DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–105474–18]

RIN 1545–BO59, 1545–BM69

Guidance on Passive Foreign Investment Companies

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking; notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under sections 1291, 1297, and 1298 of the Internal Revenue Code (''Code'') regarding the determination of ownership in a passive foreign investment company within the meaning of section 1297(a) (''PFIC'') and the treatment of certain income received or accrued by a foreign corporation and assets held by a foreign corporation for purposes of section 1297. The regulations provide guidance regarding when a foreign corporation is a qualifying insurance corporation (''QIC'') under section 1297(f) of the Code and the amounts of income and assets that a QIC excludes from passive income and assets pursuant to section 1297(b)(2)(B) (''PFIC insurance exception'') for purposes of section 1297(a). The regulations also clarify the application and scope of certain rules that determine whether a United States person that directly or indirectly holds stock in a PFIC is treated as a shareholder of the PFIC, and whether a foreign corporation is a PFIC. The regulations affect United States persons with direct or indirect ownership interests in certain foreign corporations.

DATES: Written or electronic comments and requests for a public hearing must be received by September 9, 2019.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–105474–18), room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG–105474–18), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW, Washington, DC 20224, or sent electronically via the Federal eRulemaking Portal at *www.regulations.gov* (IRS REG–105474–18).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Josephine Firehock at (202) 317–4932 (for the PFIC Insurance Exception) or Jorge M. Oben at (202) 317–6934 (for general rules, including indirect ownership and look-through rules); concerning submissions and requests for a public hearing, Regina L. Johnson at (202) 317–6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

I. In General

This document contains proposed amendments to 26 CFR part 1 under sections 1291, 1297, and 1298. Sections 1291 through 1298 set forth tax regimes for shareholders that own stock of a PFIC. Under section 1297(a), a foreign corporation (''Tested Foreign Corporation'') qualifies as a PFIC if it satisfies either of the following tests: (i) 75 percent or more of the Tested Foreign Corporation's gross income for a taxable year is passive (''Income Test''); or (ii) the average percentage of assets held by the Tested Foreign Corporation during a taxable year that produce (or that are held for the production of) passive income is at least 50 percent (''Asset Test''). Section 1297(b)(1) generally defines passive income as any income of a kind that would constitute foreign personal holding company income (''FPHCI'') under section 954(c), and section 1297(b)(2) provides exceptions to this general definition. Income of a kind not described in section 954(c)(1) (for example, premiums on insurance and annuity contracts) is excluded from passive income.

In addition, section 1297(c) provides a look-through rule that applies when determining the PFIC status of a Tested Foreign Corporation that directly or indirectly owns at least 25 percent of the stock (determined by value) of another corporation.

Section 1298(b)(3) provides an exception from PFIC status for certain Tested Foreign Corporations that change from one active business to another active business. Section 1298(b)(7) provides that certain stock (''qualified stock'') in a domestic C corporation owned by a Tested Foreign Corporation through a 25-percent-owned domestic corporation is treated as an asset generating non-passive income for purposes of section 1297(a), provided that the Tested Foreign Corporation is subject to the accumulated earnings tax or waives any treaty protections against the imposition of the accumulated earnings tax.

Section 1298(a) sets forth special rules applicable to shareholders of PFICs, including attribution rules that treat a United States person as the owner of PFIC stock that is owned by another person (other than an individual). For instance, section 1298(a)(2) sets forth the attribution rules for ownership through a corporation, and section 1298(a)(3) sets forth the attribution rules for ownership through a partnership, estate, or trust. In addition, section 1298(a)(1)(B) provides that, except to the extent provided in regulations, section 1298(a) will not apply to treat stock owned (or treated as owned) by a United States person as owned by another United States person.

The Department of the Treasury (''Treasury Department'') and the IRS announced their intention to issue regulations that address the operation of the Income Test and Asset Test in Notice 88–22, 1988–1 C.B. 489 (''Notice 88–22'').

II. PFIC Insurance Exception

Before its amendment by section 14501 of the Tax Cuts and Jobs Act, Pub. L. 115–97, 131 Stat. 2234 (2017) (the ''Act''), former section 1297(b)(2)(B) provided that passive income generally did not include investment income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation. Congress was concerned about a lack of clarity and precision in the PFIC insurance exception, and in particular about the lack of precision regarding how much insurance or reinsurance business a company must do to qualify under the exception, which made the exception difficult to enforce. H.R. Report 115–409 at 409–410. To address these concerns, the Act modified the PFIC insurance exception to provide that passive income does not include investment income derived in the active conduct of an insurance business by a QIC. Thus, for taxable years beginning after December 31, 2017, the PFIC insurance exception provides that a foreign corporation's income attributable to an insurance business will not be passive income if three requirements are met. First, the foreign corporation must be a QIC as defined in section 1297(f). Second, the foreign corporation must be engaged in an ''insurance business.'' Third, the income must be derived from the ''active conduct'' of that insurance business.

On April 24, 2015, the **Federal Register** published a notice of proposed rulemaking at 80 FR 22954 (the ''2015 proposed regulations'') under former sections 1297(b)(2)(B) and 1298(g). The 2015 proposed regulations addressed the PFIC insurance exception and provided guidance regarding the extent to which a foreign corporation's investment income and the assets producing that income are excluded from passive income and passive assets for purposes of the passive income and passive asset tests in section 1297(a). Comments were received on the previously proposed regulations. A public hearing was requested and was held on September 18, 2015.

This document withdraws the 2015 proposed regulations and proposes new regulations with respect to the insurance exception as amended by the Act. Accordingly, this preamble does not address the comments received regarding the 2015 proposed regulations unless the comment relates to these new proposed regulations.

Explanation of Provisions

I. General Rules

A. Overview

These regulations provide guidance with respect to a number of issues that are not specifically addressed in the current regulations and resolve some of the complexities that arise in the determination of the ownership of a PFIC and in the application of the Income Test and Asset Test in cases in which the look-through rule of section 1297(c) applies to a Tested Foreign Corporation.

Specifically, these regulations provide guidance on the application of the corporate attribution rules when a partnership indirectly holds a Tested Foreign Corporation through a corporation that is not a PFIC. These regulations also clarify the scope of the section 1297(b)(1) cross-reference to section 954(c) for purposes of defining passive income, and they set forth rules that address certain computational and characterization issues that arise in applying the Asset Test. In addition, these regulations provide rules concerning the treatment of income and assets of a 25-percent-owned subsidiary under section 1297(c). These regulations provide guidance on the application of the section 1298(b)(3) change of business exception and also propose a new rule analogous to the section 1298(b)(3) change of business exception that takes into consideration the assets of the Tested Foreign Corporation. Finally, these regulations provide guidance on the application of the section 1298(b)(7) qualified stock exception and provide a rule for waiving treaty benefits that would exempt a Tested Foreign Corporation from the accumulated earnings tax.

B. Determination of Ownership and Attribution Through Partnerships

Section 1298(a) provides attribution rules that apply to the extent that the effect is to treat stock of a PFIC as owned by a United States person. Except as provided in regulations, the attribution rules do not apply to treat stock owned or treated as owned by a United States person as owned by any other person.

Section 1298(a)(2)(A) provides that if 50 percent or more in value of the stock of a corporation is owned, directly or indirectly, by or for any person, that person is considered to own the stock owned directly or indirectly by or for the corporation in proportion to the person's ownership of the corporation. However, under section 1298(a)(2)(B), the 50 percent ownership threshold does not apply in the case of stock held through a PFIC or a corporation that would be a PFIC if it were not a controlled foreign corporation within the meaning of section 957(a) (''CFC''). Section 1298(a)(3) provides that stock owned, directly or indirectly, by a partnership, estate, or trust is considered owned proportionately by its partners or beneficiaries. The current rules in § 1.1291–1(b)(8) are consistent with these statutory provisions.

Comments have inquired whether the attribution rules are intended to be applied to a tiered ownership structure on a ''top-down'' basis, by starting with a United States person and determining what stock is considered owned at each successive lower tier on a proportionate basis. Alternatively, the comments have posited, the rules could be applied on a ''bottom-up'' basis, by starting with a PFIC and attributing ownership of its stock upwards to each successive upper tier until the United States person whose ownership in the PFIC is being tested is reached.

The two approaches can have different ownership consequences when a partnership indirectly owns stock of a Tested Foreign Corporation through a corporation that is not a PFIC. A United States person not treated as a shareholder of PFIC stock indirectly held by a partnership through a non-PFIC corporation under a ''top-down'' approach may be treated as a shareholder under a ''bottom-up'' approach as a result of the application of section 1298(a)(3) and § 1.1291–1(b)(8)(iii), which provide that holders of interests in a pass-through entity are considered to proportionately own stock owned directly or indirectly by the pass-through entity. Consider, for example, the following fact pattern. A, a United States citizen, owns 50 percent of the interests in Foreign Partnership, a foreign partnership, the remainder of which is owned by an unrelated foreign person. Foreign Partnership owns 100 percent of the stock of FC1 and 50 percent of the stock of FC2, the remainder of which is owned by an unrelated foreign person. Both FC1 and FC2 are foreign corporations that are not PFICs (determined without applying section 1297(d)). FC1 and FC2 each own 50 percent of the stock of FC3, a foreign corporation that is a PFIC. Under a ''bottom-up'' approach, Foreign Partnership could be treated as owning 75 percent of the stock of FC3 indirectly through FC1 and FC2, and accordingly, A could be treated as owning 37.5 percent of the stock of FC3. Under a ''top-down'' approach, however, A would be treated as owning 50 percent of the stock of FC1 and 25 percent of the stock of FC2, and the only stock of FC3 that would be attributed to A would be the 25 percent of the FC3 stock treated as indirectly owned by A through FC1. Comments have noted that a ''top-down'' approach produces the same result as if the partnership were disregarded and partners were treated as if they directly or indirectly owned a partnership's direct and indirect interests in a non-PFIC foreign corporation; it could thus be viewed as consistent with an aggregate theory of partnerships.

Under the proposed regulations, the attribution rules apply consistently whether a United States person owns stock of a non-PFIC foreign corporation through a partnership or directly, as they would under the ''top-down'' approach. This ensures that ownership of a foreign corporation that is a PFIC through a partnership will not change the amount of the stock of the PFIC that the United States person is treated as owning. Accordingly, under the proposed regulations, for purposes of determining whether a partner, S corporation shareholder, or beneficiary in a partnership, S corporation, estate, or nongrantor trust is considered under § 1.1291–1(b)(8)(ii)(A) to own a portion of stock of a PFIC owned indirectly by the partnership, S corporation, estate, or trust through a non-PFIC foreign corporation, the partner, shareholder, or beneficiary will be considered to own 50 percent or more in value of the stock of the non-PFIC foreign corporation through the partnership, estate, or trust only if the partner, shareholder, or beneficiary directly or indirectly owns 50 percent or more of the ownership interests in the partnership, estate, or trust. *See* proposed § 1.1291–1(b)(8)(iii).

If, in the previously posited example, Foreign Partnership were replaced with another foreign corporation, FC4, the proposed regulations would not apply. It may seem less appropriate for the amount of FC3 stock that is treated as owned by A to be limited to the 25 percent of FC3 indirectly owned by A through FC4 and FC1. Instead, FC4 could be treated as owning 25 percent of the stock of FC3 indirectly through FC2, and thus A could be treated as owning 12.5 percent of the stock of FC3 indirectly through FC4 and FC2 in addition to the 25 percent owned indirectly through FC4 and FC1. The Treasury Department and the IRS request comments as to whether a ''top-down'' attribution analysis or some alternative analysis should apply under section 1298(a) in a purely corporate structure such as this one, such that A would not be treated as owning any stock of FC3 indirectly through FC4 and FC2.

C. Income Test

1. In General

In the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100–647, 102 Stat. 3342), Congress amended section 1297(b)(1) to define the term passive income generally as any income of a kind that would constitute FPHCI under section 954(c). FPHCI, and thus passive income, includes interest income that would be tax-exempt under section 103. *See* §§ 1.954–2(b)(3), 1.952–2(c)(1). Neither the rules under subtitle A, chapter 1, subchapter N, part III, subpart F of the Code (''subpart F'') nor rules under section 1297, however, address the treatment for purposes of FPHCI or the Income Test of other types of income that are otherwise excluded from gross income, such as intercompany dividends that are excluded from the income of a recipient under the consolidated return regulations. *See* § 1.1502–13(f)(2)(ii). As discussed in more detail in Part I.F of this Explanation of Provisions, a Tested Foreign Corporation may be treated under section 1297(c) as receiving directly income received by a 25-percent-owned subsidiary, including a domestic corporation. As discussed in more detail in Part I.H of this Explanation of Provisions, a Tested Foreign Corporation could own a second domestic corporation through a 25-percent-owned domestic corporate subsidiary and could thus be treated under sections 1297(c) and 1298(b)(7) as receiving intercompany dividends from the lower-tier domestic corporation that would be excluded from the income of the upper-tier domestic corporation under the consolidated return regulations. Accordingly, the operation of the statutory rules under sections 1297 and 1298 indicate that the Income Test is intended to take into account all income of a Tested Foreign Corporation, without regard to reductions or exclusions that might apply for purposes of determining the U.S. Federal income tax imposed on such income. Consistent with those rules, the Treasury Department and the IRS have concluded that intercompany dividends received by a corporation from a member of its consolidated group and treated as received under section 1297(c) by a Tested Foreign Corporation that directly or indirectly owns stock in the corporation should be taken into account for purposes of the Income Test. Thus, the proposed regulations indicate that income for purposes of the Income Test includes all dividend income, including dividends that are excluded from gross income under section 1502 and § 1.1502–13. *See* proposed § 1.1297–1(b). The Treasury Department and the IRS welcome comments on this approach. However, see Part I.F.3 of this Explanation of Provisions for a discussion of rules that could eliminate such dividends.

2. Exceptions From Passive Income

Furthermore, there are a number of exceptions to the definition of FPHCI in section 954(c), as well as in section 954(h) and (i), and special rules and definitions in section 954(c) that affect the determination of FPHCI. Specifically, in addition to the exceptions contained within the general definition of FPHCI in section 954(c)(1), section 954(c)(2) provides three exceptions: (i) An active rents and royalties exception; (ii) an export financing exception; and (iii) a dealer exception. Section 954(c)(3) provides two additional exceptions: (i) A related person, same country dividend and interest exception; and (ii) a related person, same country rents and royalty exception. In addition, for taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2020, section 954(c)(6) excludes from FPHCI certain dividends, interest, rents, and royalties received or accrued from a related corporation that is a CFC. Moreover, section 954(h) provides rules that apply for purposes of section 954(c)(1) pursuant to which income derived in an active banking or financing business is excluded from FPHCI. Additionally, under section 954(i), income from an active insurance business is excluded from FPHCI for purposes of section 954(c)(1). Finally, section 954(c)(4) contains a look-through rule that applies in the case of a sale of certain partnership interests, and section 954(c)(5) contains definitions and special rules applicable to commodity transactions.

Separately, section 1297(b)(2) provides explicit exclusions to the general definition of passive income set forth in section 1297(b)(1). Specifically, section 1297(b)(2) provides four exceptions: (i) An active banking exception; (ii) an active insurance business exception; (iii) a related person interest, dividends, rents, and royalties exception; and (iv) an export trade financing exception.

Questions have been raised regarding the scope of the cross-reference to section 954(c) in section 1297(b)(1) for purposes of defining passive income for PFIC purposes. Comments have inquired whether the section 954(c) reference in section 1297(b) incorporates all of the exceptions to FPHCI that are in section 954(c). In addition, by their terms, certain exceptions to FPHCI apply only to a foreign corporation that is a CFC. If these exceptions apply for PFIC purposes, the comments also question whether a Tested Foreign Corporation must also be a CFC in order to benefit from the exceptions.

The Treasury Department and the IRS understand that Congress did not intend for all of the exceptions in section 954(c) to apply for purposes of determining passive income under the PFIC provisions. In particular, the exceptions in section 954(c)(3) (relating to certain income received from related persons) and 954(c)(6) (relating to certain income received from related CFCs) were not meant to be taken into account for PFIC purposes. The legislative history indicates that Congress intended for the section 1297(c) look-through rules or the section 1297(b)(2)(C) exception to apply to income items that otherwise would be entitled to the section 954(c)(3) exception. It indicates:

> The bill conforms the PFIC definition of passive income to the definition of passive income under subpart F (sec. 954(c)). This change, in conjunction with the look-through rule for certain 25-percent-owned corporations and the lookthrough rules added by the bill (described below), makes it explicit that earnings of certain related foreign corporations organized in the same country as its shareholder that, if distributed to the shareholder would be excluded from foreign personal holding company income under the same-country exception of subpart F (sec. 954(c)(3)), are subject to either the section [1297(c)] look-through treatment or the look-through treatment for amounts paid by related parties that are not 25 percent owned (described below).

H.R. Rep. No. 100–795, at 271–272 (1988); S. Rep. No. 100–445, at 285–286 (1988).

Thus, the proposed regulations do not incorporate the section 954(c)(3) exception for purposes of determining passive income for PFIC purposes. Similarly, under the proposed regulations, the section 954(c)(6) exception also does not apply for determining PFIC status because the section 1297(b)(2)(C) related-person exception is intended to be the sole related-person exception applicable for determining passive income under the PFIC rules.

Additional questions are raised with respect to the FPHCI exceptions for active banking, financing, and insurance income because section 1297(b) does not specifically cross-reference section 954(h) and (i). As with section 1297(b)(2)(C), it is possible that sections 1297(b)(2)(A) and (B) were intended to be the sole exceptions for active banking, financing, and insurance income applicable for determining passive income under the PFIC rules because section 1297(b) has specific exceptions for active banking, financing, and insurance income. Alternatively, the section 1297(b) cross-reference to section 954(c) could be read to include the exceptions provided in section 954(h) and (i), which apply for purposes of section 954(c) by their terms. It may be appropriate for income that satisfies the requirements in section 954(h) and (i) to be excluded from passive income because Congress generally defined passive income by reference to FPHCI, and when section 954(h) and (i) were enacted, each with a cross-reference to section 954(c), Congress did not provide that section 954(h) or (i) should not apply for PFIC purposes. Moreover, the fact that the PFIC provisions are more generally not intended to apply to foreign corporations engaged in active businesses supports the application of rules excluding active banking, financing, and insurance income from the definition of passive income.

However, with respect to section 954(i), Congress recently amended the exclusion for income derived in the active conduct of an insurance business in section 1297(b)(2)(B) to require that income be earned by a QIC, as discussed in Part II of the Background section of this preamble. Given this statutory change and the tests contained in the definition of QIC in section 1297(f), the Treasury Department and the IRS have determined that the exception for insurance income in section 954(i) should not apply in addition to the newly modified exception in section 1297(b)(2)(B). Accordingly, the proposed regulations provide that the section 954(i) exception to FPHCI does not apply in addition to the PFIC exception. *See* proposed § 1.1297–1(c)(1)(i)(B). By contrast, 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. *See* proposed § 1.1297–1(c)(1)(i)(A). The application of section 954(h) is in addition to the PFIC exception. The Treasury Department and the IRS request comments about whether, when regulations are in force under section 1297(b)(2)(A), the corollary FPHCI exclusion should also continue to apply.

Comments have noted that the application of section 954(c) for PFIC purposes can be uncertain when a Tested Foreign Corporation is not also a CFC. For instance, the application of section 954(h) for PFIC purposes could be interpreted to apply only to amounts received by a Tested Foreign Corporation that also is a CFC. Passive income for PFIC purposes is defined by cross-reference to section 954(c) because the income items that comprise FPHCI are generally passive in nature. The CFC status of the recipient of an item of FPHCI does not affect the passive nature of the item, and thus is not relevant for purposes of determining whether an item is passive under the PFIC rules. Therefore, it is appropriate for income derived by any Tested Foreign Corporation, and not just Tested Foreign Corporations that also are CFCs, to be eligible for the exceptions to FPHCI, including the section 954(h) exception.

For the reasons discussed in this Part I.C.2, the proposed regulations provide that for purposes of section 1297(b)(1), passive income is determined by reference to the items of income listed in section 954(c)(1), subject only to the exceptions found in section 954(c)(1), section 954(c)(2)(A) (relating to active rents and royalties), section 954(c)(2)(B) (relating to certain export financing interest), section 954(c)(2)(C) (relating to dealers), and section 954(h) (relating to entities engaged in the active conduct of a banking, financing, or similar business). *See* proposed § 1.1297–1(c)(1)(i) and (c)(1)(i)(A). In addition, the rules in section 954(c)(4) (relating to sales of certain partnership interests) and 954(c)(5) (relating to certain commodity hedging transactions) apply for PFIC purposes. *See* proposed § 1.1297–1(c)(1)(i)(C). However, for the reasons stated in this Part I.C.2, the exceptions in section 954(c)(3) (relating to certain income received from related persons), section 954(c)(6) (relating to certain amounts received from related controlled foreign corporations), and section 954(i) (relating to entities engaged in the active conduct of an insurance business) are not taken into account for purposes of section 1297(b)(1). *See* proposed § 1.1297–1(c)(1)(i)(B). The proposed regulations also provide that an entity is treated as a CFC for purposes of applying an exception to FPHCI and for purposes of determining whether a person is a related person with respect to the entity. *See* proposed § 1.1297–1(c)(1)(i)(D). Comments are requested as to whether regulations should provide any additional special rules concerning the definition of a related person under section 954(d)(3) for purposes of applying an FPHCI exception to a Tested Foreign Corporation that is not a CFC.

3. Income and Gains From Certain Transactions

The Income Test is computed based on a Tested Foreign Corporation's gross income. However, pursuant to section 954(c), certain categories of income are FPHCI only to the extent that gains exceed losses with respect to the category. For instance, under section 954(c)(1)(B) only "the excess of gains over losses from the sale or exchange" of certain property is treated as FPHCI. Similar rules apply to income from commodities transactions under section 954(c)(1)(C), foreign currency gains under section 954(c)(1)(D), and income from notional principal contracts under section 954(c)(1)(F). The proposed regulations provide that for purposes of the Income Test, items of income under section 954(c) that are determined by netting gains against losses are taken into account by a corporation on that net basis, so that only net gains in a particular category of FPHCI are taken into account. *See* proposed § 1.1297–1(c)(1)(ii). However, the net amount of income in each category of FPHCI is determined separately for each relevant corporation, such that net gains or losses of a corporation, at least 25 percent of the value of stock of which is owned, directly or indirectly, by a Tested Foreign Corporation ("Look-Through Subsidiary") may not be netted against net losses or gains of another Look-Through Subsidiary or of a Tested Foreign Corporation.

4. Income Earned Through Partnerships

The proposed regulations provide guidance on the treatment of a corporation's distributive share of partnership income for purposes of the

Income Test. The Treasury Department and the IRS have determined that income earned by a Tested Foreign Corporation through a partnership should be treated similarly to income earned through a corporate subsidiary. As discussed in more detail in Part I.F of this Explanation of Provisions, if a Tested Foreign Corporation owns a Look-Through Subsidiary, the Tested Foreign Corporation is treated as if it directly received its proportionate share of the income of the Look-Through Subsidiary, and certain items of income received from the Look-Through Subsidiary are proportionately eliminated. If a corporation is not a Look-Through Subsidiary, income received from the corporation is characterized in accordance with the general rules described in Part I.C.2 of this Explanation of Provisions, under which dividends generally will be passive. Accordingly, the proposed regulations provide that a Tested Foreign Corporation's distributive share of any item of income of a partnership is treated as income received directly by the Tested Foreign Corporation, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the value of the partnership, in which case the partnership is referred to as a ''Look-Through Partnership,'' and income elimination rules similar to those for Look-Through Subsidiaries apply. *See* proposed § 1.1297–1(c)(2)(i). If the Tested Foreign Corporation owns less than 25 percent of the value of a partnership, the corporation's distributive share of any item of income of the partnership is passive income. *See* proposed § 1.1297–1(c)(2)(ii).

As a result of these rules, in cases in which the Tested Foreign Corporation owns at least 25 percent of the value of the partnership, the exceptions to passive income contained in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) and (h) that are based on whether income is derived in the active conduct of a business generally apply if, and only if, the partnership engages in the relevant business activities. The focus on partnership activities is consistent with the principles applicable to partnership interests under the regulations under subpart F. *See* § 1.954–2(a)(5)(ii)(A); § 1.954–3(a)(6). However, as described in Part I.F.5 of this Explanation of Provisions, these proposed regulations also include rules that, in certain circumstances, allow the character of income to be determined at the level of the Tested Foreign Corporation, taking into account activities performed by the Tested Foreign Corporation and certain subsidiaries of the Tested Foreign Corporation, whether such subsidiaries are in corporate or partnership form.

Although the subpart F regulations provide rules concerning the classification of a CFC's distributive share of partnership income that, absent these proposed regulations, would generally be applicable by virtue of section 1297's adoption of FPHCI as the basis for passive income, the Treasury Department and the IRS have determined that the differing policies of the subpart F and PFIC regimes warrant different rules for partnerships. Specifically, the Treasury Department and the IRS have concluded that it is appropriate to generally characterize a corporation's distributive share of partnership income as passive when the corporation owns less than 25 percent of the value of the partnership, consistent with the treatment of Look-Through Subsidiary income, notwithstanding the fact that under the subpart F regulations, such income could have been excluded from FPHCI by virtue of the partnership's activities regardless of the corporation's level of ownership. The different treatment is warranted because of the flexibility that entities have in their characterization for U.S. Federal income tax purposes under § 301.7701–3 and because of the fact that treating a subsidiary as a partnership may not have U.S. income tax consequences for a Tested Foreign Corporation, as it could for a CFC. However, the Treasury Department and the IRS request comments as to whether a 25 percent threshold for the Tested Foreign Corporation's percentage ownership in the partnership is the appropriate threshold for distinguishing between a distributive share of partnership income that is automatically treated as passive and a distributive share that is characterized in accordance with the activities undertaken by the partnership (or, as applicable under the rules described in Part I.F.5 of this Explanation of Provisions, the Tested Foreign Corporation and certain subsidiaries of the Tested Foreign Corporation), or whether an alternative threshold should be considered. Furthermore, the Treasury Department and the IRS request comments as to whether different rules should apply with respect to partners in general partnerships than with respect to partners in limited partnerships, or with respect to partners that materially participate in the activities of the partnership.

5. Income From a Related Person

The proposed regulations provide additional guidance on the application of the section 1297(b)(2)(C) related-person exception to dividends, interest, rents, and royalties. The proposed regulations provide that the determination of whether the payor of an item of income is a related person should be made on the date of receipt or accrual, as applicable based on the recipient's method of accounting, of the item of income. *See* proposed § 1.1297–1(c)(3)(iv).

Under § 1.904–5(c)(2)(ii)(C) (the ''cream-skimming rule''), interest paid to a related person is treated as passive income to the payee to the extent that the payor has passive income. Under this rule, if a foreign corporation had $200 of passive gross income and $200 of non-passive gross income, and that foreign corporation made an interest payment of $100 to a related foreign corporation, for purposes of determining the nature of the interest income in the hands of the payee foreign corporation, the entire $100 of interest would be treated as passive income rather than as ratably allocable between passive and non-passive income. Although the Treasury Department and the IRS considered applying a cream-skimming rule for purposes of section 1297(b)(2)(C), the Treasury Department and the IRS have concluded that the PFIC regime does not raise the policy concerns addressed by the cream-skimming rule in the foreign tax credit and subpart F contexts. In those contexts, because interest expense can reduce a foreign corporation's subpart F income or otherwise affect the calculation of foreign tax credits, an interest payment could otherwise be used to try to reduce the passive income of the payor and convert it into non-passive income of the payee. However, because the Income Test is applied on the basis of gross income, an interest payment cannot be used in the same fashion for purposes of the Income Test. Accordingly, under the proposed regulations, for purposes of the section 1297(b)(2)(C) exception, interest is properly allocable to income of the related person that is not passive income based on the relative portion of the related person's income for its taxable year that ends in or with the taxable year of the recipient that is not passive income. *See* proposed § 1.1297–1(c)(3)(i). Dividends are treated as properly allocable to income of the related person that is not passive income based on the portion of the related payor's current-year earnings and profits for the taxable year that ends in or with the taxable year of the recipient that are attributable to non-passive income. *See* proposed § 1.1297–1(c)(3)(ii). Comments are specifically requested concerning 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 earnings and profits), including by reference to accumulated earnings and profits, and if so, how to address concerns about the availability of information. The proposed regulations further provide that rents and royalties are allocable to income of the related person which is not passive income to the extent the related person's deduction for the rent or royalty is allocated to non-passive income under the principles of §§ 1.861–8 through 1.861–14T. *See* proposed § 1.1297–1(c)(3)(iii). Comments are specifically requested regarding any concerns about the availability of information and alternative methods of determining the portion of rents and royalties treated as properly allocable to income of a related person that would address any such concerns.

D. Asset Test

1. Methodology of Application of Asset Test

Section 1297(a)(2) provides that a Tested Foreign Corporation is a PFIC if the average percentage of assets held by the corporation during a taxable year that produce passive income or are held for the production of passive income is at least 50 percent. Notice 88–22 provides that the average percentage of assets of a Tested Foreign Corporation is calculated by averaging the value of the assets of the corporation, determined as of the end of each quarterly period of the corporation's taxable year.

These regulations clarify that the average percentage of a Tested Foreign Corporation's assets is determined using the average of the gross values (or adjusted bases) at the end of each quarter of the foreign corporation's taxable year. *See* proposed § 1.1297–1(d)(1)(i) and (d)(1)(ii)(A). Alternatively, the assets of a Tested Foreign Corporation can be measured for purposes of the Asset Test more frequently than quarterly (for example, weekly or monthly). The quarter or shorter interval used by a Tested Foreign Corporation is referred to as its ''measuring period.'' Applying the Asset Test based on a period that recurs more frequently than a quarter provides a more precise measurement of ''average,'' but the more frequently recurring basis is not required because of the potential administrative burden that it could impose on a shareholder of a Tested Foreign Corporation. The same measuring period must be used for the Tested Foreign Corporation for the initial year (including a short year) that for which the shareholder elects to use the alternative measuring period and any and all subsequent years unless the election to use the more frequently recurring measuring period is revoked. *See* proposed § 1.1297–1(d)(1)(ii)(B).

If a Tested Foreign Corporation has a short taxable year, the quarterly measuring dates for purposes of the Asset Test are the same as they would be for a full taxable year, except that the final quarterly measuring date will be the final day of the short taxable year. *See* proposed § 1.1297–1(d)(1)(ii)(C). Thus, for instance, if a Tested Foreign Corporation for which the election for a shorter period has not been made has a short year of eight months, the corporation would have two quarters ending on the foreign corporation's normal quarterly measuring dates and a third quarter ending on the final day of the short taxable year. The asset amounts for those three quarterly measuring dates would be averaged to determine the average percentage of a Tested Foreign Corporation's assets that are passive for the year. The Treasury Department and the IRS have determined that applying the Asset Test based on the taxable year quarters that ended during the short year properly accounts for the administrative difficulties of calculating quarterly measurements with respect to a short year.

Under section 1297(e), the assets of a Tested Foreign Corporation are required to be measured based on (i) value, pursuant to section 1297(e)(1), if it is a publicly traded corporation for the taxable year, or if section 1297(e)(2) does not apply to it for the taxable year; or (ii) adjusted basis, pursuant to section 1297(e)(2), if it is a CFC, or elects the application of section 1297(e)(2). The statute does not specify whether a corporation that is publicly traded during only part of the taxable year is publicly traded ''for the taxable year,'' and thus whether such a corporation's assets should be measured for the taxable year based on value or on adjusted basis or whether, if the corporation is a CFC for the remainder of the year, a combination of the two should be used. For instance, a Tested Foreign Corporation that is a CFC at the beginning of its taxable year and became publicly traded during the last month of its taxable year could be required under section 1297(e) to have its assets measured based on either adjusted basis or value for all four quarterly measuring periods or based on adjusted basis for its first three quarterly measuring periods and value for its fourth quarterly measuring period. The proposed regulations provide that the Asset Test should apply on the basis of value for the entire year if the corporation was publicly traded on the majority of days during the year or section 1297(e)(2) did not apply to the corporation on the majority of days of the year. Otherwise, the Asset Test should apply on the basis of adjusted basis for the entire year. *See* proposed § 1.1297–1(d)(1)(v). The Treasury Department and the IRS have determined that allowing a shareholder the option of choosing either method with respect to a Tested Foreign Corporation could facilitate the avoidance of the PFIC rules, and that the rule in the proposed regulation imposes the least administrative burden. The Treasury Department and the IRS welcome comments on these rules.

Under the proposed regulations, the rules described in this Part I.D.1 for making or revoking an election for an alternative measuring period also apply for purposes of the election provided in section 1297(e)(2)(B) to use adjusted bases of assets for purposes of the Asset Test. *See* proposed § 1.1297–1(d)(1)(iii)(B) and (d)(1)(iv). Both elections may be made by a United States person that is eligible under § 1.1295–1(d) with respect to the Tested Foreign Corporation or that would be eligible if the Tested Foreign Corporation were a PFIC. *See* proposed § 1.1297–1(d)(1)(iv)(A). Thus, in the case of a Tested Foreign Corporation owned by a domestic partnership in which U.S. individuals are partners, only the domestic partnership and not its partners may make the elections, ensuring that the Tested Foreign Corporation is treated consistently for all of the partners, which would facilitate reporting by the partnership if the Tested Foreign Corporation were a PFIC. However, the Treasury Department and the IRS request comments as to whether either election should be available to any United States person that is a shareholder (within the meaning of § 1.1291–1(b)(7) or (8)) of the Tested Foreign Corporation or that would be a shareholder of the Tested Foreign Corporation if it were a PFIC.

If the person is required to file the Form 8621 (or successor form) with respect to the Tested Foreign Corporation, the elections may be made in the manner provided in the instructions to the Form 8621; until such instructions are provided, the elections may be made by attaching a written statement to the Form 8621 providing for the election to a return for the year for which the election is made. If the person is not required to file the Form 8621 with respect to the Tested Foreign Corporation (for example, because the Tested Foreign Corporation is not a PFIC), the person may make the elections by attaching a written statement providing for the election to a return for the year for which the election is made. *Id.* The elections are revoked in a similar manner. *See* proposed § 1.1297–1(d)(1)(iv)(B). A new election for an alternative measuring period or under section 1297(e)(2)(B) may not be made until the sixth taxable year following the year for which the previous such election was revoked, and such subsequent election may not be revoked until the sixth taxable year following the year for which the subsequent election was made. *See id.*

2. Characterization of Dual-Character Assets

Pursuant to section 1297(a), an asset is considered passive for purposes of the Asset Test if it produces passive income or is held for the production of passive income. Notice 88–22 states that an asset that produces both passive income and non-passive income during a Tested Foreign Corporation's taxable year is treated partly as a passive asset and partly as a non-passive asset in proportion to the relative amounts of income generated by the asset during the year. Proposed § 1.1297–1(d)(2) generally adopts the rule set forth in Notice 88–22, and provides that an asset that produces both passive income and non-passive income during a taxable year is treated as two assets, one of which is passive and one of which is non-passive. Consistent with the rule in Notice 88–22, for purposes of applying the Asset Test, the value (or adjusted basis) of the asset is allocated between the passive assets and non-passive assets based on the ratio of passive income produced by the asset during the taxable year to non-passive income.

The proposed regulation also provides a specific rule for stock of a related person with respect to which no dividends are received or accrued, as applicable based on the recipient's method of accounting, 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). *See* proposed § 1.1297–1(d)(2)(iii). The stock is characterized based on the dividends received or accrued, as applicable based on the recipient's method of accounting, with respect thereto for the prior two years. *Id.*

The Treasury Department and the IRS have determined that it may also be appropriate to bifurcate an asset that in part produces income and in part does not produce income between a passive and a non-passive asset for purposes of the Asset Test in order to provide a more accurate measure of the Tested Foreign Corporation's passive assets. For example, if a Tested Foreign Corporation uses a portion of a building, which is depreciable real property, in its trade or business that generates non-passive income, while renting a portion of the building in exchange for rents that are treated as passive, it would be appropriate for the portions of the building to be considered separately as non-passive and passive assets, respectively. Accordingly, the proposed regulations provide that for purposes of applying the Asset Test, if an asset in part produces income and in part does not produce any income, the asset must be bifurcated pursuant to the method that most reasonably reflects the uses of the property. *See* proposed § 1.1297–1(d)(2)(ii). A similar approach applies to characterize gain for subpart F purposes. *See* § 1.954–2(e)(1)(iv).

The Treasury Department and the IRS welcome comments on these rules, including suggestions for how to minimize the burden associated with determining how to bifurcate the relevant assets.

3. Characterization of Partnership Interests

The proposed regulations provide guidance on the characterization of a partnership interest for purposes of the Asset Test. As discussed in Part I.C.4 of this Explanation of Provisions, the Treasury Department and the IRS have determined that it is appropriate to treat a partnership in a manner similar to a corporate subsidiary for purposes of determining whether a Tested Foreign Corporation is a PFIC. Accordingly, the proposed regulations provide that for purposes of the Asset Test, a Tested Foreign Corporation that directly or indirectly owns an interest in a partnership is treated as if it held its proportionate share of the assets of a partnership, provided the Tested Foreign Corporation owns, directly or indirectly, at least 25 percent, by value, of the interests in the partnership. *See* proposed § 1.1297–1(d)(3)(i). A corporation's proportionate share of a partnership asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the partnership's hands, taking into account only the partnership's activities, unless the rules described in Part I.F.5 of this Explanation of Provisions apply to allow the character of the income to be determined at the level of the Tested Foreign Corporation, taking into account activities performed by certain subsidiaries of the Tested Foreign Corporation. If a Tested Foreign corporation owns less than 25 percent of the value of the partnership, its interest in the partnership is treated as a passive asset. *See* proposed § 1.1297–1(d)(3)(ii).

4. Characterization of Dealer Property

For purposes of the Asset Test, an asset is considered passive if it produces passive income or is held for the production of passive income. Under the dealer exception in section 954(c)(2)(C), gain from the disposition of certain dealer property is treated as non-passive income for purposes of the Income Test. However, certain other income derived with respect to the dealer property (such as dividends and interest) is treated as passive income. The exception from passive income for dealer property in section 954(c)(2)(C) is predicated on the fact that a dealer holds the property as part of its trade or business and not for the production of passive income. Accordingly, the Treasury Department and the IRS have determined that, given that the PFIC regime is concerned with whether the asset is part of an active business, it is appropriate to characterize dealer property for purposes of the Asset Test based solely on the character of the gain derived from the disposition of the property. Accordingly, the proposed regulations provide that property that is subject to the dealer exception is characterized as a non-passive asset for purposes of the Asset Test, notwithstanding the dual-character asset rules discussed in Part I.D.2 of this Explanation of Provisions. *See* proposed § 1.1297–1(d)(4).

E. Treatment of Stapled Entities

The Treasury Department and the IRS understand that, in certain situations, equity interests in two or more foreign entities must be sold together as stapled interests within the meaning of section 269B(c)(3). Stapled entities (as defined in section 269B(c)(2)) may be structured in such a way that income and the assets generating the income are in one entity, while the activities generating the income are engaged in by the other entity. For example, two stapled entities might jointly carry on a real estate business, with one stapled entity owning real property that is leased to third parties to generate rental income, while the other stapled entity provides management services with respect to the real property that, if engaged in by the first stapled entity, would allow the rental income received by it to be characterized as non-passive income pursuant to section 954(c)(2)(A) and these proposed regulations. However, if the PFIC status of the stapled entity receiving the rental income were determined on a stand-alone basis, the income might be treated as passive income. Given that stapled interests represent a single economic interest to their shareholders, the Treasury Department and the IRS have determined that it is appropriate, for purposes of determining whether a stapled entity is a PFIC, to treat them as such. This is consistent with the treatment of stapled entities in section 269B(a)(3) for purposes of determining whether a stapled entity is a regulated investment company (''RIC'') or a real estate investment trust (''REIT''). Accordingly, the proposed regulations provide that for purposes of determining whether any stapled entity is a PFIC, all entities that are stapled entities with respect to each other are treated as one entity. *See* proposed § 1.1297–1(e). Comments are requested as to whether similar treatment should be provided for purposes of the subpart F rules.

F. Look-Through Rule for 25-Percent-Owned Subsidiaries

As noted in Part I.C.4 of this Explanation of Provisions, in determining PFIC status, section 1297(c) applies when a Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation, a Look-Through Subsidiary. In such instance, the Tested Foreign Corporation is treated as if it directly held its proportionate share of the assets and directly received its proportionate share of the income of the Look-Through Subsidiary. Section 1297(c) was enacted to prevent ''foreign corporations owning the stock of subsidiaries engaged in active businesses [from being] classified as PFlCs.'' H.R. Rep. No. 99–841, at II–644 (1986) (Conf. Rep.).

1. Determining a Tested Foreign Corporation's Ownership of a Look-Through Subsidiary and Proportionate Share of a Look-Through Subsidiary's Assets and Income

Neither the statute nor the regulations provide guidance on how to calculate a Tested Foreign Corporation's indirect ownership in another corporation for purposes of determining whether the corporation is a Look-Through Subsidiary under section 1297(c). In addition, the statute and regulations do not provide a methodology for determining a Tested Foreign Corporation's proportionate share of a Look-Through Subsidiary's income and assets for purposes of section 1297(c).

Under section 1297(c), the determination of whether a Tested Foreign Corporation owns, directly or indirectly, at least 25 percent of the stock of another corporation is based on value. The proposed regulations provide that indirect stock ownership for purposes of section 1297(c) is determined under the principles of section 958(a) applicable for determining ownership by value. *See* proposed § 1.1297–2(b)(1). The section 958(a) principles apply without regard to whether entities are domestic or foreign, and thus indirect ownership includes corporate ownership through intermediate corporations, partnerships, trusts, and estates, regardless of whether such intermediate entities are foreign or domestic. *Id.* In addition, stock considered owned by reason of applying the section 958(a) indirect ownership rules is generally considered actually owned for purposes of reapplying the indirect ownership rules. *See* § 1.958–2(f)(1).

Section 1297(c) provides that a Tested Foreign Corporation is treated as holding its proportionate share of the assets of the Look-Through Subsidiary, and receiving its proportionate share of the income of the Look-Through Subsidiary. The proposed regulations provide guidance on the meaning of ''proportionate share'' for purposes of section 1297(c). Specifically, proposed § 1.1297–2(b)(2) provides that a Tested Foreign Corporation is treated as owning a share of each asset, and receiving a proportionate share of each item of income, of a Look-Through Subsidiary proportionate to the Tested Foreign Corporation's percentage ownership (by value) of the Look-Through Subsidiary. Comments are requested concerning alternative methods that might better determine a Tested Foreign Corporation's proportionate share of income of a Look-Through Subsidiary that has multiple classes of stock outstanding.

Changes in stock ownership may cause fluctuations in a Tested Foreign Corporation's ownership in a Look-Through Subsidiary during a taxable year. For purposes of the Asset Test, ownership of a Look-Through Subsidiary is determined on each measuring date. *See* proposed § 1.1297–2(b)(2)(i). If the requisite 25-percent ownership is not met with respect to a corporation on the last day of a measuring period, as defined in Part I.D.1 of this Explanation of Provisions, the stock of the corporation would be a passive asset for purposes of that measuring period, absent the application of a special rule, such as the new rule for dealer property in proposed § 1.1297–1(d)(4), described in Part I.D.4 of this Explanation of Provisions. For purposes of the Income Test, a subsidiary is considered a Look-Through Subsidiary if the Tested Foreign Corporation owns an average of 25 percent of the value of the subsidiary for the year, taking into account its ownership on the last day of each measuring period of the Tested Foreign Corporation's taxable year. *See* proposed § 1.1297–2(b)(2)(ii)(A). If the Tested Foreign Corporation does not maintain, on average, at least 25-percent ownership of the subsidiary for the taxable year, the Tested Foreign Corporation is not, under the general rule in the proposed regulations, treated as receiving its proportionate share of the income of the subsidiary for that year under section 1297(c). However, the Tested Foreign Corporation may be treated as receiving directly its proportionate share of the income of the subsidiary for each measuring period in a taxable year for which the 25-percent ownership requirement is met on the relevant measuring date, provided the taxpayer can establish gross income for each of those measuring periods. *See* proposed § 1.1297–2(b)(2)(ii)(B). Comments are requested concerning appropriate methods for a taxpayer to establish gross income for a measuring period.

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

Section 1298(b)(7) provides a special characterization rule that applies when a Tested Foreign Corporation owns at least 25 percent of the value of the stock of a domestic corporation and is subject to the accumulated earnings tax under section 531 (or waives any benefit under a treaty that would otherwise prevent imposition of such tax). In such instance, section 1298(b)(7) treats the qualified stock held by the domestic corporation as a non-passive asset, and the related income as non-passive income. By its terms, the section 1297(c) look-through rule also could apply to the qualified stock, which is stock in a domestic C corporation that is not a RIC or REIT, and look through to the assets of the corporation that issued the qualified stock for purposes of the Income Test and Asset Test. For example, assume a Tested Foreign Corporation owns 50 percent of the value of the stock in a domestic corporation, US1, which, in turn, owns 50 percent of the stock of a lower tier domestic corporation, US2 (which is not a RIC or a REIT). US2 wholly owns the stock of a foreign corporation, FC. The section 1297(c) look-through rule applies to treat the Tested Foreign Corporation as if it held its proportionate share of the assets, and received a proportionate share of the income, of US1. Both the section 1297(c) look-through rule and the section 1298(b)(7) characterization rule, by their terms, would apply to the stock of US2. The section 1297(c) rule would look through to the assets of US2 and FC. The section 1298(b)(7) characterization rule would treat the stock of US2 as a non-passive asset, and the income derived from the stock as income as non-passive income.

The Treasury Department and the IRS have determined that the special characterization rule of section 1298(b)(7) should generally take precedence over the section 1297(c) look-through rule when both rules would apply simultaneously because the characterization rule of section 1298(b)(7) is the more specific rule where the Tested Foreign Corporation owns a domestic corporation. Thus, the proposed regulations provide that the look-through rule of section 1297(c) does not apply to a domestic corporation, and any subsidiaries of the domestic corporation, if the stock of the domestic corporation is characterized, under section 1298(b)(7), as a non-passive asset producing non-passive income. *See* proposed § 1.1297–2(b)(2)(iii). However, these proposed regulations provide certain limitations on the application of section 1298(b)(7), including a new anti-abuse rule, in which case section 1297(c) would apply. The limitations and anti-abuse rule are described in Part I.H of this Explanation of Provisions. The Treasury Department and the IRS welcome comments on these rules.

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

Section 1297(c) aggregates the income and assets of a Tested Foreign Corporation and a Look-Through Subsidiary for purposes of testing the PFIC status of the Tested Foreign Corporation. However, there are no statutory or regulatory rules that prevent the double counting of income and assets arising from contracts and other transactions among a Tested Foreign Corporation and one or more Look-Through Subsidiaries. Intercompany items that are not eliminated for purposes of determining a Tested Foreign Corporation's PFIC status may result in a duplication of passive income or passive assets attributed to the Tested Foreign Corporation. For instance, if a wholly-owned Look-Through Subsidiary earned $100x of passive income during a taxable year, and distributed the $100x as a dividend to a Tested Foreign Corporation, the Tested Foreign Corporation would have a total of $200x of passive income ($100x of passive income under section 1297(c) and a $100x dividend) for purposes of the Income Test, even though only $100 of passive income was earned economically. Any double-counting of intercompany income and assets distorts the effect of section 1297(c) on the Income Test and Asset Test.

The legislative history to the PFIC rules provides an approach that would eliminate certain assets and income in order to prevent double-counting. *See* H.R. Rep. No. 100–795, at 268 (1988) (''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.''); Staff, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS–10–87, at 1026 (1987). The Treasury Department and the IRS have determined that it is appropriate to follow that approach. Thus, the proposed regulations provide that intercompany payments of dividends and interest between a Look-Through Subsidiary and the Tested Foreign Corporation and stock and debt receivables are eliminated in applying the Income Test and the Asset Test. *See* proposed § 1.1297–2(c)(1) and (2). In the case of dividends, in order to qualify for elimination, the payment must be attributable to income of a Look-Through Subsidiary that was included in gross income by the Tested Foreign Corporation for purposes of determining its PFIC status. *See* proposed § 1.1297–2(c)(2). Thus, dividends attributable to income of the Look-Through Subsidiary earned in a year before the Tested Foreign Corporation owned, on average, at least 25% by value of the Look-Through Subsidiary would generally not qualify for elimination. As a result of the elimination rule, for example, interest and dividends received by a Tested Foreign Corporation from a wholly owned Look-Through Subsidiary are eliminated from the Tested Foreign Corporation's gross income for purposes of applying section 1297(a)(1), except to the extent that dividend amounts are attributable to income that has not been treated as received directly by the Tested Foreign Corporation under the section 1297(c) look-through rule. Additionally, the proposed regulations extend this treatment to intercompany payments between two Look-Through Subsidiaries of a Tested Foreign Corporation and the associated stock and debt receivables. Similarly, stock and debt investments in a lower-tier Look-Through Subsidiary are eliminated for purposes of applying the Income Test and Asset Test to the Tested Foreign Corporation. In the case of a Tested Foreign Corporation that owns less than 100 percent of a Look-Through Subsidiary, the proposed regulations provide that while stock and dividends are eliminated in their entirety, eliminations of debt receivables and interest are made in proportion to the shareholder's direct and indirect ownership (by value) in the Look-Through Subsidiary. The proposed regulations also provide for eliminations under these principles for ownership interests in a Look-Through Partnership, as well as intercompany debt receivables and interest paid or accrued thereon between a Tested Foreign Corporation and a Look-Through Partnership. *See* proposed § 1.1297–2(c)(3). Comments are requested on the application of the elimination rule if the Tested Foreign Corporation owns less than 100 percent of the Look-Through Subsidiary or Partnership. Comments are also requested as to whether the Treasury Department and the IRS should consider the elimination of rents, royalties, or any other types of intercompany income, and any related assets, and if so, how to effectuate the elimination.

4. Section 1297(b)(2)(C) Related Person Determination With Respect to Interest, Dividends, Rents, and Royalties Received by Look-Through Subsidiaries and Certain Partnerships

Section 1297(c) provides that a Tested Foreign Corporation is treated as receiving directly its proportionate share of the income of a Look-Through Subsidiary for purposes of applying the Income Test to the Tested Foreign Corporation. Section 1297(b)(2)(C) provides that, for purposes of the Income Test, passive income does not include interest, dividends, rents or royalties received or accrued from a related person (within the meaning of section 954(d)(3)) to the extent such amount is properly allocable to income of the related person that is not passive income. The statute and current regulations do not address the level at which the ''related person'' determination is made if a Look-Through Subsidiary receives or accrues an item of income that is treated as directly received by a Tested Foreign Corporation pursuant to section 1297(c). Thus, the interaction and application of the two rules is unclear in cases in which the payor of an item of income is a ''related person'' with respect to either the Look-Through Subsidiary or the Tested Foreign Corporation, but not with respect to both.

The Treasury Department and the IRS have determined that, because section 1297(c) generally applies by classifying an item at the level of Look-Through Subsidiary and then carrying that classification up to the Tested Foreign Corporation, it is appropriate to determine whether the section 1297(b)(2)(C) exception applies (and, thus, determine the passive or non-passive character of an item of income) at the Look-Through Subsidiary level, and then flow up the passive or non-passive character of the item to the Tested Foreign Corporation for purposes of applying the Income Test. Accordingly, proposed § 1.1297–2(d)(1) provides that, in applying section 1297(b)(2)(C), ''related person'' status is tested with respect to the payor of the item of income and the Look-Through Subsidiary. The same rule applies for items of income received by a partnership and treated as received directly by a Tested Foreign Corporation pursuant to proposed § 1.1297–1(c)(2). The Treasury Department and the IRS welcome comments on these rules.

5. Attribution of Activities of a Look-Through Subsidiary and Certain Partnerships

The interaction of section 1297(c) and certain exceptions from passive income also raises issues that require a threshold determination of whether an exception should apply at a Look-Through Subsidiary level or a Tested Foreign Corporation level. For instance, under proposed § 1.1296–4 in the notice of proposed rulemaking (INTL–0065–93) published in the **Federal Register** (60 FR 20922) on April 28, 1995, the banking exception in section 1297(b)(2)(A) applies only if a number of requirements are satisfied, including a deposit taking requirement, a lending requirement, and a license requirement. *See* proposed § 1.1296–4. In a bank holding company structure, in which a Tested Foreign Corporation wholly owns a Look-Through Subsidiary that separately satisfies the section 1297(b)(2)(A) requirements, the banking exception would apply to the income derived by the Look-Through Subsidiary in its banking business if an approach that applied the exception at the Look-Through Subsidiary level were adopted, but would not apply if an approach that applied the exception at the Tested Foreign Corporation level were adopted because the Tested Foreign Corporation would not literally meet all of the banking exception requirements. Similarly, the character of assets held by a Look-Through Subsidiary that is a dealer in property in the ordinary course of its trade or business as a dealer would depend on whether an approach that applied the exception in section 954(c)(2)(C) at the Look-Through Subsidiary level were adopted, or whether an approach were applied that determined the character at the level of a Tested Foreign Corporation that was not itself a dealer.

A corollary issue arises with respect to the application of other exceptions to passive income under section 954(c). For instance, under § 1.954–2(c)(1)(ii), the active rental income exception in section 954(c)(2)(A) applies if certain activities are performed with respect to real property by the lessor's own employees. In a structure in which a Tested Foreign Corporation holds real estate assets directly and employees of its Look-Through Subsidiary conduct the activities related to the Tested Foreign Corporation's real estate business necessary to satisfy the exception, the exception would apply if the character of the income were determined at the level of the Tested Foreign Corporation and the activities of the managers and employees of the Look-Through Subsidiary were attributed to the Tested Foreign Corporation. However, the exception would not apply if the activities were not attributed to the Tested Foreign Corporation, because in such case the relevant activities are not performed by employees of the Tested Foreign Corporation, as literally required in the regulation. Additional complexities arise when the Tested Foreign Corporation owns less than 100 percent of the Look-Through Subsidiary.

Under current law, the character of income or assets is determined at the level of the entity that directly earns the income or holds the assets based on the activities of that entity. However, the Treasury Department and the IRS understand that active businesses in foreign jurisdictions generating rent and royalty income are often organized with assets and income, on the one hand, and activities, on the other hand, contained in separate entities for various business reasons. The Treasury Department and the IRS have determined that if assets are held and activities undertaken in separate entities within a group of wholly-owned Look-Through Subsidiaries headed by a Tested Foreign Corporation, the activities of the Look-Through Subsidiaries should be taken into account for purposes of determining whether an item of rent or royalty income of the Tested Foreign Corporation is passive income, as they would if the Look-Through Subsidiaries were disregarded as separate from the Tested Foreign Corporation for U.S. Federal income tax purposes.

Accordingly, the proposed regulations provide that an item of rent or royalty income received or accrued by a Tested Foreign Corporation (or treated as received or accrued by the Tested Foreign Corporation pursuant to section 1297(c)) that would otherwise be passive income under the general rule is not passive income for purposes of section 1297 if the item would be excluded from passive income, determined by taking into account the activities performed by the officers and employees of the Tested Foreign Corporation as well as activities performed by the officers and employees of certain Look-Through Subsidiaries and certain partnerships in which the Tested Foreign Corporation or one of the Look-Through Subsidiaries is a partner. *See* proposed § 1.1297–2(e)(1). In some cases, a Look-Through Subsidiary or Look-Through Partnership may have more than one unrelated owner owning at least 25 percent of the entity's value. Activities, unlike income or expense, are qualitative in nature and cannot be easily allocated between owners based on their percentage ownership. If activities are attributed to any owner of 25 percent or more of the Look-Through Subsidiary or partnership, then up to four owners could potentially be able to take into account the same activities. Because it may be difficult to allocate activities among multiple entities but inappropriate to allow double-counting of the activities by attributing the activities of a Look-Through Subsidiary or a partnership to multiple unrelated entities, the proposed regulations provide that a Tested Foreign Corporation may take into account the activities performed only by those Look-Through Subsidiaries or partnerships with respect to which the Tested Foreign Corporation owns (directly or indirectly) more than 50 percent of the value, because at this level of ownership the activities of the Look-Through Subsidiary or Look-Through Partnership could be attributed to only another foreign corporation within the same chain of ownership as the Tested Foreign Corporation and not an unrelated entity.

The Treasury Department and the IRS request comments on the application of the activity attribution rules to Look-Through Subsidiaries that are not wholly owned by a Tested Foreign Corporation, including whether it is appropriate for a Tested Foreign Corporation to take into account all activities of a Look-Through Subsidiary in which the Tested Foreign Corporation owns more than 50 percent of the value of the stock, and whether a different ownership threshold for attribution of activities would be appropriate.

The Treasury Department and the IRS also request comments on whether the ability to apply an exception to passive income at the Tested Foreign Corporation level taking into account the activities of certain subsidiaries should apply for purposes of other exceptions, such as for purposes of the exception in section 1297(b)(2)(A). Comments should consider the interaction of the rules for elimination of intercompany assets and income described in Part I.F.3 of this Explanation of Provisions with the rules for taking into account the activities of certain Look-Through Subsidiaries and Look-Through Partnerships.

6. Gain on the Disposition of Stock of a Look-Through Subsidiary

Section 1297(c) does not address the treatment of a Tested Foreign Corporation's gain from the disposition of stock of a Look-Through Subsidiary for purposes of the Income Test. Questions have been raised as to whether such a disposition should be treated as a disposition of stock or a deemed disposition of the assets of the Look-Through Subsidiary, and how gain on the disposition should be characterized for purposes of the Income Test.

The proposed regulations provide that, for purposes of the Income Test, the disposition of a Look-Through Subsidiary is treated as the disposition of stock, and gain is computed accordingly. However, the proposed regulations limit the amount of the gain taken into account for purposes of the Income Test in order to avoid double-counting any income that the Tested Foreign Corporation takes into account under section 1297(c) in determining the PFIC status of the Tested Foreign Corporation during the year of the disposition or took into account for such purpose in a prior year that has not been distributed as a dividend to the Tested Foreign Corporation. Thus, the amount of gain taken into account for purposes of the Income Test (''Residual Gain'') is equal to the total gain recognized by the Tested Foreign Corporation on the disposition, reduced (but not below zero) by the amount (if any) by which (A) the aggregate income (if any) of the Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent stock in such other Look-Through Subsidiary is owned indirectly through the Look-Through Subsidiary) taken into account by the Tested Foreign Corporation under section 1297(c)(2) with respect to the disposed Look-Through Subsidiary stock exceeds (B) the aggregate dividends (if any) received by the Tested Foreign Corporation from the Look-Through Subsidiary with respect to the disposed stock (including dividends attributable to stock of any other Look-Through Subsidiary owned indirectly through the Look-Through Subsidiary). The Residual Gain is computed on a share-by-share basis with respect to income of a Look-Through Subsidiary that was taken into account by the Tested Foreign Corporation and dividends received from a Look-Through Subsidiary. *See* proposed § 1.1297–2(f)(1). Comments are requested on the calculation of Residual Gain for purposes of section 1297(a).

Gain from the disposition of stock generally is treated as FPHCI under section 954(c)(1)(B)(i). However, section 954(c) does not contain a look-through rule comparable to section 1297(c). In order to comport with the policy underlying section 1297(c), the Treasury Department and the IRS have determined that the character of the gain from the disposition of a Look-Through Subsidiary should correspond to the character of the underlying assets of the Look-Through Subsidiary. Accordingly, proposed § 1.1297–2(f)(2) provides that the Residual Gain taken into account by the Tested Foreign Corporation will be characterized as passive income or non-passive income in proportion to the passive assets and non-passive assets of the disposed-of Look-Through Subsidiary (and any other Look-Through Subsidiary, to the extent owned indirectly through the Look-Through Subsidiary) treated as held by the Tested Foreign Corporation pursuant to section 1297(c) on the date of the disposition, measured using the method (value or adjusted bases) that is used to measure the assets of the Tested Foreign Corporation for purposes of the Asset Test.

Pursuant to proposed § 1.1297–1(c)(1)(i)(C), section 954(c)(4) applies with respect to the disposition of interests in a Look-Through Partnership. Comments are requested concerning whether any additional guidance is needed concerning the disposition of interests in a Look-Through Partnership.

G. Change-of-Business Exception (Including Dispositions of Stock of a Look-Through Subsidiary)

Section 1298(b)(3) provides an exception from PFIC status (the ''Change-of-Business Exception'') for a Tested Foreign Corporation that is ''in transition from one active business to another active business.'' H.R. Rep. No. 99–841, at II–644 (1986) (Conf. Rep.). Under section 1298(b)(3), the Change-of-Business Exception applies for a taxable year of the Tested Foreign Corporation if (i) neither the Tested Foreign Corporation nor a predecessor of the Tested Foreign Corporation was a PFIC in a prior taxable year; (ii) it is established to the satisfaction of the Secretary that (A) substantially all of the passive income of the Tested Foreign Corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses, and (B) the Tested Foreign Corporation will not be a PFIC for either of the two taxable years following such taxable year; and (iii) the Tested Foreign Corporation is not, in fact, a PFIC for either of such two taxable years. Thus, notwithstanding the legislative history and the title of section 1298(b)(3), a Tested Foreign Corporation may qualify for the Change-of-Business Exception even if it does not engage in an active business after a disposition.

The proposed regulations provide general guidance with respect to the Change-of-Business Exception. First, the proposed regulations provide that for purposes of section 1298(b)(3)(B), the existence of an active trade or business and the determination of whether assets are used in an active trade or business is determined by reference to Treas. Reg. § 1.367(a)–2(d)(2), (3), and (5), except that officers and employees do not include the officers and employees of related entities as provided in § 1.367(a)–2(d)(3). *See* proposed § 1.1298–2(c)(3). If, however, the activity attribution rules described in Part I.F.5 of this Explanation of Provisions or section 954(h)(3)(E) would apply to cause the activities of another entity to be taken into account, they are taken into account for purposes of determining the applicability of the Change-of-Business Exception. *Id.* In addition, the proposed regulations provide that income attributable to proceeds from the disposition of an active trade or business means income earned on investment of such proceeds but does not include the proceeds themselves. *See* proposed § 1.1298–2(c)(1). The regulations also provide that section 1298(b)(3) may apply to either a taxable year of the disposition of the active trade or business or the immediately succeeding taxable year, but in any event may apply to only one year with respect to a disposition. *See* proposed § 1.1298–2(e). Thus, a Tested Foreign Corporation that receives proceeds from a disposition in more than one taxable year may apply the Change-of-Business Exception to only one year. A Tested Foreign Corporation can choose which year it applies the Change-of-Business Exception if the exception can apply in more than one year.

Several comments have inquired regarding the application of the Change-of-Business Exception to the sale or exchange of stock of a Look-Through Subsidiary that conducts an active trade or business. Specifically, these comments have questioned whether, by reason of section 1297(c), the Tested Foreign Corporation should be treated as disposing of an active trade or business conducted by a Look-Through Subsidiary for purposes of the Change-of-Business Exception. The Treasury Department and the IRS have determined that, given that section 1297(c) applies ''for purposes of determining whether [a] foreign corporation is a [PFIC],'' the Change-of-Business Exception should, in appropriate circumstances, apply to a Tested Foreign Corporation's disposition of its interest in a Look-Through Subsidiary that is engaged in an active trade or business. Thus, the proposed regulations provide that, for purposes of the Change-of-Business Exception, a disposition of stock of a Look-Through Subsidiary is treated as a disposition of a proportionate share of the assets held by the Look-Through Subsidiary on the date of the disposition. *See* proposed § 1.1298–2(d). Therefore, the portion of the proceeds attributable to assets used by a Look-Through Subsidiary in an active trade or business is considered for purposes of the Change-of-Business Exception to be proceeds from the disposition of an active trade or business.

The Treasury Department and the IRS also understand that Tested Foreign Corporations may not be able to satisfy the requirements of the Change-of-Business Exception provided in section 1298(b)(3) in certain situations in which proceeds from the disposition of an active trade or business cause the Tested Foreign Corporation to qualify as a PFIC pursuant to the Asset Test. The Treasury Department and the IRS have determined that if a Tested Foreign Corporation has historically engaged in an active trade or business and proceeds from the disposition of such business cause it to qualify as a PFIC, it may be appropriate in certain circumstances to which section 1298(b)(3) does not apply to treat the Tested Foreign Corporation as not a PFIC. Accordingly, the proposed regulations expand the Change-of-Business Exception in section 1298(b)(3) to apply if, on the measuring dates that occur during the taxable year to which the Change-of-Business Exception is proposed to apply and after the disposition, on average, substantially all of the passive assets of a corporation are attributable to proceeds from the disposition of one or more active trades or businesses. *See* proposed § 1.1298–2(b)(2)(ii).

Furthermore, the Treasury Department and the IRS understand that in certain circumstances, the Change-of-Business Exception could apply to the liquidation of a Tested Foreign Corporation if it were not for the fact that foreign law restrictions make it difficult to complete the liquidation within the year for which the exception applies. The Treasury Department and the IRS have determined that it is appropriate to allow the Change-of-Business Exception to be relied upon when such a liquidation is completed within a reasonable period of time after the disposition. Accordingly, in the case of a corporation, substantially all of the passive assets of which are attributable to proceeds from the disposition of one or more active trades or businesses, proposed § 1.1298–2(c)(4) provides that a Tested Foreign Corporation will be deemed to satisfy the requirement that the Tested Foreign Corporation not be a PFIC for the two years following the year for which it relies on the Change-of-Business Exception if it completely liquidates by the end of the year following the year for which it relies on the Change-of-Business Exception. U.S. Federal income tax principles apply to determine whether a Tested Foreign Corporation has completely liquidated. *See* Rev. Rul. 54–518, 1954–2 C.B. 142 (concluding that if a corporation ceases business operations, has retained no assets, and has no income, the mere retention of a charter does not prevent it from being treated as completely liquidated).

The Treasury Department and the IRS request comments concerning whether any other guidance is necessary concerning the application of section 1298(b)(3), including concerning the conditions under which the requirements of section 1298(b)(3)(C) will be considered satisfied.

H. Domestic Subsidiary Stock Rule

As discussed in Part I.F.2 of this Explanation of Provisions, section 1298(b)(7) provides a special characterization rule that applies if a Tested Foreign Corporation owns at least 25 percent of the value of the stock of a domestic corporation and is subject to the accumulated earnings tax under section 531 (or waives any benefit under a treaty that would otherwise prevent imposition of such tax). The proposed regulations clarify that stock of the 25-percent-owned domestic corporation and the qualified stock generally must be owned by the Tested Foreign Corporation and the 25-percent-owned domestic corporation, respectively, either directly or indirectly through one or more partnerships. *See* proposed § 1.1298–4(b)(1) and (c).

The Treasury Department and the IRS have determined that the accumulated earnings tax need not actually be imposed on a foreign corporation in a taxable year in order for it to qualify for section 1298(b)(7). Furthermore, a Tested Foreign Corporation's ability to rely on section 1298(b)(7) in a given year should not depend on whether it has U.S. source income in that year, as it would if § 1.532–1(c) applied to determine whether the Tested Foreign Corporation was subject to tax under section 531. Accordingly, the regulations provide that a Tested Foreign Corporation is considered subject to the tax imposed by section 531 for purposes of section 1298(b)(7) regardless of whether the tax actually is imposed on the corporation and regardless of whether the requirements of § 1.532–1(c) are met. *See* proposed § 1.1298–4(d)(1). Additionally, comments have raised questions concerning the waiver of treaty benefits that would prevent imposition of the accumulated earnings tax. The proposed regulations provide that a Tested Foreign Corporation must waive any benefit under a treaty by attaching to its U.S. Federal income tax return for the taxable year for which it applies section 1298(b)(7) a statement that it irrevocably waives treaty protection against the imposition of the accumulated earnings tax, effective for all prior, current, and future taxable years. *See* proposed § 1.1298–4(d)(2)(i). If a Tested Foreign Corporation is not otherwise required to file a U.S. Federal income tax return, the waiver can be made in a resolution (or other governance document) to be kept in the entity's records or, in the case of a publicly traded corporation, in a statement in the corporation's public filings. *See* proposed § 1.1298–4(d)(2)(ii).

The Treasury Department and the IRS understand that foreign corporations may be relying on section 1298(b)(7) to avoid being treated as PFICs notwithstanding their direct and indirect ownership of predominantly passive assets by ensuring that a sufficient amount of such assets are held indirectly through two tiers of domestic subsidiaries. For example, a Tested Foreign Corporation might hold stock of another foreign corporation that is PFIC, but rely on a two-tiered domestic chain holding passive assets to avoid being treated as a PFIC; as a result, a United States person holding stock of the Tested Foreign Corporation would generally not be treated as a shareholder of the PFIC stock owned by the Tested Foreign Corporation. Accordingly, the proposed regulations provide that, notwithstanding the general coordination rule between section 1297(c) and section 1298(b)(7) in proposed § 1.1297–2(b)(2)(iii), section 1298(b)(7) does not apply for purposes of determining if a foreign corporation is a PFIC for purposes of the ownership attribution rules in section 1298(a)(2) and Treas. Reg. § 1.1291–1(b)(8)(ii). *See* proposed § 1.1298–4(e). Thus, if a Tested Foreign Corporation would qualify as a PFIC if section 1298(b)(7) did not apply, either because section 1297(c) applied to treat the Tested Foreign Corporation as owning directly the assets of a domestic corporation in which it indirectly held qualified stock, or because the qualified stock was treated as a passive asset, then persons that held stock of a PFIC through the Tested Foreign Corporation would be considered under section 1298(a)(2)(B) and Treas. Reg. § 1.1291–1(b)(8)(ii)(B) to own a proportionate amount (by value) of the stock of the PFIC regardless of the level of their ownership interest in the Tested Foreign Corporation.

To address the possibility of passive assets—particularly non-stock assets that could not themselves be eligible for the special treatment of section 1298(b)(7)—being held through a two-tiered chain of domestic subsidiaries in order to avoid the PFIC rules, the proposed regulations further provide anti-abuse rules under the authority of section 1298(g), one of which provides that section 1298(b)(7) will not apply if the Tested Foreign Corporation would be a PFIC if the qualified stock or any income received or accrued with respect thereto were disregarded. *See* proposed § 1.1298–4(f)(1). Furthermore, under a second anti-abuse rule, section 1298(b)(7) will not apply if a principal purpose for the Tested Foreign Corporation's formation or acquisition of the 25-percent-owned domestic corporation is to avoid classification of the Tested Foreign Corporation as a PFIC. A principal purpose will be deemed to exist if the 25-percent-owned domestic corporation is not engaged in an active trade or business in the United States. *See* proposed § 1.1298–4(f)(2). No inference is intended as to the application of section 1298(b)(7) under prior law. The IRS may, where appropriate, challenge transactions under the Code, regulatory provisions under prior law, or judicial doctrines. The Treasury Department and the IRS welcome comments on these rules.

II. PFIC Insurance Exception Rules

The proposed regulations provide guidance regarding whether the income of a foreign corporation is excluded from passive income pursuant to section 1297(b)(2)(B) because the income is derived in the active conduct of an insurance business by a QIC. Part II.A of this Explanation of Provisions describes the rules in proposed § 1.1297–4 for determining whether a foreign corporation is a QIC. Part II.B of this Explanation of Provisions describes the rules in proposed § 1.1297–5(c)(2) defining the term insurance business. Part II.C of this Explanation of Provisions describes the rules in proposed § 1.1297–5(c) regarding the active conduct of an insurance business. Part II.D of this Explanation of Provisions describes the rules in proposed § 1.1297–5(f) regarding the application of the section 1297(b)(2)(B) exception to items of income treated as received or accrued or assets treated as held by a QIC pursuant to section 1297(c). Part II.E of this Explanation of Provisions describes the rules in proposed § 1.1297–5(d) regarding the treatment of income and assets of certain domestic insurance corporations owned by a QIC as active for purposes of 1297(a). Part II.F of this Explanation of Provisions describes the rule in proposed § 1.1297–5(g) prohibiting the double counting of any item for purposes of proposed §§ 1.1297–4 and 1.1297–5.

A. QIC Status Requirement

Generally, section 1297(f) provides that a QIC is a foreign corporation that (1) would be subject to tax under subchapter L if it were a domestic corporation and (2) has applicable insurance liabilities that constitute more than 25 percent of its total assets. Proposed § 1.1297–4 provides guidance regarding the requirements under section 1297(f)(1) that a foreign corporation must satisfy to qualify as a QIC.

1. Insurance Company Requirement

Proposed § 1.1297–4(b)(1) provides guidance regarding when a foreign corporation would be the type of corporation that would be taxable under subchapter L (that is, an insurance company) if the corporation were a domestic corporation. *See* section 1297(f)(1)(A). It provides that a foreign corporation would be subject to tax under subchapter L if it were a domestic corporation if it is an insurance company as defined in section 816(a) (generally requiring more than half of the corporation's business during the taxable year to be the issuing of insurance or annuity contracts, or the reinsuring of risks underwritten by insurance companies).

2. 25 Percent Test

In addition to the insurance company requirement, generally a foreign corporation's ''applicable insurance liabilities'' (defined in section 1297(f)(3)(A) and proposed § 1.1297–4(f)(2)) must exceed 25 percent of its ''total assets'' (defined in proposed § 1.1297–4(f)(7) to be a QIC. Section 1297(f)(1)(B); *see also* proposed § 1.1297–4(c). This determination is made on the basis of the foreign corporation's liabilities and assets as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year. This test hereinafter is referred to as the ''25 percent test.'' Proposed § 1.1297–4(c) provides guidance regarding the application of the 25 percent test.

3. Alternative Facts and Circumstance Test

If a foreign corporation fails the 25 percent test, section 1297(f)(2) permits a United States person to elect to treat stock in the corporation as stock of a QIC under certain circumstances. Specifically, to make the election, the foreign corporation must be predominantly engaged in an insurance business, and its applicable insurance liabilities must constitute 10 percent or more of its total assets, hereinafter the ''10 percent test.'' A United States person may only make this election if the foreign corporation fails the 25 percent test solely due to runoff-related or rating-related circumstances involving its insurance business, as further described in Part II.A.3.b of this Explanation of Provisions.

a. Predominantly Engaged in an Insurance Business

Proposed § 1.1297–4(d)(2) provides guidance regarding the circumstances under which a foreign corporation is predominantly engaged in an insurance business. In the case of a foreign corporation that fails the 25-percent test, Congress included the predominantly engaged requirement as part of the alternative facts and circumstances test to ascertain whether a foreign corporation is truly engaged in an insurance business despite the low ratio of applicable insurance liabilities to assets. *See* H.R. Rep. No. 115–466, at 671 (2017) (Conf. Rep.) (''Facts and circumstances that tend to show the firm may not be predominantly engaged in an insurance business include a small number of insured risks with low likelihood but large potential costs; workers focused to a greater degree on investment activities than underwriting activities; and low loss exposure. Additional relevant facts for determining whether the foreign corporation is predominantly engaged in an insurance business include: Claims payment patterns for the current year and prior years; the foreign corporation's loss exposure as calculated for a regulator or for a rating agency, or if those are not calculated, for internal pricing purposes; the percentage of gross receipts constituting premiums for the current and prior years; and the number and size of insurance contracts issued or taken on through reinsurance by the foreign corporation. The fact that a foreign corporation has been holding itself out as an insurer for a long period is not determinative either way.''). The proposed regulations clarify that each of these factors is intended to be tested based on whether the particular facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's length transactions.

As noted in Part II.A.1 of this Explanation of Provisions, to qualify as an insurance company, more than one half of a corporation's business must be the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. *See* sections 816(a) and 831(c). Although such a corporation might otherwise be considered to be ''predominantly engaged'' in an insurance business (where predominantly means ''for the most part''), the predominantly engaged requirement of the alternative facts and circumstances test in section 1297(f) is separate from, and in addition to, the requirement that a corporation would be subject to tax under subchapter L if the foreign corporation were a domestic corporation. Therefore, in order to give effect to this predominantly engaged requirement, proposed § 1.1297–4(d)(2) incorporates the specific factors enumerated in the legislative history as a part of a foreign corporation's analysis of whether it is predominantly engaged in an insurance business under the alternative facts and circumstances test, while retaining the requirement that ''more than half'' of the business be of a certain type, because the foreign corporation must separately satisfy that threshold with respect to the character of its insurance business under section 1297(f)(1)(A).

The Treasury Department and the IRS request comments regarding whether this proposed test appropriately determines whether a foreign corporation is predominantly engaged in an insurance business and invite comments on whether the proposed test would have material effects upon the way in which entities engaged in the provision of insurance are structured.

b. Runoff-Related or Rating-Related Circumstances

To qualify for the alternative facts and circumstances test, proposed § 1.1297–4(d)(3) and (4) clarify the circumstances under which a foreign corporation fails to satisfy the 25 percent test solely due to runoff-related or rating-related circumstances involving its insurance business.

Proposed § 1.1297–4(d)(3) provides that runoff-related circumstances occur when a corporation has adopted a plan of liquidation or termination of operations under the supervision of its applicable insurance regulatory body. Additionally, the corporation may not issue or enter into any new insurance, annuity, or reinsurance contracts during the taxable year (other than contractually obligated renewals of existing insurance contracts or reinsurance contracts pursuant to and consistent with the corporation's plan of liquidation or termination of operations) and must make payments during the annual reporting period covered by the applicable financial statement to satisfy the claims under insurance, annuity, or reinsurance contracts issued or entered into before the corporation ceased entering into new business.

Proposed § 1.1297–4(d)(4) provides that rating-related circumstances occur when a generally recognized credit rating agency requires a foreign corporation to maintain a surplus of capital to receive or maintain a minimum credit rating for the foreign corporation to be classified as secure to write new insurance business for the current year. The Treasury Department and the IRS understand that it is possible that the minimum credit rating required to be classified as secure to write new insurance business may be higher for some lines of insurance business than for other lines of insurance business. For this purpose, the proposed rule is intended to apply to the highest minimum credit rating required to be classified as secure to write new insurance business for any line of insurance business.

The Treasury Department and the IRS understand that there may be certain lines of insurance business, such as financial guaranty insurance, where market realities require a credit rating in excess of the minimum credit rating for a foreign corporation to be classified as secure to write new insurance business in the relevant business line for the current year. The Treasury Department and the IRS request comments regarding this fact pattern and how best to address these lines of business in the context of the rating-related circumstances test.

c. Election To Apply the Alternative Facts and Circumstances Test

Proposed § 1.1297–4(d)(5)(i) generally requires that the foreign corporation with respect to which the election is made directly provide the United States person a statement or make a publicly available statement (such as in a public filing, disclosure statement, or other notice provided to United States persons that are shareholders of the foreign corporation) that it satisfied the requirements of section 1297(f)(2) and § 1.1297–4(d)(1) during the foreign corporation's taxable year and certain information relevant to that statement. A United States person, however, may not rely upon any statement by the foreign corporation to make the election under section 1297(f)(2) if the shareholder knows or has reason to know that the statement made by the foreign corporation was incorrect. Because the foreign corporation possesses the information necessary to make an election under the alternative facts and circumstances test, the Treasury Department and the IRS have determined that it is appropriate to require a United States person to obtain that information from the foreign corporation in order to make the election. Comments are requested regarding the form and content of the statement provided by the foreign corporation to United States persons as set forth in proposed § 1.1297–

4(d)(5)(i)–(ii), and whether there are alternative ways of satisfying the requirements of 1297(f)(2).

Proposed § 1.1297–4(d)(5)(iii) describes the time and manner for making the election. To make the election before final regulations are published, a United States person that owns stock of a foreign corporation electing to treat that stock as stock of a QIC under the alternative facts and circumstances test must file a limited-information Form 8621 (or successor form). For this purpose, a United States person must file a Form 8621 with the box checked regarding the QIC election and must provide the identifying information of the shareholder and the foreign corporation. The United States person is not required to complete any other part of Form 8621 if that person is only filing the Form 8621 to make the QIC election under the alternative facts and circumstances test.

The Treasury Department and the IRS request comments on ways to reduce burden on small shareholders with respect to the alternative facts and circumstances test.

4. Limitations on the Amount of Applicable Insurance Liabilities

When applying the 25 percent test to a foreign corporation, section 1297(f)(3)(B) provides that the amount of the foreign corporation's applicable insurance liabilities cannot exceed the lesser of (i) the amount that the foreign corporation reported to its ''applicable insurance regulatory body'' (defined in section 1297(f)(4)(B) and proposed § 1.1297–4(f)(3)), (ii) the amount required by applicable law or regulation, or (iii) the amount determined under regulations prescribed by the Treasury Department and the IRS.

Proposed § 1.1297–4(e) provides additional guidance regarding the limitation on the amount of applicable insurance liabilities for purposes of the 25 percent test and the 10 percent test. Specifically, the proposed regulations provide that the amount of applicable insurance liabilities may not exceed the lesser of (1) the amount shown on the most recent applicable financial statement; (2) the minimum amount required by applicable law or regulation of the jurisdiction of the applicable insurance regulatory body; and (3) the amount shown on the most recent financial statement made on the basis of U.S. generally accepted accounting principles (''US GAAP'') or international financial reporting standards (''IFRS'') if such financial statement was not prepared for financial reporting purposes. The Treasury Department and the IRS have determined that the additional limitations are necessary to clarify which financial statements are used to apply the 25 percent test and the 10 percent test, and that it is appropriate to limit the amount of applicable insurance liabilities to the minimum amount of liabilities required to be reported by an insurance regulator, even if the foreign corporation's regulator would accept a higher liability amount for regulatory purposes. In addition, under section 1297(f)(4), an applicable financial statement only includes financial statements made on the basis of US GAAP or IFRS if such a statement has been prepared for financial reporting purposes. If a foreign corporation prepares a financial statement on the basis of US GAAP or IFRS for a purpose other than financial reporting, the Treasury Department and the IRS have determined that the amount of applicable insurance liabilities under this financial statement, if lower than the amount on the applicable financial statement, is an appropriate limit on the amount of applicable insurance liabilities. This limitation is appropriate because Congress has expressed a preference for widely used standards of financial accounting through its references to such standards in section 1297(f)(4)(A).

Under the proposed regulations, a special rule applies with respect to applicable financial statements that are neither prepared under US GAAP nor IFRS. To the extent that such an applicable financial statement does not discount losses on an economically reasonable basis, the foreign corporation must reduce its applicable insurance liabilities to reflect discounting that would apply under either US GAAP or IFRS. The Treasury Department and the IRS have determined that a method of determining insurance liabilities that fails to provide for a reasonable discounting rate does not take into account a factor that is necessary to appropriately and accurately report the amount of applicable insurance liabilities. For this purpose, the question of whether losses are discounted on an economically reasonable basis is determined under the relevant facts and circumstances. However, in order for losses to be discounted on an economically reasonable basis, discounting must be based on loss and claim payment patterns for either the foreign corporation or insurance companies in similar lines of insurance business. In addition, a discount rate based on these loss and claim payment patterns of at least the risk free rate in U.S. dollars or in a foreign currency in which the foreign corporation conducts some or all of its insurance business must be used. A loss discounting methodology consistent with that used for US GAAP or IFRS purposes is considered reasonable for this purpose.

Finally, a special rule applies for certain foreign corporations that change their method of preparing their applicable financial statement by ceasing to prepare this statement under either US GAAP or IFRS and have no non-Federal tax business purpose for preparing a statement that is not consistent with US GAAP or IFRS. Under the proposed regulations, absent a non-Federal Tax business purpose, a foreign corporation must continue to prepare its applicable financial statement under either US GAAP or IFRS. If the foreign corporation fails to do so, the foreign corporation will be treated as having no applicable insurance liabilities for purposes of the QIC test. Absent this proposed rule, the Treasury Department and the IRS are concerned that a foreign corporation may change its method for preparing its financial statement to benefit from certain elements of a local regulatory accounting regime, such as a more expansive definition of insurance liability or a method of calculating a larger amount of insurance liabilities, solely for purposes of qualifying as a QIC. Comments are requested on this proposed rule.

B. Insurance Business

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

C. Active Conduct

To give effect to the active conduct requirement, the 2015 proposed regulations differentiated between activities performed by a corporation through its officers and employees and activities performed by other persons (for example, employees of other entities or independent contractors) for the corporation. The 2015 proposed regulations accomplished this separation by defining the term ''active conduct'' in section 1297(b)(2)(B) to have the same meaning as in § 1.367(a)–2T(b)(3) (now § 1.367(a)–2(d)(3)), except that officers and employees would not have included the officers and employees of related entities. Hence, under the 2015 proposed regulations, only insurance investment business activities performed by a corporation's officers and employees would be included in the corporation's active conduct of its insurance business. Accordingly, under the 2015 proposed regulations, investment income would have qualified for the PFIC insurance exception only if the corporation's own officers and employees performed the insurance business activities that produce the income.

Proposed § 1.1297–5(c)(3)(i) provides that the term active conduct is based on all of the facts and circumstances and that, in general, a QIC actively conducts an insurance business only if the officers and employees of the QIC carry out substantial managerial and operational activities. For this purpose, active conduct is intended to be interpreted consistently with the active conduct standard in § 1.367(a)–2(d)(5). The proposed regulation further provides that a QIC's officers and employees are considered to include the officers and employees of another corporation if the QIC satisfies the control test set forth in proposed § 1.1297–5(c)(3)(ii). Generally, to satisfy the control test, (i) the QIC must either own, directly or indirectly more than 50 percent of the vote and value (for a corporation) or capital and profits interest (for a partnership) of the entity whose officers or employees are performing services for the QIC or (ii) a common parent must own, directly or indirectly, more than 80 percent of the vote and value or capital and profits interest of both the QIC and the entity performing services for the QIC. In addition, the QIC must exercise regular oversight and supervision over the services performed by the other entity's officers and employees for the QIC. The QIC must also either (i) pay directly all the compensation of the other entity's officers and employees attributable to services performed for the QIC for the production or acquisition of premiums and investment income on assets held to meet obligations under insurance, annuity, or reinsurance contracts issued or entered into by the QIC; (ii) reimburse the other entity for the portion of its expenses, including compensation and related expenses (determined in accordance with section 482, taking into account all expenses that would be included in the total services costs under § 1.482–9(j) and § 1.482–9(k)(2)) and add a profit markup, as appropriate, for these services performed for the QIC by the other entity's officers and employees; or (iii) otherwise pay arm's length compensation in accordance with section 482 on a fee-related basis to the other entity for the services provided to the QIC. For example, it is common to charge for investment advisory or management services via a fee calculated as a percentage of the underlying assets under management (AUM), and a fee calculated on this basis may be arm's length under section 482 principles.

Under proposed § 1.1297–5(c)(4), a QIC determines the annual amount of its income that is derived in the active conduct of an insurance business (the active conduct test) and excluded from passive income under section 1297(b)(2)(B) for purposes of section 1297(a). To make this determination, the QIC must determine its active conduct percentage.

If the QIC's active conduct percentage is greater than or equal to 50 percent, then all of the QIC's passive income (as defined in § 1.1297–1, taking into account the exceptions in section 1297(b)(2) other than section 1297(b)(2)(B) and § 1.1297–5) is excluded from passive income pursuant to the exception in section 1297(b)(2)(B) for the active conduct of an insurance business. If the QIC's active conduct percentage is less than 50 percent, then none of its income is excluded from passive income pursuant to the exception in section 1297(b)(2)(B) for the active conduct of an insurance business. In response to comments made to the 2015 proposed regulations, the active conduct percentage is based on the QIC's expenses to provide a bright-line test for measuring the QIC's active conduct. The Treasury Department and the IRS determined that the amount of expenses for insurance activities performed by the QIC (or by a related party) as compared to the total expenses of the QIC indicates the extent to which the QIC conducts the business itself and therefore, actively engages in an insurance business.

The Treasury Department and the IRS request comments on the following topics:

1. Whether the relative amount of expenses for insurance activities performed by the QIC accurately assesses whether a QIC is engaged in the active conduct of an insurance business.

2. The contours of the control test, which allow for a QIC to benefit from a higher active conduct percentage based on activities (paid for by the QIC) of an entity in which a common parent, but not the QIC itself, owns more than 80 percent of the interests. The Treasury Department and IRS propose this standard based on an understanding of common ownership structures in the insurance industry, and note that the attribution of activities described in Part I.F.5 of this Explanation of Provisions (regarding the active rent or royalty exception) is more limited as it provides that a Tested Foreign Corporation may take into account the activities performed only by those Look-Through Subsidiaries or partnerships with respect to which the Tested Foreign Corporation owns (directly or indirectly) more than 50 percent of the value.

3. The active conduct percentage calculation in general, including whether this test should be the only test for determining whether income is derived in the active conduct of an insurance business or whether such a percentage would better serve as an objective safe harbor alongside a facts and circumstances test.

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

Proposed § 1.1297–5(f) provides that certain items of income and assets that are passive in the hands of a look-through subsidiary or look-through partnership may be treated as active by a QIC. Under this provision, a Tested Foreign Corporation is treated as if it directly holds its proportionate share of the assets and as if it directly receives its proportionate share of the income of the Look-Through Subsidiary or Look-Through Partnership. Generally, if the income or assets are passive in the hands of the Look-Through Subsidiary or Look-Through Partnership, the income or assets are treated as passive income and passive assets of the Tested Foreign Corporation. However, if the Tested Foreign Corporation is a QIC, the income and assets are tested under section § 1.1297–5(c) and (e) to determine if they qualify for the section 1297(b)(2)(B) insurance exception to passive income. However, for this rule to apply, the Look-Through Subsidiary or Look-Through Partnership, as the case may be, must have its assets and liabilities included in the applicable financial statement of the foreign corporation for purposes of the 25 percent test and the 10 percent test. This rule does not change the character of the items of income or assets as passive income or passive assets to the Look-Through Subsidiary or Look-Through Partnership.

E. Qualifying Domestic Insurance Corporations

Proposed § 1.1297–5(d) provides that income of a qualifying domestic insurance corporation is not treated as passive income. Similarly, proposed § 1.1297–5(e)(2) provides that assets of a qualifying domestic insurance corporation are not treated as passive assets. A qualifying domestic insurance corporation is a domestic corporation that is subject to tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Code and is subject to Federal income tax on its net income. This rule is intended to address situations where a Tested Foreign Corporation owns a domestic insurance corporation through a structure to which section 1298(b)(7) does not apply.

F. No Double Counting Rule

Proposed § 1.1297–5(g) provides that nothing in proposed § 1.1297–4 or § 1.1297–5 permits any item to be counted more than once (for example, for determining a reserve or an applicable insurance liability for purposes of the 25 percent test and the 10 percent test). Including this general principle is consistent with subchapter L provisions that do not allow double counting. For example, section 811(c)(2) provides that the same item may not be counted more than once for reserve purposes, section 811(c)(3) provides that no item may be deducted (either directly or as an increase in reserves) more than once, and section 832(d) prohibits the same item from being deducted more than once.

Applicability Dates

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

Special Analyses

I. Regulatory Planning and Review—Economic Analysis

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

The proposed regulation has been designated by the Office of Information and Regulatory Affairs (OIRA) as significant under Executive Order 12866 pursuant to the Memorandum of Agreement (MOA, April 11, 2018) between the Treasury Department and the Office of Management and Budget regarding review of tax regulations.

A. Background

Various provisions of the tax code allow tax on certain sources of income to be deferred, which means that the income is not taxed when it is earned but at some later date, based on specific events or conditions. Tax deferral is advantageous to taxpayers because the taxpayer can in the meantime earn a return on the amount that would otherwise have been paid as tax. Prior to the Act, income earned abroad generally was not taxed until it was repatriated to the United States. After the Act, income earned abroad by a CFC is generally taxed immediately to the United States shareholders of the CFC, but income earned by foreign corporations that are not CFCs, particularly where the owners of the foreign corporations are individuals or other entities not eligible for the dividends received deduction under section 245A, may still be eligible for deferral. However, deferral is not available with respect to income of foreign corporations that earn primarily certain kinds of passive income, which in general includes dividends, interest, royalties, rents, and certain gains on the exchange of property, commodities, or foreign currency. Limiting deferral of foreign source income discourages U.S. taxpayers from holding mobile, passive investments, such as stock, in a foreign corporation in order to defer U.S. tax.

A particular set of rules limiting deferral applies to U.S. persons who own interests in passive foreign investment companies (''PFICs''). In general, a PFIC is a foreign corporation that, in a given year, has income that is 75 percent or more passive income or that owns, on average, assets that are 50 percent or more passive-income-producing. Taxpayers subject to another set of rules limiting deferral, the subpart F rules, are not subject to the PFIC rules.

Long-standing sections 1291 through 1298 provide rules regarding the tax treatment of income from PFICs. The PFIC itself is not subject to U.S. tax under the PFIC regime; rather, only the U.S. owner of the PFIC is required to determine whether he or she has invested in a PFIC, and if so, what tax is due as a result. The U.S. owner is responsible for getting the appropriate information from the foreign corporation to determine if the corporation is a PFIC.

Before its amendment by the Act, the PFIC provisions provided an exception from passive income for any income (including investment income) earned in the active conduct of an insurance business by a foreign corporation that (i) was predominantly engaged in an insurance business and (ii) would be taxed as an insurance company if it were a domestic corporation. Congress determined that this exception enabled U.S. owners of some foreign insurance companies to escape the PFIC regime. This exception, (the ''PFIC insurance exception''), was established because insurance companies must hold significant amounts of investment assets (which generate income that would otherwise be classified as passive under the PFIC rules) in the normal course of business to fund obligations under the insurance contracts they issue. Staff, Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, JCS–10–87, at 1025 (1987); IRS, Corporate Income Tax Returns Complete Report, 2013, Table 1).

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

Congress modified section 1297 under the Act out of concern that the active insurance company exception to the PFIC rules lacked clarity and precision. This lack of clarity with respect to how much insurance business the company must do to qualify under the exception raised concerns that certain companies with U.S. shareholders were structuring themselves to take advantage of the exception but conducting a token insurance business while focusing primarily on investment activities. Such strategies erode the U.S. tax base, and reflect inefficient investment incentives for U.S. taxpayers. As a result, the Act adopted a more formulaic rule that is easier to enforce and apply, while still allowing a facts and circumstances approach for showing insurance activity. *See* Senate Budget Explanation of the Bill (2017–11–20) at p. 397.

B. Need for the Proposed Regulations

The Treasury Department and the IRS view the Act modifications regarding PFIC determination as generally self-executing (although regulatory guidance is needed in order for U.S. owners to elect QIC status under the facts and circumstances test), which means that the statute is binding on taxpayers and the IRS without further regulatory action. The Treasury Department and the IRS recognize, however, that the statute provides interpretive latitude for taxpayers and the IRS that could, without further guidance, prompt inefficient investment patterns due to divergent interpretations. Consequently, many of the details behind the relevant terms and necessary calculations required for the determination of PFIC status would benefit from greater specificity. The proposed regulations provide details and specifics for the definitions and concepts described in sections 1291, 1297, and 1298 so that taxpayers can readily and accurately determine if their investment is in a PFIC, given the significant consequences of owning a PFIC, which may continue to be treated as such even after the foreign corporation ceases to satisfy the Income Test or Asset Test. *See* section 1298(b)(1). The regulations further resolve ambiguities in determining ownership of a PFIC and in the application of the Income Test and Asset Test under the statutory provisions that existed prior to the Act.

The Treasury Department and the IRS have also identified actions that foreign companies might take to qualify for QIC designation even though the nature of their active insurance business would not merit QIC designation under the intents and purposes of the statute. The proposed regulations are needed to avoid the inefficient economic decisions that would arise from those tax avoidance actions. For example, in the absence of the proposed regulations, taxpayers may be incentivized to adopt accounting methods that inappropriately inflate applicable insurance liabilities or exaggerate the degree to which income of a QIC is derived in the active conduct of an insurance business.

C. Overview of the Proposed Regulations

The proposed regulations can be divided into two parts. The rules described in Part I of the Explanation of Provisions section of this preamble provide general guidance regarding PFICs (the ''General Rules''). *See* Part I.D.2 of this Special Analyses section. The rules described in Part II of the Explanation of Provisions section of this preamble relate specifically to the implementation of the PFIC insurance exception (the ''PFIC Insurance Exception Rules''). *See* Part I.D.3 of this Special Analyses section. Among other things, the General Rules (1) describe and clarify how assets are measured for the asset test; and (2) clarify attribution rules for determining some forms of active income. The PFIC Insurance Exception Rules provide guidance regarding qualification for the PFIC insurance exception, define statutory terms relevant to QIC status, and provide instructions on electing QIC status under the alternative facts and circumstances test.

D. Economic Analysis

1. Baseline

The Treasury Department and the IRS have assessed the benefits and costs of the proposed regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these proposed regulations.

2. Summary of Economic Effects

The proposed regulations provide certainty and consistency in the application of sections 1291, 1297, and 1298 with respect to PFICs and QICs by providing definitions and clarifications regarding the statute's terms and rules. In the absence of such guidance, the chances that different U.S. owners (or potential owners) of foreign companies would interpret the statute differentially, either from each other or from the intents and purposes of the statute, would be exacerbated. This divergence in interpretation could cause U.S. investors to choose investment vehicles based on different interpretations of, for example, whether particular income would avoid qualifying as passive income and thus avoid the less favorable tax treatment applied by the PFIC regime. If economic investment is not guided by uniform incentives across otherwise similar investors and across otherwise similar investments, the resulting pattern of investment is generally inefficient, conditional on the Code's provisions governing passive income.[1] In the context of U.S. investment in foreign insurance corporations, the proposed regulations help to ensure that similar economic activities, representing similar passive and non-passive attributes, are taxed similarly. Thus, the Treasury Department and the IRS expect that the definitions and guidance provided in the proposed regulation will lead to an improved allocation of investment among taxpayers contingent on the overall Code.

The Treasury Department and the IRS have not quantified the expected economic benefits or the costs to the U.S. economy, or the scope of taxpayers benefitting from or burdened by the proposed regulations. The Treasury Department and the IRS request comment on these issues and particularly solicit comments that provide data, evidence, or models that would enhance the rigor by which the non-revenue economic effects might be determined and quantified for the final regulations.

[1] General economic principles do not clearly prescribe the efficient relative tax treatment of passive income versus non-passive income and therefore do not indicate whether a shift in investment from passive-income-producing activities to non-passive-income-producing activities is economically beneficial. This economic analysis draws conclusions about the efficient tax treatment of different investments by evaluating incentives in light of the intents and purposes of the underlying statutes.

The following sections describe the economic effects of specific major provisions of these proposed regulations relative to possible alternative provisions. The Treasury Department and IRS solicit comments on each of the items discussed subsequently and on any other provisions of the proposed regulations not discussed in this section. The Treasury Department and the IRS particularly solicit comments that provide data, other evidence, or models that could enhance the rigor of the process by which these or further provisions might be developed for the final regulations.

3. Economic Analysis of Specific Provisions of the General Rules

a. Averaging Period for the Asset Test

A foreign corporation is considered a PFIC if it satisfies either of the following tests: (i) 75 percent or more of the corporation's gross income for a taxable year is passive (''Income Test''); or (ii) the average percentage of assets held by the corporation during the year producing passive income is at least 50 percent (''Asset Test''). If a foreign corporation is a PFIC, the U.S. owner of the PFIC is subject to tax under the PFIC regime. Regarding the Asset Test, section 1297(e) provides rules for how to determine the value of assets using either the fair market value or the adjusted basis, but does not indicate what period should be used to determine the ''average percentage.'' Notice 88–22, which was issued following the enactment of the PFIC regime to provide guidance on a number of issues related to the Income and Asset Tests pending regulations, required taxpayers to determine value at the end of each quarter and average those numbers on an annual basis for the test. *See* Part I.D.1 of the Explanation of Provisions section of this preamble. Notice 88–22 announced the intention of the Treasury Department and IRS to issue regulations addressing this and other issues under the PFIC regime; however, no regulations addressing the Asset Test were issued until the proposed regulations.

To remedy this omission and specify the period over which the average percentage would be calculated, the Treasury Department and the IRS considered three alternatives: (i) Semi-annual measurement, (ii) quarterly measurement, and (iii) daily measurement.[2] The Treasury Department and the IRS also considered, once a default measuring period was set, offering flexibility to shareholders to determine their own measurement period as long as the period was shorter than the default period. In each respective case, the Asset test would be based on the annual average of the semi-annual, quarterly, or daily asset values.

The first option, to require taxpayers to determine the average value of assets that produce passive income on a semi-annual basis, has lower costs than the other suggested approaches since calculations have to be done just twice a year and these costs (or cost-savings) are borne directly or indirectly by the owners of the corporation. The benefit of these lower costs to U.S. taxpayers must be balanced against the projected accuracy of semi-annual measurement. Because the period examined is long, semi-annual amounts are relatively easy for the corporation to manipulate so as to avoid having 50 percent or more passive-income producing assets as measured by value over the averaging period discussed here (the Asset Test) and therefore avoid PFIC treatment, even in cases where the company held significant amounts of passive-income-producing assets during the year.

The third option, to require taxpayers to average daily asset values for the asset test, provides a more exact measure of the assets of the company but the costs for the company to provide such information to their owners can be significant and some companies might choose not to provide such calculations to their small U.S. owners.[3] On the other hand, daily measurement would make it costly for the entity to avoid PFIC determination by ''removing'' assets generating passive income at measurement times.

The proposed regulations, consistent with the second option, require at least quarterly measurement and further allow taxpayers to elect to use a shorter period, such as monthly or daily measurement of asset values. Shorter period alternatives (relative to a semi-annual period) curtail the ability of foreign corporations to avoid PFIC designation through asset management strategies that would be tax-driven rather than market-driven. The Treasury Department and the IRS project that the increase in compliance costs of quarterly measurement over semi-annual measurement would be minor, because quarterly measurement aligns with general accounting practices, and because many taxpayers were likely already relying on the provision in Notice 88–22 that provided for quarterly measurement. The election to choose monthly or daily measurement allows U.S. persons who own interests in foreign corporations to use even more precise measurement of asset holdings if, based on business-specific accounting practices and the availability of that information to the U.S. person, the U.S. person deems that any higher compliance costs they might incur are warranted.

The Treasury Department and IRS solicit comments on this proposal, particularly comments that provide data, other evidence, or models that could enhance the rigor of the process by which the average percentage period might be developed for the final regulations.

b. Attribution of Activities

For purposes of determining whether a corporation is a PFIC, section 1297(c) treats a foreign corporation (FC1) that owns 25 percent or more of another foreign corporation (FC2) as owning and earning the proportional amount of FC2's income and assets under the so called Look-Through Subsidiary rules.[4] However, the statute is silent on whether the activities of FC2 can be attributed to FC1 for purposes of determining whether the income of FC1 qualifies as being treated as non-passive income. Under current practice, some businesses structure their organization for legal or commercial reasons to have all employees for a business in one corporation, say FC2, while the rents and royalties are received by FC1. Without attribution of activities, FC1 could not qualify for an exception that treats these rents and royalties as active, as opposed to passive, income. This could result in FC1 being treated as a PFIC even though, on the whole, its income and economic activities were related to active business operations and not comparable to the passive income generating activities generally undertaken by PFICs.

To address the attribution of activities in foreign businesses in structures similar to those described, the Treasury Department and the IRS considered three alternatives: (1) Do not allow any attribution of activities; (2) allow attribution of activities to multiple U.S. owners; or (3) allow attribution only if there is greater than a 50 percent ownership percentage; that is, if the

[2] Other units could have been considered, such as months or weeks, but these three options span the reasonable possibilities.

[3] It would further generally be difficult for a U.S. owner to calculate, on his or her own, the value of PFIC assets on a daily basis, especially if the owner were a minority shareholder.

[4] For purposes of the rest of this discussion, FC1 can be considered the parent corporation with U.S. owners that is tested as to whether it is a PFIC or not. FC2 is a subsidiary of FC1.

foreign corporation owns more than 50 percent of the other foreign corporation.

Under the first alternative (no attribution), a foreign corporation that separated activities and income could satisfy the passive income exception only if it reorganized such that the entity being tested as a PFIC received both the active rents and royalties as well as had the employees that performed the related activities. This is potentially costly or even infeasible, depending on local requirements. The Treasury Department and the IRS determined that this alternative would potentially lead to costly reorganization, a cost that would either be passed on to U.S. investors or that, in the absence of such reorganization, would inhibit U.S. investment in a foreign corporation that was otherwise similar to corporations that were not PFICs. These are economically undesirable outcomes in light of the intents and purposes of the statute, relative to the proposed regulations.

Under the second alternative, activities could be attributed similarly to how the Look-Through Rule attributes income and assets. In general, because the Look-Through Rule requires ownership of only 25 percent of a foreign corporation in order to apply, the income and assets of a foreign corporation may be attributed to multiple owners. The statute specifies that this be done on a pro rata basis—for example, if a U.S. person owns 100 percent of foreign corporation (FC1) that owns 60 percent of FC2, 60 percent of the income and assets of FC2 could be attributed to FC1 for purposes of applying the Income and Asset tests, and 40 percent of the income and assets could be allocated to another shareholder of FC2. This alternative generates significant difficulties, however, in the context of attribution of activities. While income and assets can be allocated between owners based on percentage ownership, activities are not measured by a numerical amount and thus are not easily separated between two owners. Additionally, allowing multiple shareholders to use the activities of a single corporation to treat income as non-passive could result in double counting of activities (*i.e.,* attributing the same activity to multiple parent companies). The Treasury Department and the IRS determined that potential double counting of activities could result in less tax revenue being raised than intended by Congress.

Under the third alternative, the activities of a foreign corporation could only be attributed to one shareholder. The proposed regulations adopt this third alternative, specifically by allowing attribution if there is an ownership percentage greater than 50 percent. Thus, where FC1 owns 60 percent of FC2 and another shareholder owns the remaining 40 percent, only FC1 could get credit for the activities of FC2 for purposes of applying the active rents and royalties test. No other shareholder of FC2 would qualify for attribution. The Treasury Department and the IRS project that this proposed regulation would allow entities to satisfy the passive income exception under conditions consistent with the intents and purposes of the statute without requiring potentially substantial reorganization costs.

The Treasury Department and the IRS solicit comments on this proposal and in particular solicit data, evidence, or models that could enhance the rigor of the process by which the ownership percentage might be developed for the final regulations.

c. Look-Through Partnerships

As discussed in Part I.D.3.b of this Special Analyses, for purposes of determining whether a corporation is a PFIC, section 1297(c) treats a foreign corporation (FC1) that owns 25 percent or more of another foreign corporation (FC2) as owning and earning the proportional amount of FC2's income and assets under the so called Look-Through Subsidiary rules. Absent this rule, any distributions from FC2 to FC1 would generally be treated as passive income to FC1 for purposes of the Income Test, and the stock of FC2 would generally be treated as a passive income-producing asset for purposes of the Asset Test. The statute does not provide any specific rule for the treatment of a partnership interest owned by a foreign corporation for purposes of determining whether the foreign corporation is a PFIC.

In order to provide guidance on the treatment of partnership interests owned by foreign corporations for purposes of the Income and Asset Tests, the Treasury Department and the IRS considered three principal alternative thresholds regarding when to treat the income and assets of a partnership as earned or held directly by the foreign corporation. These thresholds are: (1) Apply no threshold; (2) apply a 10 percent threshold; or (3) apply the same 25 percent ownership threshold to partnership interests as is applied to interests in corporations.

Under the first alternative, 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 foreign corporation for purposes of determining whether the foreign corporation is a PFIC, no matter how much of the partnership was owned by the foreign corporation. A similar rule to this applies for purposes of the subpart F regime, and thus there could be benefits in applying consistent rules across the two regimes. However, the purpose of the Income and Asset Tests is to determine whether the foreign corporation has a primarily active or passive business. An ownership interest of less than 10 percent is unlikely to give the foreign corporation significant control over the partnership activities such that it represents an active business interest. Additionally, providing a lower threshold for partnership interests, by contrast to the threshold applicable to corporate interests, creates incentives for foreign corporations to hold minority interests in partnerships rather than corporations, and in some cases, because of the U.S. entity classification rules, the classification of the entity as a partnership may be solely for U.S. tax purposes. This means that the same investment that Congress determined could only be active if it accounted for 25 percent of the value of the entity would now qualify as active even though the nature of the investment has not substantially changed. This latter case is economically undesirable since it can result in differential tax treatment of corporations and partnerships. Moreover, this outcome is less consistent with the intents and purposes of the statute, than the approach taken in the proposed regulations. Under the second alternative, a proportionate amount of the income and assets of the partnership would be considered as earned or held directly by the foreign corporation only if the foreign corporation owned 10 percent or more of the partnership. Existing rules under section 904, which relates to the foreign tax credit limitation, utilize a 10 percent threshold for purposes of determining whether to characterize income and assets of a partnership as passive category income and assets. There could be benefits in applying an existing threshold from the foreign tax credit regime to PFICs since taxpayers would be familiar with this regime. However, similar to the no threshold option, because section 1297(c)(2) requires a 25 percent ownership for corporations to apply for the Look-Through Subsidiary rules, this alternative would still lead to differing treatment of minority interests in subsidiary corporations as opposed to partnerships. Again, this could lead to similarly situated entities being treated differently and resultant economic distortions.

Under the third alternative, the same 25 percent ownership threshold is applied to partnership interests as is applied to interests in corporations. The Treasury Department and IRS project this will maintain parity between the treatment of minority interests in corporations and partnership interest for purposes of the Income and Asset test, and it gives effect to the 25 percent limitation in section 1297(c)(2). The Treasury Department and the IRS project that this proposed regulation would achieve consistent treatment across entity types as well as the appropriate treatment of minority interests in corporations and partnerships under conditions consistent with the intents and purposes of the statute.

The Treasury Department and the IRS solicit comments on this proposal and in particular solicit data, evidence, or models that could enhance the rigor of the process by which the treatment of partnership interests might be developed for the final regulations.

4. Economic Analysis of PFIC Insurance Exception Rules

Under the statute, the income of a qualifying insurance corporation (QIC) derived in the active conduct of its insurance business is not treated as passive income for purposes of deciding whether the corporation is a PFIC. The test for a QIC under section 1297(f) is based on the ratio of the foreign insurance company's ''applicable insurance liabilities'' to its total assets. The statute limits the applicable insurance liabilities to the smallest of: (1) The insurance liabilities shown on the company's most recent applicable financial statement (''AFS''); (2) the amount of such liabilities required by applicable local law or regulation, and (3) as provided under Treasury regulations.

Under the statute, the AFS is the financial statement used by the foreign corporation for financial reporting purposes that is: (i) Made on the basis of U.S. generally accepted accounting principles (''US GAAP''); (ii) made on the basis of international financial reporting standards (''IFRS''), if there is no statement that is made on the basis of US GAAP; or (iii) the annual financial statement required to be filed with the applicable insurance regulatory body (''local accounting''), if the company does not prepare a statement for financial reporting purposes based on US GAAP or IFRS. Thus, the statute has a preference for financial statements prepared on the basis of US GAAP or IFRS, which are rigorous and widely-respected accounting standards, but will permit a foreign corporation to use a local accounting AFS if it does not do financial reporting based on US GAAP or IFRS.

The statute creates an incentive for foreign insurance companies (FCos) to inflate applicable insurance liabilities in order to qualify as QICs and avoid PFIC status. This strategy (inflating applicable insurance liabilities to qualify as a QIC) could make the FCo more attractive to U.S. investors relative to investing in a domestic company or a company that is a PFIC, which could potentially lead to investment patterns that are inefficient. Although the statutory caps on applicable insurance liabilities provide a check on this behavior, FCos (and thus their U.S. owners) might look for options under their financial reporting rules to increase the amount of insurance liabilities reported on their AFS, or even shift to a different financial reporting standard with more favorable rules. The proposed regulations address this issue in a number of ways.

a. Change in Accounting Rules Used for an AFS

The statute may, in some circumstances, introduce an incentive for an FCo to change its method of preparing its AFS to benefit from certain elements of a local accounting regime, such as a more expansive definition of insurance liability or a method of calculating a larger amount of insurance liabilities, solely for purposes of increasing its applicable insurance liabilities in order to qualify as a QIC. This strategy, by allowing a company to avoid being characterized as a PFIC and thus providing an incentive for U.S. investors to route their investment dollars through foreign corporations that otherwise would fail the QIC test, yields a potential tax advantage to U.S. investors relative to other investments they might make, an outcome that is economically inefficient in light of the intents and purposes of the statute.

To address this issue, the proposed regulations provide a special rule for FCos that change their method of preparing their AFS by ceasing to prepare this statement under either US GAAP or IFRS without a non-Federal tax business purpose for the change. Under the proposed regulations, an FCo must continue to prepare its AFS under either US GAAP or IFRS and if it fails to do so, it will be treated as having no applicable insurance liabilities for purposes of the QIC test.

The Treasury Department and the IRS considered as an alternative not providing regulations to address a change in the method of preparing an AFS. The Treasury Department and the IRS do not have readily available data to allow estimation of the tax advantage or volume of investment that might be drawn to such companies (and away from others) in the absence of regulations to address a change in the method of preparing an AFS. The Treasury Department and the IRS further have not estimated the benefit that arises from the improved integrity of the tax system under the proposed regulations relative to not providing regulations to govern changes in the FCo's AFS method. The Treasury Department and the IRS solicit comments on all aspects of these proposed regulations, including comments on (1) the determination of a ''non-Federal tax business purpose,'' and (2) how an FCo that changes its AFS method should be treated. The Treasury Department and the IRS particularly solicit comments that would provide data, other evidence, or models that would enhance the rigor of evaluating FCos that change their AFS method, for purposes of developing the final regulations.

b. Cap on Applicable Insurance Liabilities

Under the statute, a foreign corporation that does not prepare an AFS using US GAAP or IFRS may use an AFS prepared under local accounting rules to determine the amount of its applicable insurance liabilities. However, it is possible that local accounting rules in some foreign jurisdictions may permit reporting of insurance liabilities in a way that is economically unreasonable and inconsistent with the intent of the QIC rules. For example, US GAAP and IFRS both require discounting of insurance liabilities to determine the present value of an insurance company's liabilities. However, the Treasury Department and the IRS understand that local accounting rules in some foreign jurisdictions might not require discounting or might not adequately discount reserves (or other applicable insurance liabilities). This would make it easier for a foreign corporation that uses local accounting to qualify as a QIC. This could provide an incentive for U.S. investors to route their investment dollars through foreign corporations that otherwise would fail the QIC test, yielding a potential tax advantage to U.S. investors relative to other investments they might make, an outcome that is economically inefficient.

To address this issue, the proposed regulations provide that, if a foreign insurance company prepares its AFS under a local accounting standard that does not require discounting of unpaid losses and other loss reserves on an economically reasonable basis, for purposes of the QIC test, the company's AFS insurance liabilities must be reduced using US GAAP or IFRS discounting principles. Local accounting rules will otherwise continue to apply for determining amounts relevant to the QIC test. Applicable insurance liabilities may not exceed the discounted amount. As a point of reference, the discounting of unpaid losses is required by all domestic insurance companies that are taxed on their underwriting income or that file US GAAP-based financial statements.

The question of whether losses are discounted on an economically reasonable basis is determined under the relevant facts and circumstances. However, in order for losses to be discounted on an economically reasonable basis, discounting must be based on loss and claim payment patterns for either the foreign corporation or insurance companies in similar lines of insurance business. In addition, a discount rate based on these loss and claim payment patterns of at least the risk free rate in U.S. dollars or in a foreign currency in which the foreign corporation conducts some or all of its insurance business must be used. A loss discounting methodology consistent with that used for US GAAP or IFRS purposes will be considered reasonable for this purpose.

The Treasury Department and the IRS considered as alternatives (i) issuing no regulations to govern discounting of insurance losses for purposes of determining whether applicable insurance liabilities exceed the statutory cap, and (ii) capping the amount of applicable insurance liabilities at the amount that would be permitted to an insurance company subject to the insurance reserve calculation rules under Subchapter L of the Code.

Under the first approach, U.S. investors would have an incentive to seek out those corporations that do not file US GAAP or IFRS statements, an outcome that would provide an economically inefficient tax advantage to U.S. investors in those companies.

The second approach would be considerably more burdensome to a foreign corporation because, as a practical matter, it would require foreign corporations to apply complex U.S. tax rules with which they are likely not familiar. An excessive compliance burden on foreign corporations not subject to U.S. taxation would make it less likely that they would do the work necessary to enable their minority U.S. owners to determine if the corporation is a PFIC. Thus, this alternative was rejected because it could unduly inhibit U.S. investors from placing their funds in profitable foreign corporations that are legitimate active insurance companies, an economically desirable activity in light of the intents and purposes of the statute, relative to the proposed regulations.

The Treasury Department and the IRS do not have data available and models sensitive enough to estimate the additional volume of U.S. investment that might be drawn under this alternative approach to QICs that did not discount insurance losses in an economically reasonable manner, relative to the proposed regulations. The Treasury Department and the IRS also do not have data available and models sensitive enough to estimate the benefit that arises from the improved integrity of the tax system arising from the proposed regulations relative to not issuing such regulations. Further, the Treasury Department and the IRS do not have data available to estimate the additional accounting burden that would fall on FCos under the proposed regulations, relative to not issuing such regulations, a cost that would potentially be passed on to U.S. investors.

The Treasury Department and the IRS also do not have data available to estimate the increased loss to minority U.S. shareholders if the second alternative approach (capping liabilities to the amount that would be permitted under Subchapter L) were adopted.

The Treasury Department and the IRS solicit comments on all aspects of these proposed regulations and particularly solicit comments that would provide data, other evidence, or models that would enhance the rigor by which conditions on the cap on applicable insurance liabilities will be developed for the final regulations.

II. Paperwork Reduction Act

The collections of information in these proposed regulations are in proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv), proposed § 1.1297–4(d)(5)(i) and (iii), and proposed § 1.1298–4(d)(2). The information in all of the collections of information provided will be used by the IRS for tax compliance purposes.

A. Collections of Information Under Existing Tax Forms

The collections of information in proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) are required to be provided by taxpayers that make an election or revoke an election to use an alternative measuring period or adjusted bases to measure assets for purposes of the Asset Test with respect to a foreign corporation. These collections of information are satisfied by filing Form 8621 or attachments thereto. For purposes of the Paperwork Reduction Act, 44 U.S.C. 3501 *et seq.* (''PRA''), the reporting burden associated with the collection of information in the Form 8621 will be reflected in the Paperwork Reduction Act Submission associated with that form (OMB control number 1545–1002). If a Form 8621 is not required to be filed, the collections of information under proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) are satisfied by attaching a statement to the taxpayer's return. For purposes of the Paperwork Reduction Act, the reporting burden associated with these collections of information will be reflected in the Paperwork Reduction Act Submissions associated with Forms 990–PF and 990–T (OMB control number 1545–0047); Form 1040 (OMB control number 1545–0074); Form 1041 (OMB control number 1545–0092); Form 1065 (OMB control number 1545–0123); and Forms 1120, 1120–C, 1120–F, 1120–L, 1120–PC, 1120–REIT, 1120–RIC, and 1120–S (OMB control number 1545–0123).

The collection of information in proposed § 1.1297–4(d)(5)(iii) is required to be provided by taxpayers that make an election under section 1297(f)(2). This collection of information is satisfied by filing Form 8621. For purposes of the Paperwork Reduction Act, the reporting burden associated with the collection of information in the Form 8621 will be reflected in the Paperwork Reduction Act Submission associated with Form 8621 (OMB control number 1545–1002).

The following table displays the number of respondents estimated to be required to report on Form 8621 or, in the case of individual filers, on attachments to Form 1040, as applicable, with respect to the collections of information in these regulations. Due to the absence of available tax data, estimates of respondents required to attach a statement to other types of tax returns, as applicable, are not available.

	Number of respondents (estimated)
Form 1040	35,000–45,000
Form 8621	50,000–55,000

Source: RAAS:CDW.

The numbers of respondents in the table were estimated by the Research, Applied Analytics and Statistics Division (''RAAS'') of the IRS from the Compliance Data Warehouse (''CDW'').

Data for Form 1040 represents estimates of the total number of taxpayers that may attach a statement to their Form 1040 to make or revoke the elections in proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv). The lower bound estimate reflects the CDW-based estimate of unique individual taxpayers filing Form 8621 between 2014 and 2017. The upper bound estimate reflects the CDW-based estimate of unique individual taxpayers that filed Form 8938 between 2016 and 2017 indicating that they owned an interest in a foreign partnership or corporation.[5] Accordingly, the difference between the lower bound and upper bound estimates reflects an estimate of the possible change in the number of respondents as a result of the changes made by the Act and the proposed regulations.

Data for Form 8621 represent estimates of the total number of taxpayers that may be required to file Form 8621. The lower bound estimate reflects the CDW-based estimate of unique taxpayers filing Form 8621 between 2014 and 2017. The upper bound estimate reflects an estimated 10 percent increase in the amount of taxpayers that may file to make or revoke the elections in proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed § 1.1297–4(d)(5)(iii). Accordingly, the difference between the lower bound and upper bound estimates reflect an estimate of the possible change in the number of respondents as a result of the changes made by the Act and the proposed regulations.

The current status of the PRA submissions related to the tax forms on which reporting under these regulations will be required is summarized in the following table. The burdens associated with the information collections in the forms are included in aggregated burden estimates for the OMB control numbers 1545–0047 (which represents a total estimated burden time for all forms and schedules for tax-exempt entities of 50.5 million hours and total estimated monetized costs of $3.59 billion ($2018)), 1545–0074 (which represents a total estimated burden time for all forms and schedules for individuals of 1.784 billion hours and total estimated monetized costs of $31.764 billion ($2017)), 1545–0092 (which represents a total estimated burden time for all forms and schedules for trusts and estates of 307.8 million hours and total estimated monetized costs of $9.95 billion ($2016)), and 1545–0123 (which represents a total estimated burden time for all forms and schedules for corporations of 3.157 billion hours and total estimated monetized costs of $58.148 billion ($2017)). The burden estimates provided in the OMB control numbers in the following table are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and will in the future include, but not isolate, the estimated burden of only those information collections associated with these proposed regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by these regulations. To guard against over-counting the burden that international tax provisions imposed prior to the Act, the Treasury Department and the IRS urge readers to recognize that these burden estimates have also been cited by regulations (such as the foreign tax credit regulations, 83 FR 63200) that rely on the applicable OMB control numbers in order to collect information from the applicable types of filers.

In 2018, the IRS released and invited comment on drafts of Forms 990–PF (Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation), 990–T (Exempt Organization Business Income Tax Return), 1040 (U.S. Individual Income Tax Return), (U.S. Income Tax Return for Estates and Trusts), 1065 (U.S. Return of Partnership Income), 1120 (U.S. Corporation Income Tax Return), and 8621 (Return by a Shareholder of a Passive Foreign Investment Co. or Qualified Electing Fund). The IRS received comments only regarding Forms 1040, 1065, and 1120 during the comment period. After reviewing all such comments, the IRS made the forms available on December 21, 2018 for use by the public.

No burden estimates specific to the forms affected by the proposed regulations are currently available. The Treasury Department and the IRS have not estimated the burden, including that of any new information collections, related to the requirements under the proposed regulations. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the proposed regulations, including estimates for how much time it would take to comply with the paperwork burdens described above for each relevant form and ways for the IRS to minimize the paperwork burden. In addition, drafts of IRS forms are posted for public review at *https://apps.irs.gov/app/picklist/list/draftTaxForms.htm.* Comments on these forms can be submitted at *https://www.irs.gov/forms-pubs/comment-on-tax-forms-and-publications.* These forms will not be finalized until after they have been approved by OMB under the PRA.

Form	Type of filer	OMB Nos.	Status
Forms 990–PF, 990–T	Tax exempt entities (NEW Model).	1545–0047	Published 60-day **Federal Register** notice on 8/22/18.
	Link: *https://www.federalregister.gov/documents/2018/08/22/2018-18135/proposed-collection-comment-request-for-forms-990-990-ez-sch-b-br-br-990-ez-sch-l-lp-990-ez-990-pf.*		
Form 1040	Individual (NEW Model)	1545–0074	Limited Scope submission (1040 only) approved on 12/7/18. Full ICR submission for all forms in 3/2019. 60 Day **Federal Register** notice not published yet for full collection.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201808-1545-031.*		

[5] While PFICs are corporations, partnerships are included in our count given taxpayers may own an interest in a foreign corporation through a foreign partnership. More robust reporting on Form 8938 started in 2016 so we do not include prior years in our estimate.

Form	Type of filer	OMB Nos.	Status
Form 1041	Trusts and estates	1545–0092	Submitted to OMB for review on 9/27/18.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014.*		
Form 1065	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/11/18. Public Comment period closed on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
Forms 1120, 1120–C, 1120–F, 1120–L, 1120–PC, 1120–REIT, 1120–RIC, 1120–S.	Business (NEW Model)	1545–0123	Published in the **Federal Register** on 10/11/18. Public Comment period closed on 12/10/18.
	Link: *https://www.federalregister.gov/documents/2018/10/09/2018-21846/proposed-collection-comment-request-for-forms-1065-1065-b-1066-1120-1120-c-1120-f-1120-h-1120-nd.*		
Form 8621	Share-holders	1545–1001	Approved by OMB on 12/19/2018.
	Link: *https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201805-1545-007.*		

B. Collections of Information Generally Not Included on Existing Forms

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

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

The collection of information in proposed § 1.1297–4(d)(5)(i) is required for a foreign corporation for which a taxpayer makes an election under section 1297(f)(2). This collection of information is satisfied by a foreign corporation providing a statement to a shareholder.

The collection of information contained in proposed § 1.1298–4(d)(2) (for foreign corporations that are not required to file Form 1120–F) and proposed § 1.1297–4(d)(5)(i) will be submitted to the Office of Management and Budget in accordance with the Paperwork Reduction Act. Comments on the collections of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by September 9, 2019.

Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the duties of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information;

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchases of services to provide information for the collections discussed in Part II.B of this Special Analyses.

Estimated total annual reporting burden: 200 hours.

Estimated total annual monetized cost burden: $19,000.

Estimated average annual burden hours per respondent: One hour.

Estimated number of respondents: 200.

Estimated annual frequency of responses: Once.

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

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

III. Regulatory Flexibility Act

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

The statutory provisions in sections 1291 through 1298 (the ''PFIC regime'') generally affect U.S. taxpayers that have ownership interests in foreign corporations that are not controlled foreign corporations (''CFCs''). The reporting burdens in proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed § 1.1297–4(d)(5)(iii) generally affect the described U.S. taxpayers that elect to make or revoke certain elections related to the PFIC regime. The reporting burdens in proposed § 1.1297–4(d)(5)(ii) and proposed § 1.1298–4(d)(2) affect only foreign corporations. In general, foreign corporations are not considered small entities. Nor are U.S. taxpayers considered small entities to the extent the taxpayers are natural persons or entities other than small entities. Data estimating the number of filers for the PRA section indicate that individuals (Form 1040 filers) make up approximately 70 percent of those who report PFIC income while U.S.

businesses of all sizes make up approximately 20 percent of Form 8621 filers. Most of these U.S. businesses are partnerships that do not pay entity level taxes. Accordingly, only small entities that have ownership interests in foreign corporations that are not CFCs and that wish to make or revoke an election pursuant to proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed § 1.1297–4(d)(5)(iii) are affected by the proposed regulations.

The data to assess the number of small entities potentially affected by proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed § 1.1297–4(d)(5)(iii) are not readily available.

Regardless of the number of small entities potentially affected by the proposed regulations, the Treasury Department and the IRS have concluded that there is no significant economic impact on such entities as a result of the proposed regulations.

Data on U.S. businesses that invest in a PFIC is limited. To get a sense of the magnitude of the taxes currently collected by businesses that invest in PFICs, the ratio of PFIC regime tax to (gross) total income was calculated for 2012 through 2017 for C corporations that filed the Form 8621. Total income was determined by matching each C corporation filing the Form 8621 to its Form 1120. Ordinary QEF income was assumed to be taxed at 37 percent while QEF capital gains and mark-to-market income was assumed to be taxed at the lower 20 percent capital gains rate. The section 1291 tax and interest charge tax were included as reported. Only those corporations where a match was found and that had positive total income were included in the analysis.[6] While the number was small, approximately 150 to 250 C corporations per year, the ratio of the tax to total income was less than 0.01 percent even when $100 million of the additional tax estimated by the Joint Committee on Taxation was included each year. Looking only at the approximately 50 to 150 C corporations per year with $25 million or less of total income resulted in the tax to total income percentage increasing to at most 1.39 percent in 2017.

	($ millions)					
	2012	2013	2014	2015	2016	2017
All C corporations						
Tax	99	108	118	126	110	121
Total Income	6,487,867	4,205,127	14,154,789	19,935,845	16,443,073	16,888,107
Tax to Total Income	0.002%	0.003%	0.001%	0.001%	0.001%	0.001%
C corporations with total income of $25 million or less						
Tax	*	*	*	3	3	5
Total Income	302	463	563	627	562	348
Tax to Total Income	0.039%	0.068%	0.008%	0.516%	0.524%	1.390%

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

Thus, even if the economic impact of the proposed regulations is interpreted broadly to include the tax liability due under the PFIC regime, which small entities would be required to pay even if the proposed regulations were not issued, the economic impact should not be regarded as significant under the Regulatory Flexibility Act.

Additionally, the economic impact of the proposed regulations when considered alone should be minimal. Any economic impact of the final regulations stems from the collection of information requirements imposed by proposed § 1.1297–1(d)(1)(ii)(B), (d)(1)(iii)(B), and (d)(1)(iv) and proposed § 1.1297–4(d)(5)(iii). The Treasury Department and the IRS have determined that the average burden is 1 hour per response. The IRS's Research, Applied Analytics, and Statistics division estimates that the appropriate wage rate for this set of taxpayers is $95 per hour. Thus, the annual burden per taxpayer from the collection of information requirement is $95. Furthermore, these requirements apply only if a taxpayer chooses to make an election or rely on a favorable rule.

Accordingly, it is hereby certified that the proposed rule would not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments from the public on both the number of entities affected (including whether specific industries are affected) and the economic impact of this proposed rule on small entities.

Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking has been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses.

IV. Unfunded Mandates Reform Act

Section 202 of the Unfunded Mandates Reform Act of 1995 (UMRA) requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of $100 million in 1995 dollars, updated annually for inflation. In 2018, that threshold is approximately $150 million. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

V. Executive Order 13132: Federalism

Executive Order 13132 (entitled ''Federalism'') prohibits an agency from publishing any rule that has federalism implications if the rule either imposes substantial, direct compliance costs on state and local governments, and is not required by statute, or preempts state law, unless the agency meets the consultation and funding requirements of section 6 of the Executive Order. This proposed rule does not have federalism implications and does not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any

[6] To be conservative, C corporations reporting more than $6 billion of total income are excluded since we suspect these amounts are improperly reported.

comments that are timely submitted to the IRS as prescribed in this preamble under the **ADDRESSES** heading. The Treasury Department and the IRS specifically request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time and place for the public hearing will be published in the **Federal Register**.

Statement of Availability of IRS Documents

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

Drafting Information

The principal drafters of these regulations are Josephine Firehock, Rose E. Jenkins, and Jorge M. Oben of the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS also participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Withdrawal of Proposed Regulations

Accordingly, under the authority of 26 U.S.C. 7805, the notice of proposed rulemaking (REG–108214–15) that was published in the **Federal Register** on April 24, 2015, (80 FR 50814) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

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

Authority: 26 U.S.C. 7805 * * *

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

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

* * * * *

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

* * * * *

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

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

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■ **Par. 2.** Section 1.1291–0 is amended by revising the heading for § 1.1291–1 and adding entries for § 1.1291–1(b)(8)(iv)(A) and (B), (b)(8)(iv)(B)(*1*) and (*2*), (b)(8)(iv)(C), and (b)(8)(iv)(C)(*1*) and (*2*) to read as follows:

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

* * * * *

§ 1.1291–1 Taxation of United States persons that indirectly own PFIC stock.

* * * * *

(b) * * *

(8) * * *

(iv) * * *

(A) Example 1.

(B) Example 2.

(*1*) Facts.

(*2*) Results.

(C) Example 3.

(*1*) Facts.

(*2*) Results.

* * * * *

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

■ 1. Revising the section heading.

■ 2. Revising the second sentence of paragraph (b)(8)(ii)(B).

■ 3. Revising paragraphs (b)(8)(iii)(A), (B), and (C).

■ 4. Designating *Example 1* in paragraph (b)(8)(iv) as paragraph (b)(8)(iv)(A).

■ 5. Adding paragraphs (b)(8)(iv)(B) and (C).

■ 6. Revising paragraph (j)(3).

■ 7. Adding paragraph (j)(4).

The revision and additions read as follows:

§ 1.1291–1 Taxation of United States persons that indirectly own PFIC stock.

* * * * *

(b) * * *

(8) * * *

(ii) * * *

(B) * * * Sections 1297(d) and 1298(b)(7) and § 1.1297–4(b)(2) and (f)(2) do not apply in determining whether a foreign corporation is a PFIC for purposes of this paragraph (b)(8)(ii)(B).

* * * * *

(iii) *Ownership through pass-through entities*—(A) *Partnerships.* Except as otherwise provided in this paragraph (b)(8)(iii)(A), if a foreign or domestic partnership directly or indirectly owns stock, the partners of the partnership are considered to own such stock proportionately in accordance with their ownership interests in the partnership. Solely for purposes of determining whether a person satisfies the ownership threshold described in paragraph (b)(8)(ii)(A) of this section with respect to a foreign corporation that is not a PFIC (determined without applying sections 1297(d) and 1298(b)(7)), the first sentence of this paragraph (b)(8)(iii)(A) applies only in the case of a partner that owns 50 percent or more of the ownership interests in the partnership that directly or indirectly owns the stock of the foreign corporation.

(B) *S Corporations.* Except as otherwise provided in this paragraph (b)(8)(iii)(B), if an S corporation directly or indirectly owns stock, each S corporation shareholder is considered to own such stock proportionately in accordance with the shareholder's ownership interest in the S corporation. Solely for purposes of determining whether a person satisfies the ownership threshold described in paragraph (b)(8)(ii)(A) of this section with respect to a foreign corporation that is not a PFIC (determined without applying sections 1297(d) and 1298(b)(7)), the first sentence of this paragraph (b)(8)(iii)(B) applies only in the case of a S corporation shareholder that owns 50 percent or more of the ownership interests in the S corporation that directly or indirectly owns the stock of the foreign corporation.

(C) *Estates and nongrantor trusts.* Except as otherwise provided in this paragraph (b)(8)(iii)(C), if a foreign or domestic estate or nongrantor trust (other than an employees' trust described in section 401(a) that is exempt from tax under section 501(a)) directly or indirectly owns stock, each beneficiary of the estate or trust is considered to own a proportionate amount of such stock. For purposes of this paragraph (b)(8)(iii)(C), a nongrantor trust is any trust or portion of a trust that is not treated as owned by one or more persons under sections 671 through 679. Solely for purposes of determining whether a person satisfies the ownership threshold described in paragraph (b)(8)(ii)(A) of this section with respect to a foreign corporation that is not a PFIC (determined without applying sections 1297(d) and 1298(b)(7)), the first sentence of this paragraph (b)(8)(iii)(C) applies only in the case of a beneficiary whose proportionate share of the estate or trust that directly or indirectly owns the stock of the foreign corporation is 50 percent or more.

* * * * *

(iv) * * *

(B) *Example 2*—(*1*) *Facts.* A, a United States citizen, owns 50% of the interests in Foreign Partnership, a foreign partnership, the remaining interests in which are owned by an unrelated foreign person. Foreign Partnership owns 100% of the stock of FC1 and 50% of the stock of FC2, the remainder of which is owned by an unrelated foreign person. Both FC1 and FC2 are foreign corporations that are not PFICs (determined without applying sections 1297(d) and 1298(b)(7)). FC1 and FC2 each own 50% of the stock of FC3, a foreign corporation that is a PFIC.

(*2*) *Results.* Under paragraph (b)(8)(iii)(A) of this section, for purposes of determining whether A is a shareholder of FC3, A is considered to own 50% (50%x100%), or 50% or more, of FC1, because A owns 50% or more of Foreign Partnership, but 25% (50%x50%) of FC2. Thus, under paragraph (b)(8) of this section, A is considered to own 25% of the stock of FC3 (50%x100%x50%) indirectly through FC1, and thus is a shareholder of FC3 for purposes of the PFIC provisions, but is not considered to own any stock of FC3 indirectly through FC2.

(C) *Example 3*—(*1*) *Facts.* The facts are the same as in paragraph (b)(8)(iv)(B)(*1*) of this section (the facts in *Example 2*), except that A owns 40% of the interests in Foreign Partnership.

(*2*) *Results.* Under paragraph (b)(8)(iii)(A) of this section, for purposes of determining whether A is a shareholder of FC3, A is not considered to own 50% or more of FC1 or FC2 because it does not own 50% or more of the interests in Foreign Partnership. Thus, under paragraph (b)(8) of this section, A is not considered to own any stock of FC3 indirectly through FC1 or FC2.

* * * * *

(j) * * *

(3) Except as otherwise provided in paragraph (j)(4) of this section, paragraphs (b)(2)(ii) and (v), (b)(7) and (8), and (e)(2) of this section apply to taxable years of shareholders ending on or after December 31, 2013.

(4) Paragraphs (b)(8)(ii)(B), (b)(8)(iii)(A), (B), and (C), and (b)(8)(iv)(B) and (C) of this section apply to taxable years of shareholders beginning on or after the date of publication of a Treasury decision adopting these rules as final regulations in the **Federal Register**.

■ **Par. 4.** Section 1.1297–0 is amended by revising the introductory text and adding entries for §§ 1.1297–1, 1.1297–2, and 1.1297–4 in numerical order to read as follows:

§ 1.1297–0 Table of contents.

This section contains a listing of the headings for §§ 1.1297–1, 1.1297–2, 1.1297–3, 1.1297–4, and 1.1297–5.

(h) Applicability date.

* * * * *

§ 1.1297–4 Qualifying insurance corporation.

(a) Scope.
(b) Qualifying insurance corporation.
(c) 25 percent test.
(d) Election to apply the alternative facts and circumstances test.
(1) In general.
(2) Predominantly engaged in an insurance business.
(i) In general.
(ii) Facts and circumstances.
(iii) Examples of facts indicating a foreign corporation is not predominantly engaged in an insurance business.
(3) Runoff-related circumstances.
(4) Rating-related circumstances.
(5) Election.
(i) In general.
(ii) Information provided by foreign corporation.
(iii) Time and manner for making the election.
(e) Rules limiting the amount of applicable insurance liabilities.
(1) In general.
(2) General limitation on applicable insurance liabilities.
(3) Additional limitation on amount of applicable insurance liabilities for a foreign corporation that does not prepare a financial statement based on a financial reporting standard.
(i) In general.
(ii) Choice of accounting method.
(4) Changes to financial statements prepared.
(f) Definitions.
(1) Applicable financial statement.
(2) Applicable insurance liabilities.
(3) Applicable insurance regulatory body.
(4) Financial reporting standard.
(5) Generally accepted accounting principles or GAAP.
(6) Insurance business.
(7) Total assets.
(g) Applicability date.

§ 1.1297–5 Exception from the definition of passive income for active insurance income.

(a) Scope.
(b) Exclusion from passive income of active insurance income.
(c) Income derived by a QIC in the active conduct of an insurance business.
(1) In general.
(2) Insurance business.
(3) Active conduct of an insurance business.
(i) In general.
(ii) Control test.
(A) Ownership.
(*1*) Ownership by or of a corporation.
(*2*) Ownership of a partnership.
(B) Control and supervision.
(C) Compensation.
(4) Active conduct percentage.
(i) In general.
(ii) Related expense determination.
(iii) Ceding commission.
(d) Income of qualifying domestic insurance corporation.
(e) Exclusion of assets for purposes of the passive asset test under section 1297(a)(2).
(f) Treatment of income and assets of certain look-through subsidiaries and look-through partnerships for purposes of the section 1297(b)(2)(B) exception.
(1) General rule.
(2) Applicable statement for tested foreign corporations applying paragraph (g)(1) of this section.
(g) No double counting.
(h) Definitions.
(1) Insurance services.
(2) Investment activity.
(3) Qualifying insurance corporation or QIC.
(i) Applicability date.

■ **Par. 5.** Sections 1.1297–1 and 1.1297–2 are added to read as follows:

§ 1.1297–1 Definition of passive foreign investment company.

(a) *Overview.* This section provides rules concerning the income test set forth in section 1297(a)(1) and the asset test set forth in section 1297(a)(2). Paragraph (b) of this section provides a rule relating to the definition of gross income for purposes of section 1297. Paragraph (c) of this section sets forth rules relating to the definition of passive income for purposes of section 1297. Paragraph (d) of this section provides rules relating to the asset test of section 1297. See §§ 1.1297–2 and 1.1298–4 for additional rules concerning the treatment of the income and assets of a corporation subject to look-through treatment under section 1297(c). Paragraph (e) of this section sets forth rules relating to the determination of passive foreign investment company (PFIC) status for stapled entities. Paragraph (f) of this section sets forth definitions applicable for this section, and paragraph (g) of this section sets forth the applicability date of this section.

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

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

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

(c) *Passive income*—(1) *Foreign personal holding company income*—(i) *General rule.* For purposes of section 1297, except as otherwise provided in section 1297(b)(2), this section, and § 1.1297–4, the term passive income means income of a kind that would be foreign personal holding company income as defined under section 954(c)(1). For the purpose of this paragraph (c)(1)—

(A) The exceptions to foreign personal holding company income in section 954(c)(1), 954(c)(2)(A) (relating to active rents and royalties), 954(c)(2)(B) (relating to export financing income), 954(c)(2)(C) (relating to dealers), and 954(h) (relating to entities engaged in the active conduct of a banking, financing, or similar business) are taken into account;

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

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

(D) An entity is treated as a controlled foreign corporation within the meaning of section 957(a) for purposes of applying an exception to foreign personal holding company income in section 954(c) and (h) and for purposes of identifying whether a person is a related person with respect to such entity within the meaning of section 954(d)(3).

(ii) *Determination of gross income on a net basis for certain items of foreign personal holding company income.* For purposes of section 1297, the excess of gains over losses from property transactions described in section 954(c)(1)(B), the excess of gains over losses from transactions in commodities described in section 954(c)(1)(C), the excess of foreign currency gains over foreign currency losses described in section 954(c)(1)(D), and positive net income from notional principal contracts described in section 954(c)(1)(F) are taken into account as gross income. The excess of gains over losses and positive net income is calculated separately with respect to the tested foreign corporation and each look-through subsidiary (as defined in § 1.1297–2(g)(1)).

(iii) *Dividends.* For purposes of section 1297, the term dividend includes all amounts treated as dividends for purposes of this chapter, including amounts treated as dividends pursuant to sections 302, 304, 356(a)(2), 964(e), and 1248.

(2) *Treatment of share of partnership income*—(i) *Look-through partnership.* A tested foreign corporation is treated as if it received directly its share of any item of income of a look-through partnership, and the exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) and (h) that are based on whether income is derived in the active conduct of a business or whether a corporation is engaged in the active conduct of a business apply to such income only if the exception would have applied to exclude the income from passive income or foreign personal holding company in the hands of the partnership, determined by taking into account only the activities of the partnership. See § 1.1297–2(e) for rules that allow the activities of certain other entities to be taken into account for purposes of determining the characterization of a tested foreign corporation's share of partnership income. See also § 1.1297–2(d) for rules determining whether a person is a related person for purposes of applying section 1297(b)(2)(C) in the case of income received or accrued by a partnership that is treated as received directly by a tested foreign corporation pursuant to this paragraph (c)(2).

(ii) *Less-than-25-percent-owned partnership.* For purposes of section 1297, a tested foreign corporation's share of any item of income of a partnership in which the corporation owns, directly or indirectly, less than 25 percent of the value is treated as passive income.

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

(ii) *Allocation of dividends.* For purposes of section 1297(b)(2)(C), dividends that are received or accrued, as applicable based on the recipient's method of accounting, from a related person are allocated to income of the related person that is not passive income based on the relative portion of the related person's current earnings and profits for its taxable year that ends with or within the taxable year of the recipient that are attributable to non-passive income.

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

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

(d) *Asset test*—(1) *Calculation of average annual value (or adjusted bases)*—(i) *General rule.* For purposes of section 1297, the calculation of the average percentage of assets held by a tested foreign corporation during its taxable year that produce passive income or that are held for the production of passive income is determined based on the average of the fair market values (or the average of the adjusted bases) of the passive assets and total assets held by the foreign corporation on the last day of each measuring period (*measuring date*) of the foreign corporation's taxable year. The average of the fair market values (or the average of the adjusted bases) of the foreign corporation's passive assets or total assets for the taxable year is equal to the sum of the values (or adjusted bases) of the passive assets or total assets, as applicable, on each measuring date of the foreign corporation's taxable year, divided by the number of measuring dates in the taxable year.

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

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

(C) *Short taxable year.* For purposes of applying section 1297 to a tested foreign corporation that has a taxable year of less than twelve months (short taxable year), the average values (or adjusted bases) are determined based on the measuring dates of the foreign corporation's taxable year (determined as if the taxable year were not a short taxable year), and by treating the last day of the short taxable year as a measuring date.

(iii) *Adjusted basis.* (A) [Reserved]

(B) *Election.* An election under section 1297(e)(2)(B) with respect to an eligible tested foreign corporation or a revocation of such an election must be made in accordance with the rules of paragraph (d)(1)(iv) of this section.

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

(B) *Revocations and subsequent elections.* An election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii)(B) of this section made pursuant to paragraph (d)(1)(iv)(A) of this section is effective for the taxable year of the foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by the Commissioner or the owner (as defined in paragraph (d)(1)(iv)(A) of this section) of the foreign corporation. The owner of a foreign corporation may revoke such an election at any time. If an election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii)(B) of this section has been revoked under this paragraph (d)(1)(iv)(B), a new election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii)(B) of this section, as applicable, cannot be made until the sixth taxable year following the year for which the previous such election was revoked, and such subsequent election cannot be revoked until the sixth taxable year following the year for which the subsequent election was made. The owner revokes the election for a taxable year in the manner provided in the Instructions to Form 8621 (or successor form), if the owner is required to file a Form 8621 (or successor form) with respect to the foreign corporation for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is revoked ends, or by filing a written statement providing for the revocation and attaching the statement to an original or amended Federal income tax return for the taxable year of the owner in which or with which the taxable year of the foreign corporation for which the election is revoked ends clearly indicating that such election has been revoked, if the owner is not required to file Form 8621 (or successor form) with respect to the foreign corporation for the taxable year.

(v) *Change in method of measuring assets*—(A) *General rule.* For purposes of section 1297, when stock of a foreign corporation is not publicly traded for an entire taxable year, the assets of the foreign corporation must be measured for all measuring periods of the taxable year on the basis of value if the corporation was publicly traded on the majority of days during the year or section 1297(e)(2) did not otherwise apply to the corporation on the majority of days of the year, and on the basis of adjusted basis otherwise.

(B) *Example.* The following example illustrates the application of this paragraph (d)(1)(v).

(*1*) *Facts.* TFC is a controlled foreign corporation, 90% of the stock of which is wholly owned by USP at the beginning of its taxable year ending December 31 and throughout the year. The remaining 10% of its stock has historically been regularly traded on a national securities exchange that is registered with the Securities and Exchange Commission and continues to be until September 1 of the taxable year, when USP acquires all of it pursuant to a tender offer.

(*2*) *Results.* Because TFC was publicly traded on the majority of days during the year, the assets of the foreign corporation must be measured for all measuring periods of the taxable year on the basis of value.

(2) *Dual-character assets*—(i) *General rule.* Except as otherwise provided in paragraph (d)(2)(ii) of this section, for purposes of section 1297, an asset (or portion of an asset) that produces both passive income and non-passive income during a taxable year (dual-character asset) is treated as two assets for each measuring period in the taxable year, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the dual-character asset is allocated between the passive asset and the non-passive asset in proportion to the relative amounts of passive income and non-passive income produced by the asset (or portion of an asset) during the taxable year. See paragraph (d)(2)(iii) of this section for a special rule concerning stock that has previously produced dividends subject to the exception provided in section 1297(b)(2)(C).

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

(iii) *Special rule for stock that produced income that was excluded from passive income under section 1297(b)(2)(C).* Stock with respect to which no dividends are accrued or received, as applicable based on the recipient's method of accounting, during a taxable year but with respect to which dividends accrued or received, as applicable based on the recipient's method of accounting, during a prior taxable year were in whole or in part excluded from passive income under section 1297(b)(2)(C) and paragraph (c)(3)(ii) of this section is treated as two assets, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the asset is allocated between the two assets in proportion to the average percentage of dividends that were characterized as passive income, and the average percentage of dividends characterized as non-passive income, for the previous two taxable years pursuant to section 1297(b)(2)(C) and paragraph (c)(3)(ii) of this section.

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

(A) *Facts.* (*1*) USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 20% of the value of FS1, a foreign corporation, and FP owns the remaining 80% of the value of FS1. FP, TFC, and FS1 are not controlled foreign corporations within the meaning of section 957(a), and each has a calendar year taxable year. For purposes of section 1297(b)(2)(C), FP is a ''related person'' with respect to TFC because FP owns more than 50% of the vote or value of TFC, and FS1 is a ''related person'' with respect to TFC because FP owns more than 50% of the vote or value of both TFC and of FS1.

(*2*) During Year 3, FP has only passive income, and FS1 has passive income of $200x and non-passive income of $800x. FS1 does not pay dividends during Year 3, but did pay $100x of dividends in Year 2 and $300x of dividends in Year 1. In Year 2, FS1 had current earnings and profits of $1000x, attributable to passive income of $100x and non-passive income of $900x; and, in Year 1, FS1 had current earnings and profits of $1000x, attributable to passive income of $500x and non-passive income of $500x. Throughout Year 3, TFC holds an obligation of FS1 with respect to which FS1 pays $100x of interest.

(*3*) In addition to the stock in FS1 and the FS1 obligation, TFC holds an office building, 40% of which is rented to FP throughout Year 3 for $100x per quarter. For the first two quarters of Year 3, 60% of the office building is used by TFC in a trade or business generating non-passive income. For the last two quarters of Year 3, 60% of the office building is rented to an unrelated person for $300x per quarter, and TFC's own officers or staff of employees regularly perform active and substantial management and operational functions while the property is leased.

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

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

(*3*) Under paragraph (c)(3)(iii) of this section, the rent received from FP throughout Year 3 is characterized as 100% passive income. Under paragraph (c)(1)(i)(A) of this section and section 954(c)(2)(A), the rent received from the unrelated person during the last two quarters is characterized as 100% non-passive income. Accordingly, under paragraph (d)(2)(i) of this section, 40% (($100x × 4)/(($100x × 4) + ($300x × 2))) of the office building is a passive asset, and 60% (($300x × 2)/(($100x × 4) + ($300x × 2))) is a non-passive asset for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC. Paragraph (d)(2)(ii) of this section does not apply because both portions of the office building generate income during Year 3.

(3) *Partnership interest*—(i) *Look-through partnership.* A tested foreign corporation is treated as holding directly its proportionate share of the assets held by a look-through partnership. The rules and principles of sections 701 through 761 apply to determine the corporate partner's proportionate share of the value of the partnership assets, as well as the proportionate share of the partnership's adjusted basis in the partnership's assets (taking into account any adjustments to such basis with respect to such partner under section 743). A tested foreign corporation's proportionate share of a partnership asset is treated as producing passive income, or being held to produce passive income, to the extent the asset produced, or was held to produce, passive income in the hands of the partnership under the rules in paragraph (c)(2) of this section.

(ii) *Less-than-25-percent-owned partnership.* For purposes of section 1297, a tested foreign corporation's interest in a partnership in which the corporation owns, directly or indirectly, less than 25 percent of the value is treated as a passive asset.

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

(e) *Stapled stock.* For purposes of determining whether stapled entities (as defined in section 269B(c)(2)) are a PFIC, all entities that are stapled entities with respect to each other are treated as a single entity that holds all of the assets of the stapled entities, conducts all of the activities of the stapled entities, and derives all of the income of the stapled entities.

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

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

(i) For purposes of section 1297(a)(2), a partnership at least 25 percent of the value of which is owned (as determined under § 1.1297–2(b)(1) as if the partnership were a corporation) by the tested foreign corporation on the measuring date; and

(ii) For purposes of section 1297(a)(1), a partnership for which the value owned (as determined under § 1.1297–2(b)(1) as if the partnership were a corporation) by the tested foreign corporation on the date on which income is received or accrued by the partnership is at least 25 percent of the value of the partnership.

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

(3) *Measuring period.* The term *measuring period* means a quarter or an alternative measuring period, as determined in accordance with paragraph (d)(1)(ii) of this section.

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

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

(6) *Passive asset.* The term *passive asset* means an asset that produces passive income, or which is held for the production of passive income, taking into account the rules in paragraphs (c) and (d) of this section.

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

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

(g) *Applicability date.* (1) [Reserved]

(2) *In general.* The rules of this section apply to taxable years of shareholders beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

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

(a) *Overview.* This section provides rules concerning the treatment of income and assets of a look-through subsidiary for purposes of determining whether a tested foreign corporation (as defined in § 1.1297–1(f)(8)) is a passive foreign investment company (PFIC) under section 1297(a). Paragraph (b) of this section provides guidance for purposes of section 1297(c) on how to determine a tested foreign corporation's ownership in a corporation and how to determine a tested foreign corporation's proportionate share of a look-through subsidiary's assets and income. Paragraph (c) of this section provides rules that eliminate certain income and assets related to look-through subsidiaries and look-through partnerships (as defined in § 1.1297–1(f)(1)) for purposes of determining a tested foreign corporation's PFIC status. Paragraph (d) of this section sets forth a rule to determine whether certain income received or accrued by look-through subsidiaries and look-through partnerships is received or accrued from a related person for purposes of section 1297(b)(2)(C). Paragraph (e) of this section sets forth rules concerning the attribution of activities from a look-through subsidiary or look-through partnership. Paragraph (f) of this section provides rules for determining the amount of gain from the sale or exchange of stock of a look-through subsidiary that is taken into account under section 1297(a) and for determining the passive or non-passive character of the gain. Paragraph (g) of this section sets forth definitions applicable for this section, and paragraph (h) of this section sets forth the applicability date of this section.

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

(2) *Tested foreign corporation's proportionate share of the assets and income of a look-through subsidiary*—(i) *Proportionate share of assets.* For each measuring period (as defined in § 1.1297–1(f)(3)), a tested foreign corporation is treated as if it held its proportionate share of each asset of a look-through subsidiary, determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section)) of the look-through subsidiary on the measuring date (as defined in § 1.1297–1(f)(2)).

(ii) *Proportionate share of income*—(A) *General rule.* A tested foreign corporation is treated as if it received directly its proportionate share of each item of gross income of a corporation for a taxable year if the corporation is a look-through subsidiary with respect to the tested foreign corporation for the taxable year of the tested foreign corporation. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income is determined based on the corporation's average percentage ownership (by value) of the look-through subsidiary.

(B) *Special rule.* When a corporation is not a look-through subsidiary with respect to a tested foreign corporation for a taxable year of the tested foreign corporation, the tested foreign corporation may be treated as if it received directly its proportionate share of the gross income of the first corporation for each measuring period in the year for which the first corporation is a look-through subsidiary, provided that the gross income of the first corporation for each such measuring period can be established. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income is determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section) of the look-through subsidiary on the relevant measuring date.

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

(3) *Examples.* The following examples illustrate the rules of this paragraph (b). For purposes of the examples in this paragraph (b)(3), for TFC's and LTS's entire taxable years, USP is a domestic corporation; USP owns 30% of TFC; TFC owns the amount of stock of LTS provided in each example; LTS owns 25% of the only class of FS stock; and TFC, LTS, and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a).

(i) *Example 1*—(A) *Facts.* TFC directly owns 80% of the only class of LTS stock for TFC's and LTS's entire taxable year. Pursuant to the principles of section 958(a), TFC owns 80% of the value of LTS, LTS owns 25% of the value of FS, and TFC owns 20% of the value of FS.

(B) *Results.* Under paragraph (b) of this section, in determining whether LTS is a PFIC under section 1297(a), LTS is treated as if it held 25% of each of FS's assets on each of the measuring dates in its taxable year, and received directly 25% of the gross income of FS for the taxable year. In determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held an 80% interest in each of LTS's assets on each of the measuring dates in its taxable year, and received directly 80% of the income of LTS for the taxable year. However, TFC is treated as if it held a 20% interest in the stock of FS (and not the assets of FS), and received 80% of any dividends paid from FS to LTS (and not any income of FS).

(ii) *Example 2*—(A) *Facts.* TFC directly owns 25% of the only class of LTS stock on the last day of each of the first three quarters of its taxable year, but disposes of its entire interest in LTS during the fourth quarter of its taxable year. Pursuant to the principles of section 958(a), on each of its first three measuring dates, TFC owns 25% of the value of LTS and 6.25% of the value of FS.

(B) *Results.* Under paragraph (b) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 25% of LTS's assets on each of the first three measuring dates in its taxable year. However, because it held an average of 18.75% of the value of LTS on the measuring dates in the taxable year, it is not treated as receiving directly the gross income of LTS for the taxable year. If information about the gross income for LTS for each of the first three quarters of its taxable year is available, TFC may be treated as receiving directly 25% of the income of LTS for each of those quarters, because it owned 25% of the value of LTS on the measuring dates with respect to those measuring periods. For each of its first three quarters, TFC is treated as if it held a 6.25% interest in the stock of FS (and not the assets of FS) and may, if information about the income for LTS for each of the first three quarters of its taxable year is available, be treated as receiving 25% of any dividends paid from FS to LTS (and not any income of FS).

(iii) *Example 3*—(A) *Facts.* TFC directly owns 100% of the only class of LTS stock for TFC's and LTS's entire taxable year. Pursuant to the principles of section 958(a), TFC owns 100% of the value of LTS, and TFC owns 25% of the value of FS. TFC earns $5x of rents from renting a building to LTS, a related person with respect to TFC within the meaning of section 954(d)(3). TFC also sells one item of property described in section 954(c)(1)(B)(i) for a gain of $25x and another for a loss of $10x, and no exception from passive income applies to either amount. LTS has $100x of revenues from selling property described in section 1221(a)(1) to unrelated persons, but $150x of cost of goods sold with respect to such property. None of LTS's deduction for the rent paid to TFC is allocated to non-passive income under the principles of §§ 1.861–8 through 1.861–14T. During the taxable year, FS sells one item of property described in section 954(c)(1)(B)(i) for a gain of $50x and another for a loss of $100x, and no exception from passive income applies to either amount.

(B) *Results.* Under paragraph (b) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 100% of LTS's assets on each of the measuring dates in its taxable year, and received directly 100% of the gross income of LTS for the taxable year. Accordingly, TFC is treated as receiving directly $0x of gross income from the sale of property by LTS given that LTS revenues are fully offset by costs of goods sold. Furthermore, TFC is treated as if it held a 25% interest in FS's assets, and received directly 25% of the gross income of FS. Pursuant to § 1.1297–1(c)(1)(ii), only the excess of gains over losses from property transactions described in section 954(c)(1)(B) is taken into account as gross income for purposes of section 1297. Accordingly, TFC is treated as receiving directly $0x of gross income from the sales of property by FS. TFC's rental income constitutes passive income pursuant to § 1.1297–1(c) and section 954(c)(1)(A), the exception in section 954(c)(2)(A) does not apply, and, taking into account § 1.1297–1(c)(3)(iii), section 1297(b)(2)(c) does not apply to characterize any of the rental income as non-passive income. TFC's income from its sales of property constitutes passive income pursuant to § 1.1297–1(c) and section 954(c)(1)(B), although, pursuant to § 1.1297–1(c)(1)(ii), only the excess of gains over losses is taken into account as gross income for purposes of section 1297. As a result, TFC's income, all of which is passive income, equals $20x ($5x + ($25x − $10x)) of gross income.

(c) *Elimination of certain intercompany assets and income*—(1) *General rule for asset test.* For purposes of section 1297, a tested foreign corporation does not take into account the value (or adjusted basis) of stock of a look-through subsidiary (*LTS stock*) or its proportionate share of an obligation of a look-through subsidiary (*LTS debt*) that it owns on a measuring date, including LTS stock and LTS debt that it is treated as owning pursuant to section 1297(c) and paragraph (b)(2) of this section or § 1.1297–1(c)(2). The tested foreign corporation's proportionate share of a LTS debt is the value (or adjusted basis) of the debt multiplied by the tested foreign corporation's percentage ownership (by value) in the debtor look-through subsidiary. Furthermore, for purposes of section 1297, a tested foreign corporation does not take into account the value (or adjusted basis) of stock or obligations of the tested foreign corporation that it is treated as owning pursuant to section 1297(c) and paragraph (b)(2) of this section or § 1.1297–1(c)(2).

(2) *General rule for income test.* For purposes of section 1297, a tested foreign corporation does not take into account dividends derived with respect to LTS stock or its proportionate share of interest derived with respect to LTS debt, including amounts that it is treated as receiving pursuant to section 1297(c) and paragraph (b)(2) of this section or § 1.1297–1(c)(2), other than dividends that are attributable to income that was not treated as received directly by the tested foreign corporation pursuant to paragraph (b)(2) of this section. The tested foreign corporation's proportionate share of interest is the amount of interest multiplied by the tested foreign corporation's percentage ownership (by value) in the debtor look-through subsidiary. Furthermore, for purposes of section 1297, a tested foreign corporation does not take into account dividends or interest with respect to stock or obligations of the tested foreign corporation that it is treated as receiving pursuant to section 1297(c) and paragraph (b)(2) of this section or § 1.1297–1(c)(2).

(3) *Partnerships.* For purposes of section 1297, the principles of paragraphs (c)(1) and (2) of this section apply with respect to ownership interests in and debt of a look-through partnership and with respect to distributions by a look-through partnership, other than distributions that are attributable to income that was not treated as received directly by the tested foreign corporation pursuant to § 1.1297–1(c)(2), and interest derived with respect to the debt of a look-through partnership.

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

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

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

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

(B) *Results.* The results are the same as in paragraph (c)(4)(i)(B) of this section (the results in *Example 1*), except that TFC's assets also do not include the stock of LTS2. Similarly, although TFC would be treated under paragraph (b)(2) of this section as owning $80x (40% × $200x) of the LTS1 loan to LTS2, under paragraph (c) of this section, TFC does not take into account $60x (30% × $200x)) of the loan to LTS2, and accordingly, its assets include only $20x ($80 − $60x) of the loan to LTS1. Furthermore, although TFC would be treated under paragraph (b)(2) of this section as receiving $2x (40% × $5x) of the interest received by LTS1 from LTS2, under paragraph (c) of this section, TFC does not take into account $1.5x (30% × $5x) of the interest received by LTS1, and accordingly, its income includes only $0.5x ($2x − $1.5x) of the interest from LTS2. Furthermore, TFC's assets include $2x (40% × $5x) of LTS1's cash received from LTS2.

(iii) *Example 3*—(A) *Facts.* TFC directly owns 80% of the value of LTS1 stock on each of the measuring dates, and thus is treated under paragraph (b)(1) of this section as owning 80% of LTS1 on each of the measuring dates. TFC also directly owns 50% of the value in FPS on each of the measuring dates. LTS1's assets include the remaining 50% of the value in FPS and a loan to FPS with a balance of $500x on each of the measuring dates. FPS's assets include a loan to TFC with a balance of $1000x on each of the measuring dates. During the first measuring period of the taxable year, FPS received $30x of interest from TFC, and LTS1 received $15x of interest from FPS, both of which were paid in cash. During the last measuring period of the taxable year, FPS received $80x of income from an unrelated person in cash and distributed $60x of such income in cash to TFC and LTS1 in proportion to their interests in FPS.

(B) *Results.* Under paragraph (c) of this section, for purposes of applying section 1297(a), TFC's assets do not include the stock of LTS1, the interests in FPS owned by TFC directly and through LTS1, any of the loan by FPS to TFC, or any of the loan by LTS1 to FPS. Similarly, TFC's income does not include any of the $30x of interest received by FPS from TFC, any of the $15x of interest received by LTS1 from FPS, or any of the $60x of distributions received by TFC and LTS1 from FPS. However, on each of the measuring dates, TFC's assets include $27x ((50% × $30x) + (80% × 50% × $30x)) of the $30 of cash received by FPS from TFC and $12x (80% × $15x) of the $15 of cash received by LTS1 from FPS. Moreover, on the last measuring date of the taxable year, TFC's assets include $18x ((50% × $20x) + (80% × 50% × $20x)) of the $20x ($80x − $60x) of cash received by FPS from the unrelated person and retained and $54 ((50% × $60x) + (80% × 50% × $60x)) of the $60x cash received by FPS from the unrelated person and distributed. Furthermore, TFC's income includes $72x ((50% × $80x) + (80% × 50% × $80x)) of the $80x of income received by FPS from an unrelated person.

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

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

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

(ii) *Results.* Pursuant to section 1297(c) and paragraph (b)(2) of this section, TFC is treated as receiving directly $30x of the dividend income received by FS1. FS2 is a ''related person'' with respect to FS1 for purposes of section 1297(b)(2)(C) because FS1 owns more than 50% of the vote of FS2. FS2 is not a ''related person'' with respect to TFC for purposes of section 1297(b)(2)(C). Under paragraph (d) of this section, for purposes of determining whether the dividend income received by FS1 is subject to the exception in section 1297(b)(2)(C) for purposes of testing the PFIC status of TFC, the dividend is treated as received from a related person because FS1 and FS2 are related persons within the meaning of section 1297(b)(2)(C). Therefore, to the extent the dividend income received by FS1 would be properly allocable to income of FS2 that is not passive income, the dividend income that TFC is treated as receiving under section 1297(c) is treated as non-passive income (as defined in § 1.1297–1(f)(5)).

(e) *Treatment of activities of certain look-through subsidiaries and look-through partnerships for purposes of section 954(c)(2)(A) active rents and royalties exception*—(1) *General rule.* An item of rent or royalty income received by a tested foreign corporation (including an amount treated as received or accrued pursuant to section 1297(c) and paragraph (b)(2) of this section or pursuant to § 1.1297–1(c)(2)) that would be passive income in the hands of the entity that actually received or accrued it is not passive income pursuant to § 1.1297–1(c)(1)(i)(A) and section 954(c)(2)(A) if the item would be excluded from foreign personal holding company income under section 954(c)(2)(A) and § 1.954–2(b)(6), (c), and (d), determined by taking into account the activities performed by the officers and staff of employees of the tested foreign corporation as well as activities performed by the officers and staff of employees of any look-through subsidiary in which the tested foreign corporation owns more than 50 percent by value (as determined under paragraph (b)(1) of this section) and any look-through partnership in which the tested foreign corporation owns, directly or indirectly, more than 50 percent.

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

(i) *Example 1*—(A) *Facts.* USP is a domestic corporation that directly owns 20% of the outstanding stock of FS1. The remaining 80% of the outstanding stock of FS1 is directly owned by a foreign person that is not related to USP. FS1 directly owns 100% of the value of the outstanding stock of FS2 and directly owns 80% of the value of the outstanding stock of FS3. The remaining 20% of the outstanding stock of the value of the FS3 is directly owned by a foreign person that is not related to USP. FS2 directly owns 80% of the value of the outstanding stock of FS4. The remaining 20% of the value of the outstanding stock of FS4 is directly owned by a foreign person that is not related to USP. FS1, FS2, FS3 and FS4 are all organized in Country A and are not controlled foreign corporations within the meaning of section 957(a). FS4 owns real property that is leased to a person that is not a related person, but does not perform any activities. FS1 and FS2 also do not perform any activities. Officers and employees of FS3 in Country A perform activities with respect to the real property of FS4 that, if performed by officers or employees of FS4, would allow the rental income in the hands of FS4 to qualify for the exception from foreign personal holding company income in section 954(c)(2)(A) and § 1.954–2(b)(6) and (c)(1)(ii).

(B) *Results.* Under this paragraph (e), for purposes of determining whether the rental income treated under section 1297(c) and paragraph (b)(2) of this section as received directly by FS1 with respect to the real property owned and rented by FS4 is passive income for purposes of section 1297, the activities of FS3 are taken into account as a result of FS1's ownership of 80% by value (as determined under paragraph (b)(1) of this section) of FS3. Thus, the exception in section 954(c)(2)(A) would apply, and the rental income treated as received by FS1 would be treated as non-passive income for purposes of determining whether FS1 is a PFIC. Because FS2 and FS4 do not own more than 50 percent by value (as determined under paragraph (b)(1) of this section) of FS3, the activities of FS3 are not taken into account for purposes of determining whether the rental income treated as received by FS2 and actually received by FS4 with respect to the real property owned and rented by FS4 is passive income for purposes of section 1297. Thus, the exception in section 954(c)(2)(A) would not apply, and the rental income treated as received by FS2 and actually received by FS4 would be treated as passive income for purposes of determining whether FS2 and FS4 are PFICs.

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

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

(f) *Gain on disposition of stock in a look-through subsidiary*—(1) *Amount of gain taken into account.* The amount of gain derived from a tested foreign corporation's direct disposition of stock of a look-through subsidiary, or an indirect disposition resulting from the disposition of stock of a look-through subsidiary by other look-through subsidiaries or by look-through partnerships, that is taken into account by the tested foreign corporation for purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298–2 is the residual gain. The residual gain equals the total gain recognized by the tested foreign corporation (including gain treated as recognized by the tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) of this section or § 1.1297–1(c)(2)) from the disposition of the stock of the look-through subsidiary reduced (but not below zero) by unremitted earnings. *Unremitted earnings* are the excess (if any) of the aggregate income (if any) taken into account by the tested foreign corporation pursuant to section 1297(c) and paragraph (b)(2) of this section or § 1.1297–1(c)(2) with respect to the stock of the disposed-of look-through subsidiary (including with respect to any other look-through subsidiary, to the extent it is owned by the tested foreign corporation indirectly through the disposed-of look-through subsidiary) over the aggregate dividends (if any) received by the tested foreign corporation from the disposed-of look-through subsidiary with respect to the stock. For purposes of this paragraph (f)(1), the amount of gain derived from the disposition of stock of a look-through subsidiary and income of and dividends received from the look-through subsidiary is determined on a share-by-share basis.

(2) *Characterization of residual gain as passive income.* For purposes of section 1297(a)(1), section 1298(b)(3), and § 1.1298–2, the residual gain is characterized as passive income or non-passive income based on the relative amounts of passive assets and non-passive assets (as defined in § 1.1297–1(f)(6) and (4), respectively) of the disposed-of look-through subsidiary (and any other look-through subsidiary to the extent owned indirectly through the look-through subsidiary) treated as held by the tested foreign corporation on the date of the disposition of the look-through subsidiary. For the purpose of this paragraph (f)(2), the relative amounts of passive assets and non-passive assets held by the look-through subsidiary are measured under the same method (value or adjusted bases) used to measure the assets of the tested foreign corporation for purposes of section 1297(a)(2).

(3) *Examples.* The following examples illustrate the rules of this paragraph (f). For purposes of the examples in this paragraph (f)(3), USP is a domestic corporation, TFC and FS are foreign corporations that are not controlled foreign corporations within the meaning of section 957(a), and USP, TFC, and FS each has outstanding a single class of stock with 100 shares outstanding and a calendar taxable year.

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

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

(ii) *Example 2*—(A) *Facts.* The facts are the same as in paragraph (f)(3)(i)(A) of this section (the facts in *Example 1*), except that in Year 1, TFC purchased 15 shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the first day of Year 3, TFC purchased an additional 15 shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the last day of Year 4, TFC recognizes gain of $10x of the sale of 15 shares of FS stock purchased in Year 1, and gain of $60x on the sale of the other 15 shares of FS stock purchased in Year 3.

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

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

(B) *Results.* The results are the same as in paragraph (f)(3)(ii)(B) of this section (the results in *Example 2*), except that the residual gain is $50x, which equals the $40x of residual gain attributable to the 15 shares acquired in Year 3, as computed in paragraph (f)(3)(ii)(B) of this section (the results in *Example 2*), plus the $10x of gain recognized on the 15 shares acquired in Year 1 reduced by $0x, the amount by which the pro rata share of aggregate income ($20x) taken into account by TFC with respect to those 15 shares of FS stock under section 1297(c) and paragraph (b)(2) of this section exceeds the aggregate pro rata amount of dividends with respect to those 15 shares of FS stock ($20x) received by TFC from FS. Under paragraph (f)(2) of this section, $35x of the residual gain is non-passive income ($50x × ($150x/$200x)) and $15x is passive income ($50x × ($50x/$200x)).

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

(1) *Look-through subsidiary.* The term *look-through subsidiary* means, with respect to a tested foreign corporation—

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

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

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

(B) For a measuring period, a corporation at least 25 percent of the value of the stock of which is owned (as determined under paragraph (b)(1) of this section) by the tested foreign corporation on the measuring date, provided all items of gross income of the corporation for each of the measuring periods in the taxable year for which the tested foreign corporation owns at least 25 percent of the value (as determined under paragraph (b)(1) of this section) on the relevant measuring dates can be established; and

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

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

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

(4) *Residual gain.* The term *residual gain* has the meaning provided in paragraph (f)(1) of this section.

(5) *Unremitted earnings.* The term *unremitted earnings* has the meaning

provided in paragraph (f)(1) of this section.

(h) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

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

§ 1.1297–4 Qualifying insurance corporation.

(a) *Scope.* This section provides rules for determining whether a foreign corporation is a qualifying insurance corporation for purposes of section 1297(f). Paragraph (b) of this section provides the general rule for determining whether a foreign corporation is a qualifying insurance corporation. Paragraph (c) of this section describes the 25 percent test in section 1297(f)(1)(B). Paragraph (d) of this section contains rules for applying the alternative facts and circumstances test in section 1297(f)(2). Paragraph (e) of this section contains rules limiting the amount of applicable insurance liabilities for purposes of the 25 percent test described in paragraph (c) of this section and the alternative facts and circumstances test described in paragraph (d) of this section. Paragraph (f) of this section provides definitions that apply for purposes of this section. Paragraph (g) of this section provides the applicability date of this section.

(b) *Qualifying insurance corporation.* For purposes of section 1297(b)(2)(B), this section and § 1.1297–5, a qualifying insurance corporation (QIC) is a foreign corporation that—

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

(2) Satisfies—

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

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

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

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

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

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

(iii) Reports an amount of applicable insurance liabilities that is at least 10 percent of the amount of the total assets on its applicable financial statement for the last annual reporting period ending with or within the corporation's taxable year (the *10 percent test*).

(2) *Predominantly engaged in an insurance business*—(i) *In general.* A foreign corporation is predominantly engaged in an insurance business in any taxable year during which more than half of the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. This determination is made based on whether the particular facts and circumstances of the foreign corporation are comparable to commercial insurance arrangements providing similar lines of coverage to unrelated parties in arm's length transactions. The fact that a foreign corporation has been holding itself out as an insurer for a long period is not determinative of whether the foreign corporation is predominantly engaged in an insurance business.

(ii) *Facts and circumstances.* Facts and circumstances to consider in determining whether a foreign corporation is predominantly engaged in an insurance business include—

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

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

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

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

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

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

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

(C) Low loss exposure.

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

(i) Was actively engaged in the process of terminating its pre-existing, active insurance or reinsurance underwriting operations pursuant to an adopted plan of liquidation or a termination of operations under the supervision of its applicable insurance regulatory body;

(ii) Did not issue or enter into any insurance, annuity, or reinsurance contract, other than a contractually obligated renewal of an existing insurance contract or a reinsurance contract pursuant to and consistent with the plan of liquidation or a termination of operations; and

(iii) Made payments during the annual reporting period covered by the applicable financial statement to satisfy the claims under insurance, annuity, or reinsurance contracts, and the payments cause the corporation to fail to satisfy the 25 percent test.

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

(i) The 25 percent test is not met as a result of the specific requirements with respect to capital and surplus that a generally recognized credit rating agency imposes; and

(ii) The foreign corporation complies with the requirements of the credit rating agency in order to maintain the minimum credit rating required for the foreign corporation to be classified as secure to write new insurance business for the current year.

(5) *Election*—(i) *In general.* A United States person may make the election under section 1297(f)(2) if the foreign corporation directly provides the United States person a statement, signed by a responsible officer of the foreign corporation or an authorized representative of the foreign corporation, or the foreign corporation makes a publicly available statement (such as in a public filing, disclosure statement, or other notice provided to United States persons that are

shareholders of the foreign corporation) that it satisfied the requirements of section 1297(f)(2) and paragraph (d)(1) of this section during the foreign corporation's the taxable year. However, a United States person may not rely upon any statement by the foreign corporation to make the election under section 1297(f)(2) if the shareholder knows or has reason to know that the statement made by the foreign corporation was incorrect.

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

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

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

(iii) *Time and manner for making the election.* The election described in paragraph (d)(1) of this section must be made by a United States person who owns stock in the foreign corporation (directly or indirectly) by completing the appropriate part of Form 8621 (or successor form) for each year in which the election applies. A United States person must attach the Form 8621 (or successor form) to its Federal income tax return for the taxable year to which the election relates on or before the due date (including extensions) for the filing of the return. The United States person must attach to the Form 8621 the statement provided by the foreign corporation described in paragraph (d)(1) of this section. If the foreign corporation makes a publicly available statement instead of providing a statement to the United States person, the United States person must attach a statement to the Form 8621 incorporating the information provided in the publicly available statement.

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

(2) *General limitation on applicable insurance liabilities.* The amount of applicable insurance liabilities may not exceed the lesser of:

(i) The amount of applicable insurance liabilities shown on the most recent applicable financial statement;

(ii) The minimum amount of applicable insurance liabilities required by the applicable law or regulation of the jurisdiction of the applicable regulatory body; or

(iii) For a foreign corporation that prepares a financial statement on the basis of a financial reporting standard for a purpose other than financial reporting, the amount of the applicable insurance liabilities on that financial statement.

(3) *Additional limitation on amount of applicable insurance liabilities for a foreign corporation that does not prepare a financial statement based on a financial reporting standard*—(i) *In general.* If a foreign corporation has an applicable financial statement described in paragraph (f)(1)(iii) of this section and the applicable financial statement does not discount incurred but unpaid losses and loss reserves on an economically reasonable basis, the amount of applicable insurance liabilities may not exceed the amount of applicable insurance liabilities on the applicable financial statement reduced in accordance with the discounting principles that would have applied under a financial reporting standard, if the foreign corporation had prepared a financial statement under a financial reporting standard for the last year ending with or within the taxable year.

(ii) *Choice of accounting method.* The foreign corporation may choose whether to apply generally accepted accounting principles or international financial reporting principles to calculate the discounted amount of its applicable insurance liabilities for purposes of paragraph (e)(3)(i)(B) of this section. If the foreign corporation does not choose between these financial reporting standards, generally accepted accounting principles will apply.

(4) *Changes to financial statements prepared.* Any foreign corporation that has prepared a financial statement on the basis of a financial reporting standard for an annual reporting period that included December 22, 2017, or any subsequent annual reporting period, must continue to prepare its applicable financial statement using a financial reporting standard unless the foreign corporation has a non-Federal tax business purpose for using the annual statement described in paragraph (f)(1)(iii) of this section. If a foreign corporation has no non-Federal tax business purpose for using the annual statement described in paragraph (f)(1)(iii) of this section and does not continue to prepare an applicable financial statement using a financial reporting standard, its applicable insurance liabilities are treated as $0 for purposes of this section.

(f) *Definitions.* For purposes of this section, the following terms have the meanings described in this paragraph (f).

(1) *Applicable financial statement.* The term *applicable financial statement* means the financial statement that is used by the foreign corporation for financial reporting purposes and that is—

(i) Made on the basis of generally accepted accounting principles;

(ii) Made on the basis of international financial reporting standards, if there is no statement that is made on the basis of generally accepted accounting principles; or

(iii) The annual statement required to be filed with the applicable insurance regulatory body, as defined in paragraph (f)(3) of this section, if there is no statement made on the basis of either general accounting principles or international financial reporting standards. The annual statement required to be filed with the applicable insurance regulatory body must provide complete information regarding the foreign corporation's operations and financial condition for the annual reporting period ending with or within the taxable year.

(2) *Applicable insurance liabilities.* With respect to any life or property and casualty insurance business of a foreign corporation, the term *applicable insurance liabilities* means—

(i) Occurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year, including unpaid claims for death benefits, annuity contracts, and health insurance benefits;

(ii) Unpaid expenses (including reasonable estimates of anticipated expenses) of investigating and adjusted unpaid losses described in paragraph (f)(2)(i) of this section; and

(iii) The aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held for future, unaccrued health insurance claims and claims with respect to contracts providing coverage for mortality or morbidity risks, including annuity benefits dependent upon the life expectancy of one or more individuals.

(3) *Applicable insurance regulatory body.* The term *applicable insurance regulatory body* means the entity that

has been established by law to license or authorize a corporation to engage in an insurance business, to regulate insurance company solvency and to which the applicable financial statement is provided.

(4) *Financial reporting standard.* The term *financial reporting standard* means either GAAP or international financial reporting standards.

(5) *Generally accepted accounting principles or GAAP.* The term *generally accepted accounting principles* or *GAAP* means United States generally accepted accounting principles.

(6) *Insurance business.* Solely for purposes of this section, *insurance business* has the meaning described in § 1.1297–5(c)(2).

(7) *Total assets.* For purposes of section 1297(f) and this section, a foreign corporation's *total assets* are the aggregate end-of-period value of the real property and personal property that the foreign corporation reports on its applicable financial statement for the last annual accounting period ending with or within the taxable year.

(g) *Applicability date.* This section applies to taxable years of United States persons that are shareholders in certain foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

§ 1.1297–5 Exception from the definition of passive income for active insurance income.

(a) *Scope.* This section provides rules pertaining to the exception from passive income under section 1297(b)(2)(B) for income derived in the active conduct of an insurance business and rules related to certain income of a qualifying domestic insurance corporation. Paragraph (b) of this section provides a general rule that excludes from passive income certain income of a qualifying insurance corporation (QIC) and certain income of a qualifying domestic insurance corporation. Paragraph (c) of this section provides rules for determining the amount of income derived by a QIC in the active conduct of an insurance business. Paragraph (d) of this section defines income of a qualifying domestic insurance corporation that is not treated as passive for purposes of section 1297. Paragraph (e) of this section provides rules excluding certain assets for purposes of the passive asset test under section 1297(a)(2). Paragraph (f) of this section provides rules concerning the treatment of income and assets of certain look-through subsidiaries and look-through partnerships of a QIC. Paragraph (g) of this section provides a rule prohibiting the double counting of any item for purposes of this section. Paragraph (h) of this section provides definitions applicable to the rules of this section. Paragraph (i) of this section provides the applicability date of this section.

(b) *Exclusion from passive income of active insurance income.* For purposes of section 1297 and § 1.1297–1, passive income does not include—

(1) Income that a QIC derives in the active conduct of an insurance business as determined under paragraph (c) of this section; and

(2) Income from a qualifying domestic insurance corporation as determined under paragraph (d) of this section, except that this exclusion does not apply to determine whether a tested foreign corporation (as defined in § 1.1297–1(f)(8)) is a PFIC for purposes of section 1298(a)(2) and § 1.1291–1(b)(8)(ii).

(c) *Income derived by a QIC in the active conduct of an insurance business*—(1) *In general.* Income that a QIC derives in the active conduct of an insurance business is an amount equal to the QIC's passive income (as defined in § 1.1297–1(c) and taking into account the exceptions in section 1297(b)(2) other than the exception provided in section 1297(b)(2)(B) and this section) earned with respect to assets of a QIC that are available to satisfy liabilities of the QIC related to its insurance business (as described in paragraph (c)(2) of this section), multiplied by—

(i) 100 percent if the active conduct percentage determined under paragraph (c)(4) of this section equals or exceeds 50 percent; or

(ii) Zero if the active conduct percentage determined under paragraph (c)(4) of this section is less than 50 percent.

(2) *Insurance business.* Solely for purposes of § 1.1297–4 and this section, an insurance business is the business of issuing insurance and annuity contracts and the reinsuring of risks underwritten by insurance companies, together with those investment activities and administrative services that are required to support (or that are substantially related to) those insurance, annuity, or reinsurance contracts issued or entered into by the QIC.

(3) *Active conduct of an insurance business*—(i) *In general.* For purposes of determining whether a QIC engages in the active conduct of an insurance business, active conduct is determined based on all the facts and circumstances. In general, a QIC actively conducts an insurance business only if the officers and employees of the QIC carry out substantial managerial and operational activities. A QIC's officers and employees are considered to include the officers and employees of another entity only if the QIC satisfies the control test described in paragraph (c)(3)(ii) with respect to the officers and employees of the other entity. In determining whether the officers and employees of the QIC carry out substantial managerial and operational activities, however, the activities of independent contractors are disregarded.

(ii) *Control test.* A QIC's officers and employees are considered to include the officers and employees of another entity when the requirements of paragraphs (c)(3)(ii)(A) through (C) of this section are satisfied.

(A) *Ownership*—(*1*) *Ownership by or of a corporation.* If the other entity is a corporation—

(*i*) The QIC owns, or is considered to own within the meaning of section 958(a), determined without regard to whether an intermediate entity is domestic or foreign, more than 50 percent of the total combined voting power of all classes of stock of the other corporation entitled to vote, and more than 50 percent of the total value of the stock of the other corporation; or

(*ii*) A common parent owns, or is considered to own within the meaning of section 958(a), determined without regard to whether an intermediate entity is domestic or foreign, more than 80 percent of the total combined voting power of all classes of stock entitled to vote and more than 80 percent of the total value of the stock of each of the QIC and the other corporation.

(*2*) *Ownership of a partnership.* If the other entity is a partnership—

(*i*) The QIC owns, directly or indirectly, more than 50 percent of the interests in the capital and profits in the entity; or

(*ii*) A common parent owns, directly or indirectly, more than 80 percent of the interests in the capital and profits in the entity and owns, or is considered to own within the meaning of section 958(a), determined without regard to whether an intermediate entity is domestic or foreign, more than 80 percent of the total combined voting power of all classes of stock entitled to vote and more than 80 percent of the total value of the stock of the QIC.

(B) *Control and supervision.* The QIC exercises regular oversight and supervision over the services performed by the other entity's officers and employees for the QIC.

(C) *Compensation.* The QIC either—

(*1*) Pays directly all the compensation of the other entity's officers and employees attributable to services performed for the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance, annuity, or reinsurance contracts issued or entered into by the QIC (*insurance services*);

(*2*) Reimburses the other entity for the portion of its expenses, including compensation and related expenses (determined in accordance with section 482 and taking into account all expenses that would be included in the total services costs under § 1.482–9(j) and (k)(2)) for the insurance services performed for the QIC or by the other entity's officers and employees; or

(*3*) Otherwise pays arm's length compensation in accordance with section 482 on a fee-related basis to the other entity for the insurance services provided.

(4) *Active conduct percentage*—(i) *In general.* A QIC's active conduct percentage for a taxable year is the percentage calculated (to the nearest percent) by dividing—

(A) The aggregate amount of expenses, including compensation (or reimbursement of compensation) and related expenses, for services of the officers and employees of the QIC (or another entity under an arrangement that satisfies the requirements of paragraph (c)(3)(ii) of this section) incurred by the QIC for the taxable year that are related to the production or acquisition of premiums and investment income on assets held to meet its obligations under the insurance, annuity, or reinsurance contracts issued or entered into by the QIC, by;

(B) The aggregate of—

(*1*) The amount described in paragraph (c)(4)(i)(A) of this section; and

(*2*) The amount of all expenses paid for the taxable year by the QIC to a person other than a person whose services for the QIC are covered by the expenses included in paragraph (c)(4)(i)(A) of this section for the production or acquisition of premiums and investment income on assets held to meet obligations under the insurance, annuity, or reinsurance contracts issued or entered into by the QIC.

(ii) *Related expense determination.* For purposes of determining the amount included in the numerator under paragraph (c)(4)(i)(A) of this section, the cost of compensation and related expenses include all costs in cash or in kind (including stock-based compensation) that, based on analysis of the facts and circumstances, are directly identified with, or reasonably allocated in accordance with the principles of § 1.482–9(k)(2) to, the services of the officers and employees of the insurance company (or related party, as appropriate). In general, costs for the purpose of this paragraph (c)(4)(ii) include all resources expended, used, or made available to achieve the specific objective for which the service of the officer or employee is rendered. For the purpose of this paragraph (c)(4)(ii), reference to generally accepted accounting principles or Federal income tax accounting rules may provide a useful starting point but will not necessarily be conclusive regarding inclusion of costs, and such costs do not include interest expense, foreign income taxes (as defined in § 1.901–2(a)), or Federal income taxes.

(iii) *Ceding commission.* For purposes of paragraph (c)(4)(i) of this section, ceding commissions are not taken into account in either the numerator or denominator of the active conduct percentage.

(d) *Income of qualifying domestic insurance corporation.* The income of a domestic corporation is income of a qualifying domestic insurance corporation if the domestic corporation is subject to—

(1) Tax as an insurance company under subchapter L of chapter 1 of subtitle A of the Internal Revenue Code; and

(2) Federal income tax on its net income.

(e) *Exclusion of assets for purposes of the passive asset test under section 1297(a)(2).* For purposes of section 1297 and § 1.1297–1, passive assets (as defined in § 1.1297–1(f)(6)), do not include—

(1) Assets of a QIC available to satisfy liabilities of the QIC related to its insurance business (as described in paragraph (c)(2) of this section), if the active conduct percentage of the QIC equals or exceeds 50 percent; and

(2) Assets of a qualifying domestic insurance corporation that meets the requirements described in paragraph (d) of this section, except that this exclusion does not apply to determine whether a tested foreign corporation (as defined in § 1.1297–1(f)(8)) is a PFIC for purposes of section 1298(a)(2) and § 1.1291–1(b)(8)(ii).

(f) *Treatment of income and assets of certain look-through subsidiaries and look-through partnerships for purposes of the section 1297(b)(2)(B) exception*—(1) *General rule.* An item of income treated as received or accrued or an asset treated as held by a QIC pursuant to section 1297(c) and § 1.1297–2(b)(2) or pursuant to § 1.1297–1(c)(2) or (d)(3) that would be passive income or a passive asset is treated as an item of income or an asset of the QIC for purposes of paragraphs (c) and (e) of this section.

(2) *Applicable statements for tested foreign corporations applying paragraph (f)(1) of this section.* For purposes of paragraph (f)(1) of this section, an item of passive income or passive asset in the hands of an entity other than a QIC (subsidiary entity) may only be treated as an item of income or an asset used in the active conduct of an insurance business by a foreign corporation treated as a QIC for purposes of paragraphs (c) and (e) of this section if the applicable financial statement used to test the QIC status of the foreign corporation includes the assets and liabilities of the subsidiary entity.

(g) *No double counting.* Nothing in this section or § 1.1297–4 permits any item to be counted more than once.

(h) *Definitions.* For purposes of this section, the following terms have the meanings described in this paragraph (h).

(1) *Insurance services.* The term *insurance services* has the meaning provided in paragraph (c)(3)(ii)(C)(*1*) of this section.

(2) *Investment activity.* The term *investment activity* means any activity engaged in by a QIC to produce income of a kind that would be passive income (as defined in § 1.1297–1(c)). Investment activities include those activities that are required to support or are substantially related to insurance and annuity contracts issued or reinsured by a QIC only to the extent that income produced by the activities is generated by assets available to satisfy liabilities of the QIC related to the insurance business, as described in paragraph (c)(2) of this section.

(3) *Qualifying insurance corporation* or *QIC.* The term *qualifying insurance corporation* or *QIC* has the meaning described in § 1.1297–4.

(i) *Applicability date.* This section applies to taxable years of United States persons that are shareholders in certain foreign corporations beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

■ **Par. 7.** Section 1.1298–0 is amended by:

■ 1. Revising the introductory text.

■ 2. Adding entries for §§ 1.1298–2 and 1.1298–4 in numerical order.

The revision and additions read as follows:

§ 1.1298–0 Passive foreign investment company—table of contents.

This section contains a listing of the paragraph headings for §§ 1.1298–1, 1.1298–2, 1.1298–3, and 1.1298–4.

* * * * *

■ **Par. 8.** Section 1.1298–2 is added to read as follows:

§ 1.1298–2 Rules for certain corporations changing businesses.

(a) *Overview.* This section provides rules under section 1298(b)(3) and 1298(g) that apply to certain foreign corporations that dispose of one or more active trades or businesses for purposes of determining whether a foreign corporation is treated as a passive foreign investment company (PFIC). Paragraph (b) of this section sets forth a rule that applies to certain foreign corporations that dispose of one or more active trades or businesses. Paragraph (c) of this section provides special rules. Paragraph (d) of this section sets forth a rule for the treatment of the disposition of the stock of a look-through subsidiary (as defined in § 1.1297–2(g)(1)). Paragraph (e) of this section provides guidance on the application of the rules in this section. Paragraph (f) provides examples illustrating the application of the rules in this section. Paragraph (g) sets forth the applicability date for this section.

(b) *Change of business exception.* A corporation is not treated as a PFIC for a taxable year if—

(1) Neither the corporation (nor any predecessor) was a PFIC for any prior taxable year;

(2) Either—

(i) Substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses; or

(ii) Following the disposition of one or more active trades or businesses, substantially all of the passive assets of the corporation on each of the measuring dates that occur during the taxable year and after the disposition are attributable to proceeds from the disposition; and

(3) The corporation is not a PFIC for either of the first two taxable years following the taxable year.

(c) *Special rules.* The rules in this paragraph (c) apply for purposes of section 1298(b)(3) and this section.

(1) Income is attributable to proceeds from the disposition of one or more active trades or businesses to the extent the income is derived from the investment of the proceeds from the disposition of assets used in the active trade or businesses.

(2) Assets are attributable to proceeds from the disposition of one or more active trades or businesses only to the extent the assets are the proceeds of the disposition of assets used in the active trade or businesses, or are derived from the investment of the proceeds.

(3) The determination of the existence of an active trade or business and whether assets are used in an active trade or business is made under § 1.367(a)–2(d)(2), (3), and (5), except that officers and employees do not include the officers and employees of related entities as provided in § 1.367(a)–2(d)(3). However, if activities performed by the officers and staff of employees of a look-through subsidiary of a corporation (including a look-through subsidiary with respect to which paragraph (d) of this section applies) or of a look-through partnership would be taken into account by the corporation pursuant to § 1.1297–2(e) if it applied, or if activities performed by a related person would be taken into account by the corporation pursuant to section 954(h)(3)(E), such activities are taken into account for purposes of the determination of the existence of an active trade or business and the determination of whether assets are used in an active trade or business.

(4) In the case of a corporation that satisfies the condition in paragraph (b)(2)(ii) of this section, the condition in paragraph (b)(3) of this section is deemed to be satisfied if the corporation completely liquidates by the end of the taxable year following the year with respect to which the shareholder applies the exception in paragraph (b) of this section.

(d) *Disposition of stock of a look-through subsidiary.* For purposes of paragraph (b) of this section, the proceeds from a tested foreign corporation's disposition of the stock of a look-through subsidiary are treated as proceeds from the disposition of a proportionate share of the assets held by the look-through subsidiary on the date of the disposition, based on the method (value or adjusted bases) used to measure the assets of the tested foreign corporation for purposes of section 1297(a)(2). The proceeds attributable to assets used by the look-through subsidiary in an active trade or business are treated as proceeds attributable to the disposition of an active trade or business.

(e) *Application of change of business exception.* A shareholder can apply the exception in paragraph (b) of this section with respect to a taxable year of a disposition of an active trade or business or an immediately succeeding taxable year, but cannot apply the exception with respect to more than one taxable year for a disposition.

(f) *Examples.* The following examples illustrate the rules of this section. For purposes of the examples in this paragraph (f): USP is a domestic corporation; TFC and FS are foreign corporations that are not controlled foreign corporations (within the meaning of section 957(a)); each corporation has outstanding a single class of stock; USP has owned its interest in TFC since the formation of TFC; each of USP, TFC, and FS have a calendar taxable year; and for purposes of section 1297(a)(2), TFC measures the amount of its assets based on value.

(1) *Example 1*—(i) *Facts.* (A) USP owns 15% of the outstanding stock of TFC. TFC owns 30% of the outstanding stock of FS. FS operates an active trade or business and 100% of its assets are used in the active trade or business. The value of FS's non-passive assets (as defined in § 1.1297–1(f)) is $900x; the value of FS's passive assets (which include cash and accounts receivable) is $100x. TFC has not been treated as a PFIC for any taxable year prior to Year 1 and has no predecessor corporations. In addition to

holding the FS stock, TFC directly conducts its own active trade or business. The value of TFC's non-passive assets (other than FS stock) is $50x; the value of TFC's passive assets (other than FS stock and assets received during Year 1) is $30x. TFC earns $1x of non-passive income (as defined in § 1.1297–1(f)) from its directly conducted active trade or business.

(B) On January 1, Year 1, TFC sells all of its FS stock for $300x. The residual gain computed under § 1.1297–2(f)(1) on the sale of the FS stock is $10x. Under § 1.1297–2(f)(2), $9x of residual gain is characterized as non-passive income and $1x of residual gain is characterized as passive income. During the first quarter of Year 1 and apart from the sale of the FS stock, TFC earned $20x of passive income from the investment of the proceeds from the disposition of the FS stock, and TFC maintained such earnings as well as the disposition proceeds in cash for the remainder of the year. TFC reinvests the proceeds of the FS stock sale in an active trade or business during Year 2, and, thus, TFC is not a PFIC in Year 2 and Year 3. Less than 75% of TFC's gross income in Year 1 is passive income (($20x + $1x)/($10x + $20x + $1x) = 68%). However, subject to the application of section 1298(b)(3) and this section, TFC would be a PFIC in Year 1 under section 1297(a)(2) because the proceeds from the sale of the FS stock ($300x) together with TFC's other passive assets ($30x + $20x) exceed 50% of TFC's total assets ($300x + $30x + $20x + $50x).

(ii) *Results.* (A) Under paragraph (d) of this section, for purposes of applying section 1298(b)(3)(B)(i) in Year 1, TFC's proceeds from the disposition of the stock of FS that are attributable to assets used by FS in an active trade or business are considered as from the disposition of an active trade or business. Because 100% of FS's assets are used in its active trade or business, all of TFC's proceeds are considered as from the disposition of an active trade or business. Therefore, under paragraph (c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is $20x (from investment of disposition proceeds). Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of section 1298(b)(3) and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(i) of this section, assuming that the 95% (($20x/($20x + $1x)) of TFC's passive income for Year 1 that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive income.

(B) TFC would also not be treated as a PFIC in Year 1 by reason of section 1298(b)(3) and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, assuming that the 91% (($320x × 4)/(($320x + $30x) × 4)) of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets.

(C) Under paragraph (e) of this section, TFC cannot claim the section 1298(b)(3) exception in relation to the income attributable to the proceeds of the FS stock sale in Year 2.

(2) *Example 2*—(i) *Facts.* The facts are the same as in paragraph (f)(1)(i) of this section (the facts in *Example 1*), except that during the first quarter of Year 1, TFC earned only $10x of passive income from the investment of the proceeds from the disposition of the FS stock and $10x of passive income from its other passive assets and maintained such earnings in cash for the remainder of the year.

(ii) *Results.* The results are the same as in paragraph (f)(1)(ii) of this section (the facts in *Example 1*), except that under paragraph (c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is $10x. Because 48% ($10x/($10x + $10x + $1x)), and not substantially all, of TFC's passive income for Year 1 is attributable to proceeds of the disposition of FS's active trade or business, TFC does not qualify for the exception from treatment as a PFIC in section 1298(b)(3) for Year 1. However, under paragraphs (b)(2) and (d) of this section, $310x ($300x disposition proceeds + $10x from investment of disposition proceeds) of TFC's passive assets held on each quarterly measuring date after the disposition is considered attributable to the disposition of an active trade or business. Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, assuming that the 89% (($310x × 4)/(($310x + $10x + $30x) × 4)) of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets.

(g) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

■ **Par. 9.** Section 1.1298–4 is added to read as follows:

§ 1.1298–4 Rules for certain foreign corporations owning stock in 25-percent-owned domestic corporations.

(a) *Overview.* This section provides rules under section 1298(b)(7) that apply to certain foreign corporations that own stock in 25-percent-owned domestic corporations (as defined in paragraph (b) of this section) for purposes of determining whether a foreign corporation is a passive foreign investment company (PFIC). Paragraph (b) of this section provides the general rule. Paragraph (c) of this section sets forth rules concerning ownership of 25-percent-owned domestic corporations or qualified stock (as defined in paragraph (b)(2) of this section) through partnerships. Paragraph (d) of this section sets forth rules for determining whether a foreign corporation is subject to the tax imposed by section 531 (the section 531 tax) and for waiving treaty benefits that would prevent the imposition of such tax. Paragraph (e) of this section sets forth a rule governing the interaction of section 1298(b)(7) and section 1298(a)(2). Paragraph (f) of this section sets forth anti-abuse rules for the application of section 1298(b)(7). Paragraph (g) sets forth the applicability date for this section.

(b) *Treatment of certain foreign corporations owning stock in a 25-percent-owned domestic corporation*—(1) *General rule.* Except as otherwise provided in paragraphs (e) and (f) of this section, when a tested foreign corporation (as defined in § 1.1297–1(f)) is subject to the section 531 tax (or waives any benefit under any treaty that would otherwise prevent the imposition of the tax), and owns (directly or indirectly under the rules in paragraph (c) of this section) at least 25 percent (by value) of the stock of a domestic corporation (a *25-percent-owned domestic corporation*), for purposes of determining whether the foreign corporation is a PFIC, any qualified stock held directly or indirectly under the rules in paragraph (c) of this section by the 25-percent-owned domestic corporation is treated as an asset that does not produce passive income (and is not held for the production of passive income), and any amount included in gross income with respect to the qualified stock is not treated as passive income.

(2) *Qualified stock.* For purposes of paragraph (b)(1) of this section, the term *qualified stock* means any stock in a C corporation that is a domestic corporation and that is not a regulated investment company or real estate investment trust.

(c) *Indirect ownership of stock through a partnership.* For purposes of paragraph (b)(1) of this section, a tested foreign corporation that is a partner in a partnership is considered to own its proportionate share of any stock of a domestic corporation held by the partnership, and a domestic corporation that is a partner in a partnership is considered to own its proportionate share of any qualified stock held by the partnership. The rules and principles of sections 701 through 761 apply to determine the corporation's proportionate share of the stock of the domestic corporation or of the qualified stock. An upper-tier partnership's attributable share of the stock of a domestic corporation or of qualified stock held by a lower-tier partnership is treated as held by the upper-tier partnership for purposes of applying the rule in this paragraph (c).

(d) *Section 531 tax*—(1) *Subject to section 531 tax.* For purposes of paragraph (b) of this section, a tested foreign corporation is considered subject to the section 531 tax regardless of whether the tax is imposed on the corporation and of whether the requirements of § 1.532–1(c) are met.

(2) *Waiver of treaty benefits*—(i) *Tested foreign corporation that files, or is required to file, a Federal income tax return.* For purposes of paragraph (b) of this section, a tested foreign corporation that files, or is required to file, a Federal income tax return waives the benefit under a treaty that would otherwise prevent the imposition of the section 531 tax by attaching to its original or amended return for the taxable year for which section 1298(b)(7) and paragraph (b)(1) of this section are applied or any prior taxable year a statement that it irrevocably waives treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years, provided the taxable year for which the return is filed and all subsequent taxable years are not closed by the period of limitations on assessments under section 6501.

(ii) *Tested foreign corporation that is not required to file a Federal income tax return.* For purposes of paragraph (b) of this section, a tested foreign corporation that is not required to file a Federal income tax return waives the benefit under a treaty that would otherwise prevent the imposition of the section 531 tax by a date no later than nine months following the close of the taxable year for which section 1298(b)(7) and paragraph (b)(1) of this section are applied by—

(A) Adopting a resolution or similar governance document that confirms that it has irrevocably waived any treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years, and maintaining a copy of the resolution (or other governance document) in its records; or

(B) In the case of a tested foreign corporation described in section 1297(e)(3), including in its public filings a statement that it irrevocably waives treaty protection against the imposition of the section 531 tax, effective for all prior, current, and future taxable years.

(e) *Interaction of section 1298(b)(7) and section 1298(a)(2).* Section 1298(b)(7) does not apply to determine whether a tested foreign corporation is a PFIC for purposes of section 1298(a)(2) and § 1.1291–1(b)(8)(ii).

(f) *Anti-abuse rules*—(1) *Classification as PFIC excluding qualified stock.* Paragraph (b) of this section does not apply when—

(i) 75 percent or more of the gross income of the tested foreign corporation for the taxable year (taking into account § 1.1297–2 and excluding any amount included in gross income with respect to qualified stock) is passive income (as defined in § 1.1297–1(c)(1)); or

(ii) The average percentage of assets held by the tested foreign corporation (taking into account § 1.1297–2 and excluding qualified stock) that are passive assets (as defined in § 1.1297–1(f)) is at least 50 percent.

(2) *Avoidance principal purpose.* Paragraph (b) of this section does not apply when a principal purpose for the tested foreign corporation's formation or acquisition of the stock of the 25-percent-owned domestic corporation that holds the qualified stock is to avoid classification of the tested foreign corporation as a PFIC. A principal purpose to avoid classification of the tested foreign corporation as a PFIC is deemed to exist when the 25-percent-owned domestic corporation is not engaged in an active trade or business in the United States. The existence of an active trade or business is determined under § 1.367(a)–2(d)(2) and (3), except that officers and employees of the 25-percent-owned domestic corporation do not include the officers and employees of related entities as provided in § 1.367(a)–2(d)(3). However, activities performed by the officers and staff of employees of a look-through subsidiary of the 25-percent-owned domestic corporation or a partnership that would be taken into account by the corporation pursuant to § 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.

(g) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after the date of publication of the Treasury decision adopting these rules as final regulations in the **Federal Register**.

Kirsten Wielobob,

Deputy Commissioner for Services and Enforcement.

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