The New PFIC Regulations: A Belated Manual for Investors

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On Friday, December 4th, the IRS and Treasury released a pre-Federal Register publication version of the final regulations (the "Final Regulations") and new proposed regulations (the "2020 Proposed Regulations") governing direct or indirect investments in a Passive Foreign Investment Company, or PFIC. For U.S. persons who invest in PFICs, the adverse tax consequences range from complex U.S. tax filing requirements to the recognition of annual phantom income amounts (i.e., current U.S. taxation of a pro-rata share of PFIC earnings without a distribution of cash) and, potentially, punitive taxes and interest charges on distributions from the PFIC or gains from the sale of PFIC stock. In this alert, we discuss selected key takeaways from both the Final Regulations and the 2020 Proposed Regulations.

CLASSIFICATION OF A CORPORATION AS A PFIC

Historically, the rules for determining whether a corporation is a PFIC have been very difficult to navigate. The general rule is that a foreign corporation is a PFIC if either 75% or more of its income is considered passive income (the "Income Test") or the average percentage of its assets that produce passive income is at least 50% (the "Asset Test"). Passive income is generally defined, with some modifications, as income that would be foreign personal holding company income described in the subpart F provisions. While the Income Test and the Asset Test seem relatively straightforward, there are several complex questions that have arisen for which there has not been adequate guidance. Fortunately, the Final Regulations, which finalize regulations that were proposed in 2019 (the "2019 Proposed Regulations") with certain modifications, provide some answers; however, they are not always the answers that taxpayers wanted.

Interest and Debt Obligations and Rental and Royalty Income

The Final Regulations retain the taxpayer-favorable rules in the 2019 Proposed Regulations that disregard all, or a portion, of the payments of interest and debt obligations between the foreign corporation being tested for PFIC status and certain related parties, depending on the level of overlapping ownership between the parties. However, the Final Regulations extend the rules to also cover rental and royalty income between related parties.

> A&M Insight: The approach adopted in the Final Regulations is a welcome change for taxpayers, as the treatment of intercompany payables/receivables and the corresponding assets have historically been one of the most uncertain areas in the PFIC world, and it is resolved in a taxpayer favorable manner. In addition, the Final Regulations allow taxpayers to apply these regulations to an open taxable year so long as they are consistently applied to that year and all subsequent years. Therefore, taxpayers should consider whether foreign corporations that they previously treated as PFICs, are not PFICs under the Final Regulations.

Interests in a Partnership

For purposes of the Asset Test and Income Test, another formerly uncertain area that is addressed in the Final Regulations is whether a foreign corporation can look through a partnership for purposes of the income and asset tests. Under the 2019 Proposed Regulations, a look-through partnership was one in which the tested foreign corporation owned at least a 25% interest. The Final Regulations expand this treatment to any partnership in which the foreign corporation owns an interest, so long as the foreign corporation satisfies an "active partner" test.

Controlled Foreign Corporations Due to Downward Attribution

As a result of TCJA's repeal of section 958(b)(4), many more foreign corporations are controlled foreign corporations (CFCs), due to the application of the downward attribution rules. The Final Regulations retain the rule in the 2019 Proposed Regulations which provides that shareholders of a foreign corporation that became a CFC as a result of the repeal of section 958(b)(4) apply the Asset Test based on the adjusted basis of the foreign corporation's assets under section 1297(e).

Active Financing Income

The 2019 Proposed Regulations provided that the exception from passive treatment for income derived by a CFC in the active conduct of a banking or financing business (section 954(h)) was available for purposes of PFIC testing purposes (to treat these items of income and the assets associated with them as active). However, unlike the provisions discussed thus far, the Final Regulations rejected the approach. With that said, the 2020 Proposed Regulations 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.

Income of Insurance Companies

The 2020 Proposed Regulations contain extensive guidance relating to the exception from PFIC classification for qualified insurance companies, which if finalized would be very helpful. These rules provide that passive income does not include investment income derived in the active conduct of an insurance business by a foreign corporation. These provisions are generally in line with comments submitted by representatives of the insurance industry.

Treatment of Working Capital

Notice 88-22, which for many years contained the only guidance on the application of the Income Test and the Asset Test, 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 Passive Asset Test. Some advisers have consistently taken the position that Notice 88-22 is incorrect on that point. There is no question that an active business requires working capital to generate active operating income. Therefore, it seems illogical to treat cash which is necessary for the working capital needs of a business as a passive asset. Nevertheless, the final regulations reserve on (i.e. they fail to provide) an exception for working capital. The preamble explains that "The Treasury Department and the IRS continue to study the appropriate treatment of working capital."

But, the 2020 Proposed Regulations would provide a limited exception from passive treatment for an amount of cash held in a non-interest-bearing account that is held for the present needs of an active trade or business and is no greater than the amount reasonably expected to cover 90 days of operating expenses in the ordinary course of the trade or business of the tested foreign corporation (for example, accounts payable for ordinary operating expenses including employee compensation).

If finalized, this aspect of the 2020 Proposed Regulations would be a welcome (albeit limited) departure from the treatment of cash as a passive asset per se under Notice 88-22. But even with this concession, the regulations would continue to permit results that are difficult to justify. As little as one dollar of interest income could prevent a cash account from qualifying as an active asset. Also, this exception would only apply to cash accounts. It is unclear why other current assets that are part of working capital should not also qualify for an exception from passive asset treatment.

Clarification of Requirements for the Use of Fair Market Value Versus Adjusted Tax Basis for Assets of Subsidiaries of the Tested Corporation

Code section 1297(e) provides rules for determining when a tested foreign corporation's assets should be measured at fair market value versus adjusted tax basis. The language in the Code left some uncertainty in regard to the valuation of assets of look-through subsidiaries of a tested foreign corporation that is required to use a particular valuation method. The Final Regulations contain a comprehensive set of rules that remove much of that uncertainty. As a general rule, the Final Regulations require that the assets of look-through subsidiaries should be valued under the same method that applies to the assets of the tested foreign corporation. But exceptions are made for look-through subsidiaries that are themselves required to use one method or the other.

PFIC STOCK TREATED AS OWNED BY U.S. PERSONS

The potentially adverse tax consequences of investments in PFICs arise when a U.S. person owns shares in a PFIC directly or is treated as owning shares in a PFIC by virtue of the attribution rules of Section 1298(a). The final regulations continue to treat U.S. persons who directly or indirectly own 50 percent or more of the shares in a foreign corporation which is not a PFIC as owning any stock directly or indirectly owned by the foreign corporation.

In response to comments, the Final Regulations also continue to treat U.S. persons who hold interests in pass-through entities (i.e., partnerships, S corporations and trusts) as indirectly owning a proportionate amount of any stock held by the pass-through entity. The 2019 Proposed Regulations would have amended this rule to provide that U.S. persons who hold interests in pass-through entities would be treated as indirectly owning any stock held by the pass-through entity only if the U.S. person owned 50 percent or more in the pass-through entity. The final regulations did not adopt that aspect of the 2019 Proposed Regulations.

The Final Regulations make it clear that in applying the attribution rules of Section 1298(a) to a tiered structure, a top-down approach is to be applied.

A&M TAXAND SAYS

These final and proposed regulations are long overdue. Their guidance provides some much-needed clarity to U.S. taxpayers and their advisors in determining whether or not current and potential future investments fall under the PFIC rules. As discussed above, whether a U.S. taxpayer holds an interest in a foreign corporation that subjects them to the PFIC rules is a very important determination. These rules will allow U.S. taxpayers and their advisors to gain more comfort as to whether or not these rules apply to them. We believe that now is the time for U.S. taxpayers to re-evaluate their PFIC-related positions in light of this new guidance.

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