity represents an active business interest. In our view, however, it is not the partnership interest that must be active so much as the partnership’s activities, in order to avoid FPHCI/“passive income” characterization. For example, and seemingly most relevant by analogy, there is no minimum threshold under section

875(l), pursuant to which a foreign partner is deemed engaged in its partnership’s U.S. trade or business for all purposes of subtitle A.

Finally, the preamble to the Proposed Regulations highlighted Treasury’s concern that a lower ownership threshold would create an incentive for foreign corporations to classify the entities in which they hold an interest as partnerships without meaningful economic effect. We would respectfully point out that partnership classification – whether organic or via a check-the-box election – can have very real U.S. and foreign effects, including under section 267A and analogous provisions of foreign law, as well as if there are any U.S. shareholders elsewhere in the ownership chain subject to subpart F or GILTI for which an allocable share of partnership income must be recognized. Making such an election would itself trigger U.S. tax consequences (e.g., under sections 331 and 336). Additionally, as a practical commercial consideration, a minority shareholder can rarely simply force a foreign corporation to make a U.S. tax election.47

In light of the foregoing, we respectfully recommend that Proposed Regulation sections 1.1297-1(c)(2) and 1.1297-1(d)(3) be modified to provide that, regardless of the TFC’s ownership percentage interest in the partnership, the partnership is treated as a Look-Through Partnership, such that a TFC would be treated for purposes of section 1297 as (i) receiving directly its share of any item of partnership income, (ii) holding its proportionate share of the partnership assets, and (iii) being able to look to the activities of the partnership for purposes of the exceptions to FPHCI (and thus “passive income”).

When, however, a taxpayer cannot obtain the necessary information from the foreign partnership in which it is a less-than-25% partner for purposes of the Income and Asset Tests, income received from and the interest in, such partnership could then be deemed per se passive. Such a “backup” to the general rule would address practical concerns of information availability.

Finally, if, notwithstanding the foregoing, Treasury and the Service decide to implement the 25% threshold for partnerships, we would recommend adoption of the rule on a prospective basis only and with a transition period to accommodate three decades of contrary market practice.

G. Elimination of the new limitations on the Domestic Subsidiary Look-Through Rule under section 1298(b)(7), including for purposes of the section 1298(a)(2) ownership attribution rules

1. The Proposed Regulations

Under section 1298(b)(7), if a TFC owns at least 25% (by value) of the stock of a domestic corporation, then any qualified stock held by such domestic corporation is, for purposes of determining whether the TFC is a PFIC, deemed to be a non-passive asset that does not produce passive income (and is not held for the production of passive income) and income received with respect to such stock is deemed to be non-passive income (the “Domestic Subsidiary Look-Through Rule”). For these purposes “qualified stock” is stock issued by a domestic C

47 See Reg. § 301.7701-3(c)(2)(i) (requiring the election to be made either by all members of the entity or by an officer, manager, or member with authority to make the election).
corporation that is neither a RIC nor a REIT. This rule applies only when the TFC is subject to the Accumulated Earnings Tax (“AET”) or “waives any benefit under any treaty which would otherwise prevent the imposition of” the AET.

The legislative history under section 1298(b)(7) provides that the Domestic Subsidiary Look-Through Rule was designed “to mitigate the potential disparate tax treatment resulting from PFIC status if U.S. shareholders hold domestic investments through a foreign holding company over U.S. shareholders that hold domestic investments through a U.S. holding company.”48 That is, this rule is intended to level the playing field for investment in the United States and ensure that U.S. shareholders that hold U.S. investments generally receive comparable tax treatment regardless of whether they hold such investments through a U.S. or a foreign entity.

The Senate report also clarifies Congress’s intention that the AET serve as a mechanism to prevent potential abuse of section 1298(b)(7). The report states: “[i]f a foreign investment company attempts to use [the Domestic Subsidiary Look-Through Rule] to avoid the PFIC provisions, it will be subject to the accumulated earnings tax and, thus, the shareholders of that company will be subject to tax treatment essentially equivalent to that of the shareholders of PFICs.”49 Thus, it appears Congress contemplated the possibility of taxpayers taking advantage utilizing section 1298(b)(7) to avoid PFIC status but concluded that the application of the AET sufficiently mitigated the potential for abuse.

The Senate report contemplates no limitations on the application of the mechanical Domestic Subsidiary Look-Through Rule other than the requirements discussed above. In fact, nothing in the statute or legislative history suggests that qualified stock and income derived with respect to qualified stock should be treated as anything other than per se non-passive assets under the circumstances contemplated by the statute. Further, historically there have not been any administrative constraints on its application.50

The Proposed Regulations introduce new, material restrictions on the availability and application of the Domestic Subsidiary Look-Through Rule. Specifically, the Proposed Regulations introduce two broad anti-abuse rules that, if triggered, effectively make the Domestic Subsidiary Look-Through Rule inapplicable for PFIC testing purposes.51 The Proposed Regulations also turn off the Domestic Subsidiary Look-Through Rule for purposes of the section 1298(a)(2) ownership attribution rules, with the result of attributing PFIC stock through lower-tier U.S. corporations regardless of a shareholder’s level of ownership.52

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49 Id.

50 The only administrative guidance predating the Proposed Regulations consisted of PLRs that appeared to affirm the appropriateness of applying the Domestic Subsidiary Look-Through Rule to manage PFIC status in certain cases. See PLR 201515006 (Apr. 10, 2015); PLR 201322009 (May 31, 2013).

51 Prop. Reg. § 1.1298-4(f).

52 See Prop. Reg. § 1.1298-4(e).
Regulations states that these anti-abuse rules are intended to address Treasury’s concern that a TFC may use the Domestic Subsidiary Look-Through Rule to avoid PFIC status either by holding predominantly passive assets through a two-tiered U.S. structure, or by acquiring or increasing U.S. holdings to “shelter” foreign passive assets otherwise held by the TFC for PFIC testing purposes.

The first anti-abuse rule (the “Qualified Stock Anti-Abuse Rule”) “turns off” the Domestic Subsidiary Look-Through Rule if, by excluding any qualified stock, the TFC would otherwise qualify as a PFIC. Essentially, this anti-abuse rule creates a precondition for application of the Domestic Subsidiary Look-Through Rule by (i) first testing the TFC without regard to qualified stock and (ii) then applying the rule but only if the TFC is not otherwise determined to be a PFIC. If the TFC, without regard to any qualified stock, would be a PFIC, the Domestic Subsidiary Look-Through Rule is inapplicable in testing the TFC for PFIC status.

Under the second, broader anti-abuse rule (the “Principal Purpose Anti-Abuse Rule”), the Domestic Subsidiary Look-Through Rule will not apply if a principal purpose for the TFC’s formation or acquisition of a 25% owned domestic corporation is to avoid PFIC status. A principal purpose to avoid classification of the TFC as a PFIC is deemed to exist when the 25% owned domestic corporation is not engaged in an active trade or business in the United States.

Thus, the application of the Domestic Subsidiary Look-Through Rule is limited by the Proposed Regulations in three ways: (i) it is not applied if the TFC would be a PFIC without regard to qualified stock (the Qualified Stock Anti-Abuse Rule); (ii) it is not applied if the domestic corporation was formed or acquired with a principal purpose of avoiding PFIC status, which is presumed to occur when the domestic corporation is not engaged in an active trade or business in the United States (the Principal Purpose Anti-Abuse Rule); and (iii) it is not applied for testing PFIC status for ownership attribution purposes under section 1298(a)(2).

Treasury and the Service requested comments on the application of the Domestic Subsidiary Look-Through Rule as limited by the Proposed Regulations.

2. Comment

   (a) The concern addressed by the Qualified Stock Anti-Abuse Rule of Proposed Regulation section 1.1298-4(f) was addressed by Congress in section 1298(b)(7)(A)(i)

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54 Id. Proposed Regulation section 1.1298-4(f)(2) also provides that the existence of an active trade or business is determined under Reg. § 1.367(a)-2(d)(2) and (3), except that officers and employees of the 25% owned domestic corporation do not include the officers and employees of related entities as provided in Regulation section 1.367(a)-2(d)(3). However, activities performed by the officers and staff of employees of a look-through subsidiary of the 25% owned domestic corporation or a partnership that would be taken into account by the corporation pursuant to Proposed Regulation section 1.1297-2(e) if it applied are taken into account for purposes of the determination of the existence of an active trade or business. Id.
Under the Qualified Stock Anti-Abuse Rule, the statutory Domestic Subsidiary Look-Through Rule is “turned off” if the TFC would qualify as a PFIC if the qualified stock or any income received with respect to the qualified stock were disregarded. Thus, if a TFC holds investments that are predominantly passive such that the TFC would be a PFIC if its U.S. holdings were ignored, the statutory Domestic Subsidiary Look-Through Rule would not apply. This is intended to address Treasury’s and the Service’s concerns by preventing any passive U.S. assets from causing the TFC to not be a PFIC by reason of section 1298(b)(7), while permitting non-passive assets and income of a second-tier domestic subsidiary to still be taken into account as non-passive assets and income for purposes of testing the TFC’s PFIC status under section 1297(c) (so long as the TFC owns at least 25% of the second-tier domestic subsidiary by value).

The legislative history to section 1298(b)(7), however, suggests that Congress specifically contemplated that section 1298(b)(7) could have the effect of treating otherwise passive U.S. investments as non-passive for PFIC testing purposes. Additionally, as discussed above, the legislative history confirms that Congress felt that section 1298(b)(7)(A)(i), which limits the application of Domestic Subsidiary Look-Through Rule to TFCs subject to AET under section 531, was sufficient to address abuse concerns. Moreover, the application of U.S. corporate income tax to, and U.S. withholding tax on distributions by, a domestic subsidiary serves as a practical limit on a TFC artificially over-weighting its investment assets in the U.S. ownership chain. U.S. corporations, which are generally subject to full U.S. taxation, are not what the PFIC regime was intended to target. We also note that Congress did not otherwise limit the scope of the Domestic Subsidiary Look-Through Rule or the extent to which qualified stock is treated as a non-passive asset.

Since the PFIC rules provide no relief for income of a PFIC that is already subject to U.S. tax, applying the Qualified Stock Anti-Abuse Rule to create PFIC status would cause the income generated from the assets held in a domestic subsidiary to be subject to PFIC taxation despite already being subject to at least two layers of U.S. taxation (once at the corporate level and, potentially, again when the domestic subsidiary distributes a dividend to the TFC).

In light of the above, we respectfully recommend that Treasury and the Service consider eliminating the Qualified Stock Anti-Abuse Rule of Proposed Regulation section 1.1298-4(f)(1).

(b) The Principal Purpose Anti-Abuse Rule of Proposed Regulation section 1.1298-4(f) appears to be inconsistent with Congressional intent

Under the Principal Purpose Anti-Abuse Rule, the Domestic Subsidiary Look-Through Rule will not apply if a principal purpose for the TFC’s formation or acquisition of any 25% owned domestic corporation is to avoid PFIC status. A principal purpose to avoid classification of the

56 See id.
TFC as a PFIC is deemed to exist when the 25% owned domestic corporation is not engaged in an active trade or business in the United States.

Given the Qualified Stock Anti-Abuse Rule discussed above, the Principal Purpose Anti-Abuse Rule generally would apply only if the income and assets of the TFC, excluding qualified stock, would not already cause it to be a PFIC. While the specific concern intended to be addressed by this broad, secondary anti-abuse rule is not completely clear, it may be intended to prevent the TFC from “right-sizing” the balance of passive versus non-passive income and assets by putting excess passive income and assets in a U.S. chain. However, as discussed above with respect to the Qualified Stock Anti-Abuse rule, Congress understood that the mechanical Domestic Subsidiary Look-Through Rule could be used affirmatively, but did not limit its application other than as provided in the Code. Further, the Principal Purpose Anti-Abuse Rule, by potentially disregarding the statutory Domestic Subsidiary Look-Through Rule in any case in which it is employed (through any acquisition or formation of a domestic corporation), would create significant uncertainty where the Domestic Subsidiary Look-Through rule is otherwise believed to apply.

Until now, taxpayers, practitioners, and the government have accepted that the Domestic Subsidiary Look-Through rule can appropriately mitigate the harsh results of mechanically applying the Asset and Income Tests to businesses that under a less mechanical test may be considered active. In this regard, the Domestic Subsidiary Look-Through Rule also compensates somewhat for the shortcomings of the startup and active business exceptions (for example, by managing PFIC status by voluntarily subjecting certain assets and income to U.S. taxation after large cash infusions from sales of businesses or public offerings). In fact, this practice appears to have been previously embraced by multiple PLRs that sanction the use of domestic subsidiaries to manage PFIC status. The Principal Purpose Anti-Abuse Rule would appear to effectively eliminate the continuing availability of this long-standing practice of relying on the Domestic Subsidiary Look-Through Rule to reduce the risk of the otherwise inadvertent PFIC characterization of an active business – e.g., active companies during transition phases in the business life cycle. We are concerned this change would cause the PFIC rules to work mechanically to characterize foreign corporations as PFICs even when those corporations are engaged, in substance, in active businesses, while disallowing the statutorily-prescribed mechanical application of the Domestic Subsidiary Look-Through Rule when it mitigates such results, and we believe that such a change may produce harsh outcomes.

For the reasons stated above, we respectfully recommend that Treasury and the Service consider eliminating the Principal Purpose Anti-Abuse Rule of Proposed Regulation section 1.1298-4(f)(2).

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58 See PLR 201515006 (Apr. 10, 2015); PLR 201322009 (May 31, 2013).

59 In this regard, while the Proposed Regulations’ liberalization of the change of business exception is a welcome development, we don’t believe that it supports the restrictions imposed on the Domestic Subsidiary Look-Through Rule.
Proposed Regulation section 1.1298-4(e) appears to be inconsistent with the statutory language and may be difficult for minority shareholders to comply with.

Under section 1298(a)(2), investors in a non-PFIC foreign corporation are not attributed ownership in lower-tier foreign corporations unless they own at least 50% (by value) of the non-PFIC foreign corporation. This 50% threshold is eliminated when the top-tier foreign corporation is itself a PFIC, in which case the investors, regardless of their ownership interest in the PFIC, are treated as owning a proportionate share of all the stock owned directly or indirectly by the top-tier PFIC.

Although the legislative history does not explain the reason for the 50% threshold for attribution through a non-PFIC, presumably the threshold was provided to facilitate administrability and acknowledge the lack of control (and potential limits on access to information) that minority investors may have in active parent companies. In contrast, when the parent company is itself a PFIC, presumably it was necessary to eliminate the attribution threshold so as to prevent avoidance of the PFIC rules through the use of tiered foreign entities.

Proposed Regulation section 1.1298-4(e) eliminates the application of the Domestic Subsidiary Look-Through Rule for purposes of section 1298(a)(2) attribution in all cases and without regard to whether there is any perceived abuse. Eliminating the application of the Domestic Subsidiary Look-Through Rule for attribution purposes will have the effect of causing minority U.S. investors (however small their interests) that invest in a foreign corporation that is not a PFIC due to the application of the statutory Domestic Subsidiary Look-Through Rule to be attributed their proportionate share of the stock of any lower-tier PFICs held by the foreign corporation, notwithstanding section 1298(a)(2).

Disregarding the Domestic Subsidiary Look-Through Rule for attribution purposes in the Proposed Regulations would place significant administrative burdens on minority shareholders invested in non-PFICs (or, at least, heretofore non-PFICs) with respect to lower-tier foreign subsidiaries. As a practical matter, minority shareholders may not be in a position to obtain sufficient information regarding, or otherwise be aware of, the details of, all lower-tier investments held by a foreign parent. Turning off the 50% threshold codified in section 1298(a)(2) will therefore be disproportionately burdensome on minority shareholders of a non-PFIC who likely have no reason to know, or any readily available method to determine, whether the foreign non-PFIC corporation they own is now a PFIC after removing the application of the Domestic Subsidiary Look-Through Rule or whether that non-PFIC owns any stock in lower-tier PFICs.

Furthermore, we find it difficult to reconcile disregarding the Domestic Subsidiary Look-Through Rule for attribution purposes with the plain language of the Code. Section 1298(a)(2)(B) defines a PFIC for purposes of the 50% attribution threshold by utilizing only a single exception to the otherwise applicable statutory definition: PFIC status for this purpose is determined without regard to the Overlap Rule of section 1297(d). As such, Congress clearly contemplated the use of a modified version of PFIC testing for purposes of determining the applicability of the 50% threshold, as it expressly chose to exclude the application of the Overlap Rule. By not similarly excluding the Domestic Subsidiary Look-Through Rule here suggests it
was not intended to be excluded. Therefore, eliminating the application of the Domestic Subsidiary Look-Through Rule for attribution purposes, including where there is no perceived abuse, may be viewed as creating an extra-statutory exception to the use of the Domestic Subsidiary Look-Through Rule that lacks support in the statute or legislative history.

For the reasons stated above, we respectfully recommend that Treasury and the Service eliminate Proposed Regulation section 1.1298-4(e) and permit the Domestic Subsidiary Look-Through Rule to continue to be taken into account in determining PFIC status for ownership attribution purposes. 60

60 The Proposed Regulations’ clarification of other aspects of the Domestic Subsidiary Look-Through Rule (such as the application of the accumulated earnings tax and treaty waiver requirements) is a welcome development. In addition, it would be helpful if the final Regulations clarified that “any amount included in gross income with respect to” qualified stock, which is treated as non-passive under section 1298(b)(7), includes gains (e.g., from the sale of qualified stock or arising under section 301(c)(3)). For a discussion of issues (including issues not addressed in this comment) arising under section 1298(b)(7) and the other look-through rules, some of which may warrant further consideration in the final Regulations, see Christopher Ocasal and Charles S. Markham, The PFIC Look-Through Rules: A New Level of Thinking, 35 Tax Mgm’t Int’l J. 59 (2006).