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Global Tax Perspectives

Don't Let the PFIC Be the Enemy of the Good: Thoughts on the Final PFIC Regulations

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This past December—more than three decades after announcing its intention in Notice 88-22[1] to issue regulations addressing many of the core aspects of the passive foreign investment company ("PFIC") rules, Treasury released final regulations under Code Secs. 1291, 1297, and 1298 (the "Final Regulations").[2] Very generally, the Final Regulations address the determination of whether a foreign corporation constitutes a PFIC and the application and scope of certain rules that determine whether a U.S. person that indirectly holds stock in a PFIC is treated as a shareholder of a PFIC.[3] The Final Regulations represent the most significant regulatory guidance to date for determining whether a foreign corporation is a PFIC.

In this column, we do not address the Final Regulations in their entirety. Instead, we focus on three provisions in the Final Regulations that will impact PFIC determinations for a broad swath of foreign corporations: (1) the application of the "top-down" approach to indirect ownership attribution under Code Sec. 1298(a), (2) the extension of the "look-through" rule to partnership interests for purposes of Code Sec. 1297(a), and (3) the expansion of certain requirements to use value or adjusted basis for purposes of Code Sec. 1297(a)(2) in tiered ownership structures. Each of these provisions contains important nuances of which we believe corporations, shareholders, and their advisors should be aware.

The Final Regulations generally apply to tax years of U.S. persons that own shares in foreign corporations beginning on or after January 14, 2021 (*i.e.*, January 1, 2022 for a calendar-year U.S. taxpayer).[4] However, a U.S. person may generally choose to apply the Final Regulations to any open tax year, provided the U.S. person applies the regulations consistently to each tax year that follows.[5] The deferred effective date of the Final Regulations provides a welcome opportunity for both shareholders and corporations to analyze how the regulations might apply to current, future, and prior tax years and to choose to early adopt the regulations or take measures to manage their impact before the regulations' prospective effective date based on that analysis.

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Background: The PFIC Regime

In the 1980s, Congress was concerned that certain taxpayers were first deferring, and then reducing, their U.S. federal income tax liability by investing in offshore mutual funds that were not subject to U.S. tax, and then selling their mutual fund shares and converting what would have been ordinary income into capital gains that were eligible for preferential tax rates.[6] Although Congress had previously targeted the use of a wider class of foreign corporations to achieve similar benefits through the subpart F regime in 1962, that regime was more limited in scope, as it only applied to controlled foreign corporations ("CFCs").[7] A foreign corporation only can constitute a CFC if one or more U.S. persons own at least 10% of the vote or—beginning in 2018—value of the corporation (each a "United States shareholder"), and, in the aggregate, more than 50% of the corporation's total vote or value is owned by one or more United States shareholders.[8] In addition, only a United States shareholder can have subpart F inclusions. Because of the requisite ownership thresholds to trigger CFC status and subpart F inclusions, U.S. persons could invest in widely held mutual funds without running afoul of the subpart F regime. To address this perceived abuse, Congress enacted the PFIC regime (Code Secs. 1291 through 1298) as part of the Tax Reform Act of 1986.[9] As with the subpart F regime, the objective of the PFIC regime was to level the playing field between making onshore investments and offshore investments by eliminating both the deferral and preferential tax rate benefits of investing in offshore funds.[10]

To capture the structures that Congress believed facilitated the benefits that the PFIC regime sought to eliminate, Congress defined any foreign corporation (hereinafter referred to as the "tested foreign corporation") as a PFIC if it met one of the following tests for its taxable year: (1) at least 75% of its gross income is passive (the "Income Test"); or (2) at least 50% of its gross assets, on average, produce passive income or are held with a view to producing passive income (the "Asset Test", and, together with the Income Test, the "PFIC Tests").[11] Generally, under the Final Regulations, taxpayers apply the Asset Test by computing the ratio of: (1) the average of the amount of passive assets of the tested foreign corporation as of the last day (the "measuring date") of each quarter (the "measuring period") of the tested foreign corporation's U.S. taxable year; to (2) the average of the amount of gross assets of the tested foreign corporation as of the last day of each quarter of the tested foreign corporation's U.S. taxable year.[12]

In this context, the term "passive income" generally means any income of a kind that would be foreign personal holding company income ("FPHCI") as defined in Code Sec. 954(c).[13] The Final Regulations clarify that certain exceptions to FPHCI in Code Sec. 954(c) also apply for purposes of determining passive income.[14] PFIC-specific exceptions for certain income and activities that might otherwise fall within the scope of passive income/activities, as defined in the FPHCI rules, also may apply.[15] These exceptions are outside the scope of this column.

Selected Provisions in the Final Regulations

Take It from the Top: Clarity on the Application of the PFIC Indirect Ownership Rules

A U.S. person can be subject to the PFIC regime by owning PFIC stock directly or indirectly.[16] Code Sec. 1298 and the regulations under Code Sec. 1291 (the "PFIC Indirect Ownership Rules") treat a U.S. person as actually owning PFIC stock it holds indirectly, through one or more non-U.S. persons. Simply put, a U.S. person that indirectly owns stock in a PFIC may end up with a current U.S. federal income tax inclusion, notwithstanding the fact that the U.S. person may have little or no control over, or derive actual economic benefits from, the PFIC. Given this undesirable result, it is critical for both companies that seek to incentivize shareholder investment and U.S. persons that wish to manage the current U.S. federal income tax consequences of their portfolio to understand how the PFIC Indirect Ownership Rules apply in the context of tiered ownership structures.

Under the PFIC Indirect Ownership Rules, a person that directly or indirectly owns at least 50% of the value of the stock of a non-PFIC corporation is generally treated as owning a proportionate amount of the stock the corporation directly or indirectly owns.[17] In contrast, a person that directly or indirectly owns any PFIC stock is treated as owning a proportionate amount of the stock the PFIC directly or indirectly owns.[18] In practice, for widely held foreign corporations with U.S. shareholders, the question of whether any subsidiary of the group is a PFIC is typically moot if the parent is not a PFIC. If, as is typical, no U.S. person owns a majority interest in the parent, then the PFIC Indirect Ownership Rules will not attribute to any of the U.S. shareholders the parent's direct or indirect ownership of any PFIC subsidiaries.

The PFIC Indirect Ownership Rules apply an aggregate approach to stock that passthrough entities hold: the rules treat partners or beneficiaries as owning proportionately stock that a partnership, estate, or trust, as the case may be, directly or indirectly owns.[19] A U.S. person that holds a small partnership interest in a partnership that indirectly owns several PFICs is thus worse off than a U.S. person that owns a small minority interest in a corporation with the same portfolio because the U.S. partner may end up with a PFIC inclusion.

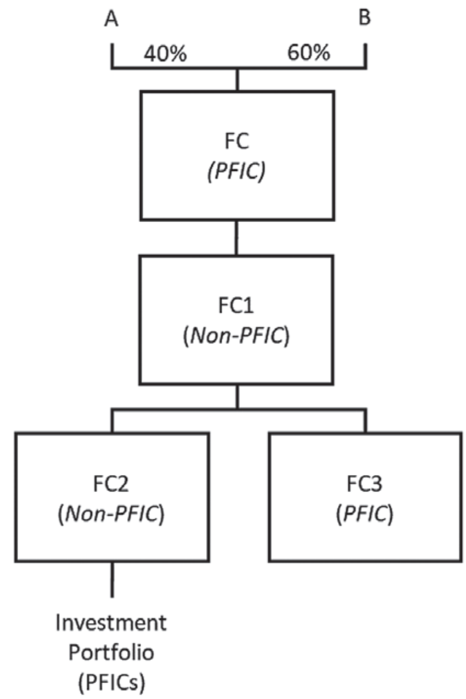
The PFIC Indirect Ownership Rules treat stock that they deem a person to own as actually owned for purposes of the PFIC Indirect Ownership Rules.[20] That, of course, can mean that a U.S. person that does not actually own any PFIC stock can end up with a robust portfolio of deemed PFIC stock. Historically, it was unclear whether the successive application of the PFIC Indirect Ownership Rules in a tiered structure proceeded on a "top-down" basis (*i.e.*, beginning with the U.S. person's direct ownership in a corporation or partnership and attributing ownership in lower-tier corporations to that U.S. person on the basis of that ownership interest), or a "bottom-up" basis (*i.e.*, beginning with the lowest-tier corporation or partnership in the chain and attributing ownership in corporations up the chain).[21] The different approaches could produce significantly different results, depending on the structure. The Final Regulations resolve the uncertainty and apply a top-down approach for all ownership structures.[22]

Examples 1 and 2 demonstrate how the top-down approach applies in the context of two common tiered ownership structures and compare the results of that approach with those of the bottom-up approach.

Example 1.

In Example 1, A, a U.S. person, owns 40% of FC, a PFIC. B, a non-U.S. person, owns the remaining 60% of FC. FC wholly owns FC1, a non-PFIC foreign corporation, which in turn wholly owns FC2, another non-PFIC foreign corporation, and FC3, a PFIC. FC2 holds an investment portfolio comprising minority interests in other PFICs (*see* Figure 1).

FIGURE 1.



Under the top-down approach that the Final Regulations adopt, the determination of whether A's interest in FC, a PFIC, results in the U.S. person being treated as a shareholder of FC3, a PFIC, and the minority interests in various PFICs that FC2, which is not a PFIC, holds, begins with A's direct ownership of FC. Because FC is a PFIC, A is treated as owning 40% of FC1, notwithstanding the fact that A does not own at least 50% of FC's stock. Because A's deemed ownership of FC1, a non-PFIC, is less than 50%, attribution ceases and A is not treated as owning FC3 or the investment portfolio of PFICs that FC2 holds.

By contrast, a "bottom-up" approach would have attributed all lower-tier PFICs to A. Under a bottom-up approach, attribution would begin with FC1's ownership of FC2. Because FC1 owns 100% of FC2, a non-PFIC, FC1 would be treated as owning 100% of the PFIC portfolio investments that FC2 holds. Because FC owns 100% of FC1, FC is treated as owning FC1's proportionate interest in FC3, a PFIC, and the PFIC portfolio investments that FC1 indirectly owns through FC2. Because FC is a PFIC, A is treated as owning 40% of FC3 (a PFIC) and 40% of the PFIC portfolio investments.

Example 2.

Example 2 differs from Example 1 only in that FC is FP, a partnership, instead of a PFIC (*see* Figure 2).

Once again, the Final Regulations require the analysis to start with A's interest in FP, as a result of which A is treated as owning 40% of FC1, a non-PFIC. From that point, the analysis replicates that of Example 1, with the result that A is not treated as owning

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FIGURE 2.

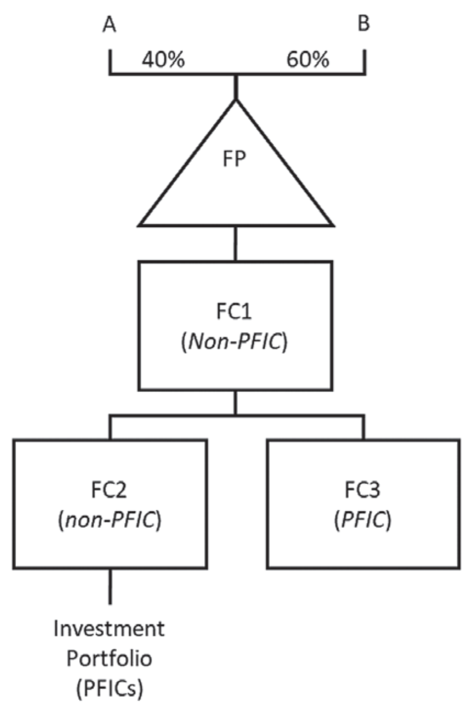
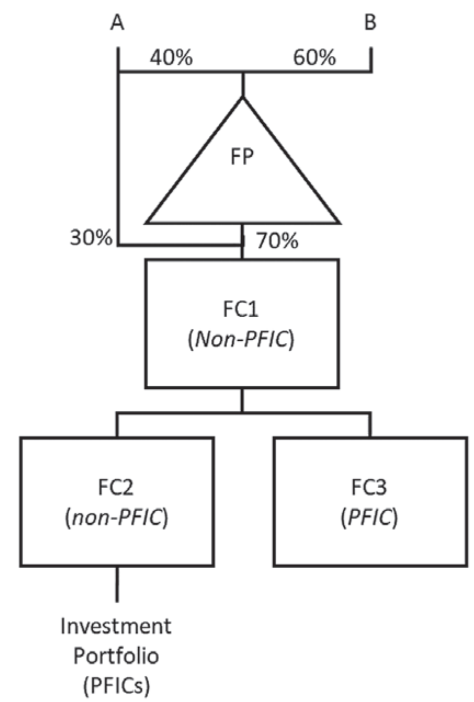


FIGURE 3.



any PFIC stock. As with Example 1, a bottom-up approach would have attributed all lower-tier PFICs to A.[23]

The adoption of a top-down approach in the Final Regulations not only brings welcome clarity to the application of the PFIC Indirect Ownership Rules, but, as demonstrated in the prior examples, will *generally* result in U.S. persons being treated as owning fewer lower-tier PFICs than under a bottom-up approach. Apart from the obvious potential shareholder savings of tax that comes from owning fewer PFICs, the relatively limited reach of the attribution rules under the top-down approach should make the PFIC regime more administrable. For example, U.S. persons owning stock of a foreign corporation through multiple tiers of foreign entities (such as investment fund structures) have long faced challenges in obtaining the necessary information to determine if the lower-tier entity is in fact a PFIC, computing their tax liability under the PFIC regime, and complying with the necessary reporting requirements. Under the top-down approach, these challenges should at least be limited to the minority PFIC and not its other investments held through a non-PFIC foreign corporation. Likewise, foreign parent corporations that are PFICs must provide certain information to their U.S. shareholders, if they wish to enable their U.S. shareholders to make QEF elections with respect to their stock.[24] To the extent the foreign parent corporation has lower-tier subsidiaries that are PFICs, or other minority interests in PFICs, similar administrative burdens arise. Under the top-down approach, if the lower-tier PFIC subsidiaries sit below a non-PFIC subsidiary, the foreign parent's administrative burden should be less because minority U.S. shareholders of the parent should not be required to make QEF elections with respect to the lower-tier subsidiaries.[25]

Nevertheless, the top-down approach is not always taxpayer favorable, as demonstrated in Example 3 below.

Example 3.

Example 3 differs from Example 2 only in that A also owns 30% of FC1 directly (*see* Figure 3).

Under the Final Regulations, A is treated as owning 58% of FC1: 30% directly, and 28% (40% × 70%) through FP. Because A's ownership of FC1 (a non-PFIC) is at least 50%, A is treated as owning its proportionate interest (*i.e.*, 58%) of FC3 (a PFIC) and 58% of FC2 (a non-PFIC). A's 58% ownership of FC2 causes A to be treated as owning 58% of the PFIC portfolio investments.

Under a pure bottom-up approach, FC1 is treated as owning the PFIC portfolio investments FC2 owns

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(in addition to the FC3 stock it directly owns). FP, in turn, is treated as owning 70% of the PFIC stock FC1 holds (*i.e.*, the PFIC portfolio investments and FC3 stock). The PFIC stock FP owns is then attributed (according to A's 40% interest in FP) to A. Thus, A is treated as owning 28% (40% of 70%) of the FC3 stock and 28% (40% of 70%) of the PFIC portfolio investments. A's 30% direct ownership of FC1 stock does not cause further attribution of PFIC stock to A, because FC1 is not a PFIC.

Arguably, the top-down approach yields a better approximation of A's direct and indirect economic interest in PFIC stock, which Treasury acknowledges as one of the reasons for choosing this approach over the bottom-up approach.[26]

We generally expect the top-down approach to make it more likely that a U.S. person will be treated as owning at least 50% of the value of the stock of a non-PFIC corporation (triggering further lower-tier attribution), because it aggregates all stock that person owns, or is treated as owning, directly before applying the 50% ownership threshold to the stock to determine if further lower-tier attribution occurs. Nevertheless, except when the U.S. person owns stock directly and through a pass through, that distinction is generally irrelevant. Particularly in the context of widely held foreign corporations, the administrative convenience that the top-down approach creates seems to outweigh the risks that Example 3 illustrates.

Look-Through Parity Between Corporations and Partnerships, and Then Some: The Partnership Look-Through Rule

For purposes of applying the PFIC Tests, a tested foreign corporation that directly or indirectly owns at least 25% (by value) of the stock of another corporation (a "look-through subsidiary") is treated as if it held its proportionate share of the assets of the look-through subsidiary and received directly its proportionate share of the income of the look-through subsidiary (the "Subsidiary Look-Through Rule").[27] Dividends a tested foreign corporation receives from a look-through subsidiary and the tested foreign corporation's stock of a look-through subsidiary are generally eliminated to avoid double counting income and assets in the PFIC Tests.[28]

Congress intended the Subsidiary Look-Through Rule to be a taxpayer-favorable provision that prevents a tested foreign corporation from constituting a PFIC simply because it conducts an active business through a subsidiary rather than directly.[29] Of course, as is the case with many of the mechanical rules governing the PFIC Tests, the Subsidiary Look-Through Rule can decrease *or* increase the likelihood that a tested foreign corporation is a PFIC, depending on the facts. For example, a look-through subsidiary that holds significant passive assets and is highly leveraged, or earns significant passive income that is reinvested rather than distributed, could lead to a tested foreign corporation having a higher passive asset and income percentage than if the subsidiary were a non-look-through subsidiary.[30]

By its terms, the Subsidiary Look-Through Rule only applies to corporate subsidiaries of a tested foreign corporation. Prior to the Final Regulations, there was no guidance in the PFIC regime on how to treat partnership interests. Taxpayers and practitioners were left to reason by analogy based on guidance in the subpart F context. Specifically, the regulations under Code Sec. 954(c) generally treat a CFC partner's distributive share of partnership income as FPHCI to the extent it would be treated as FPHCI if the CFC partner had earned the income directly, taking into account only the activities of the partnership.[31] This rule applies regardless of the size of the CFC's ownership interest in the partnership. Gain on the sale of a less-than-25% partnership interest is FPHCI. Gain on the sale of a 25%-or-greater partnership interest is characterized as if the CFC sold its proportionate share of the partnership's assets.[32]

The Final Regulations follow the spirit, but not the letter, of the subpart F rules, in the treatment of partnerships. In this regard, the Final Regulations bring *near* parity to the treatment of corporate subsidiaries and partnership investments by incorporating a look-through rule for partnerships (the "Partnership Look-Through Rule").

If the Partnership Look-Through Rule applies to a tested foreign corporation's direct or indirect interest in a partnership (a "look-through partnership"), as a general rule, the tested foreign corporation is treated as if it held directly its proportionate share of the partnership's gross assets, and received directly its proportionate share of any item of gross income or loss of the partnership.[33] Generally, the Partnership Look-Through Rule determines the character of the tested foreign corporation's proportionate share of the assets and income (or loss) of a look-through partnership as passive or non-passive at the level of the look-through partnership.[34]

If the Partnership Look-Through Rule does not apply to a partnership interest, the tested foreign corporation's distributive share of the partnership's income is generally treated as *per se* passive for the Income Test and the

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partnership interest is likewise generally treated as *per se* passive for the Asset Test.[35] This result is consistent with the treatment of corporate stock that a tested foreign corporation holds, when the Subsidiary Look-Through Rule does not apply.

Because of the disparate treatment of look-through partnerships vs non-look-through partnerships, the status of a partnership as a look-through partnership can have a determinative effect on a tested foreign corporation's PFIC status, as is the case with the status of a corporate subsidiary (*i.e.*, look-through vs non-look-through).

Qualifying as a Look-Through Partnership

The Final Regulations treat a partnership as a look-through partnership if the partnership would be a look-through subsidiary if it were a corporation—*i.e.*, generally, if the tested foreign corporation directly or indirectly owns at least 25% (by value) of the partnership (a "25% Partnership").[36] If the partnership is not a 25% Partnership, it may still qualify as a look-through partnership if the tested foreign corporation satisfies a separate test (the "Active Partner Test").[37] Generally, a tested foreign corporation can satisfy the Active Partner Test if the tested foreign corporation would not be a PFIC if it were to apply both the Income Test and the Asset Test, without regard to *any* interest in a non-25% Partnership the tested foreign corporation owns.[38]

The preamble to the Final Regulations states that satisfying the Active Partner Test as a precondition to treating a non-25% Partnership interest as a look-through partnership "can only prevent a partnership interest from tainting an otherwise non-PFIC corporation, rather than be used affirmatively."[39] For example, the preamble acknowledges that a small active business that the tested foreign corporation conducts would allow a non-25% Partnership to be a look-through partnership under the Active Partner Test if the tested foreign corporation has little-to-no other passive assets or income.[40] Thus, the Active Partner Test effectively functions as a relief provision that extends an aggregate approach to a non-25% Partnership interest to prevent the partnership interest—as a *per se* passive asset without look-through—to cause an otherwise non-PFIC to be a PFIC.

The Final Regulations require the tested foreign corporation to apply the Active Partner Test at each measurement date, for each measurement period (*i.e.*, generally each quarter-end).[41] However, because the Active Partner Test requires ascertaining whether the tested foreign corporation would be a PFIC if all non-25% Partnership interests are excluded, it appears the Active Partner Test is essentially an annual determination like the PFIC Tests themselves.[42] Accordingly, the Active Partner Test takes into account all activities, assets, and income of a tested foreign corporation for its tax year (excluding non-25% Partnership interests) that otherwise would be included in the PFIC Tests.

The Final Regulations provide an election to not apply the Partnership Look-Through Rule to a non-25% Partnership interest.[43] The election is made "for any taxable year," and thus appears to be an annual election. There is no guidance in the Final Regulations on who makes the election (*i.e.*, is it the U.S. person determining PFIC status with respect to the tested foreign corporation, or the tested foreign corporation itself?).[44] Treasury provided the election out of look-through treatment as an acknowledgment that information constraints may make it difficult for minority partners to apply the Partnership Look-Through Rule.[45] Taxpayers and their advisors will need to analyze carefully whether or not circumstances justify making the election, a topic that is outside the scope of the present column.

Active Partner Test in Action

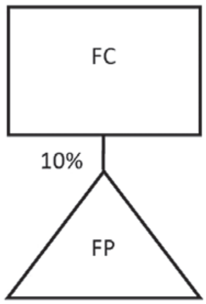
Example 4.

Example 4 illustrates the Active Partner Test in a simple fact pattern. FC, the tested foreign corporation, owns a 10% partnership interest in partnership PRS. PRS has non-passive assets of $400 as of each quarter-end during the year, and receives $100 cash in exchange for services, which constitutes non-passive income, during each quarter. PRS has no liabilities or expenses. Apart from its interest in PRS, FC holds $2 of non-passive assets as of each quarter-end during the year and derives $1 of non-passive income for the year. FC is a calendar-year taxpayer (*see* Figure 4).

PRS is a non-25% Partnership with respect to FC. For the Look-Through Partnership Rule to apply to FC's interest in PRS, FC must satisfy the Active Partner Test. Excluding FC's interest in PRS, it would not be a PFIC, as 100% of its gross assets and 100% of its gross income is non-passive. Thus, PRS is a look-through partnership and FC takes into account its proportionate share of the income and assets of PRS for purposes of its PFIC Tests.

Applying the PFIC Tests, as of 3/31, FC has $52 of gross assets ($2 of directly held assets and its 10% share of PRS's $500 of gross assets, or $50). FC's gross assets for the remaining quarters are $62, $72,

FIGURE 4.



FC	3/31	6/30	9/30	12/31	
Non-passive assets	$2	$2	$2	$2	
Non-passive income for the year					$1
PRS	3/31	6/30	9/30	12/31	
Non-passive assets	$400	$400	$400	$400	
Passive assets	$100	$200	$300	$400	
Total assets	$500	$600	$700	$800	
Non-passive income for the year					$400

and $82, respectively (representing $2 of directly held assets each quarter and FC's 10% share of PRS's $600, $700, and $800, respectively, in gross assets at each quarter-end). FC's passive assets as of 3/31 are its 10% share of PRS's $100 of cash, or $10. FC's passive assets for the remaining quarters are $20, $30, and $40, respectively. FC's average gross assets and average passive assets are thus $67 (($52 + $62 + $72 + $82)/4) and $25 (($10 + $20 + $30 + $40)/4), respectively. FC's average percentage of passive assets is 37.3%. FC's total gross income is $41 ($1 of gross income received directly and FC's 10% share of PRS's $400 of total income), 100% of which is non-passive. FC is not a PFIC.

Example 4, simple as it is, demonstrates the basic intent of the Active Partner Test, as described in the preamble, in that it prevents PFIC status when a tested foreign corporation would become a PFIC solely due to holding an interest in a partnership that is not a look-through partnership. Absent PRS being treated as a look-through partnership, FC's distributive share of PRS's income and, critically, the PRS interest FC holds would be treated as passive and cause FC to be a PFIC.[46]

Excluding a Non-25% Partnership Interest in the Active Partner Test: Does It Mean What You Think It Means?

By its terms, the Active Partner Test requires a tested foreign corporation to prove it would not be a PFIC if its *interest* in a non-25% Partnership is excluded from the PFIC Tests. Excluding the partnership interest does not erase all traces of the tested foreign corporation's status as a partner with respect to a non-25% Partnership interest. In particular, a distribution from a non-25% Partnership to the tested foreign corporation should not be treated as gross income to the tested foreign corporation, but the assets that the tested foreign corporation receives in the distribution (*e.g.*, cash) will presumably still be reflected in the hypothetical Asset Test as applied under the Active Partner Test. Consequently, the timing and extent of distributions from a non-25% Partnership and what the tested foreign corporation does with the distributions can become a determinative factor in the Active Partner Test.

Example 5.

Example 5 differs from Example 4 only in that, on the last day of the year, PRS distributes all $400 of cash it received in exchange for services during the year to its partners (*see* Figure 5).

As a result of the distribution, FC now has $40 ($400 × 10%) of cash on December 31st, which is a measuring date for its Asset Test. Revisiting the Active Partner Test, the $40 of cash is not eliminated from the hypothetical Asset Test applied to FC, because the Active Partner Test only mandates that FC's interest in PRS is excluded. Consequently, FC has average gross assets of $12 (($2 + $2 + $2 + $42)/4) and average passive assets of $10 ($0 + $0 + $0 + 40)/4), or a passive percentage of 83.33%. FC would thus be a PFIC if its interest in PRS is excluded. Accordingly,

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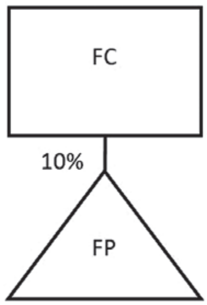
FIGURE 5.



FC	3/31	6/30	9/30	12/31	
Non-passive assets	$2	$2	$2	$2	
Passive assets	-	-	-	$40	
Total assets	$2	$2	$2	$42	
Non-passive income for the year					$1
PRS	3/31	6/30	9/30	12/31	
Non-passive assets	$400	$400	$400	$400	
Passive assets	$100	$200	$300	-	
Total assets	$500	$600	$700	$400	
Non-passive income for the year					$400

PRS is not a look-through partnership and, as a result, FC is a PFIC.

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The result under Example 5 appears consistent with the intention that Treasury expressed in the preamble as to when look-through treatment should apply to a non-25% Partnership interest. Because FC has a large amount of cash (thanks to the distribution from PRS) relative to its active assets, it is not the partnership interest itself that taints FC.[47] Thus, the outcome in the example appears consistent with the statement in the preamble that the Partnership Look-Through Rule should apply to a non-25% Partnership interest only to "prevent a *partnership interest* from tainting an otherwise non-PFIC corporation" (emphasis added).[48]

A Mixed Bag: Expanded Requirements to Use Adjusted Basis vs. Value for the Asset Test

Code Sec. 1297(e) requires a publicly traded tested foreign corporation to perform the Asset Test using the value of its assets.[49] A non-publicly traded tested foreign corporation that is a CFC performs the Asset Test using the adjusted basis of its assets.[50] A non-publicly traded, non-CFC tested foreign corporation uses asset value for the Asset Test, unless an election is made to use adjusted basis.[51]

Measuring assets according to their value is generally the only way that a tested foreign corporation can accurately represent assets with no adjusted basis, such as internally created intangibles, in the Asset Test.[52] To the extent the underlying income, or intended use, associated with the intangibles is non-passive, causing the intangibles to be treated as non-passive, the use of value for the Asset Test typically makes it less likely that a tested foreign corporation is a PFIC (at least as a result of the Asset Test).[53] Using value can therefore be critical to innovative start-up companies that are cash-rich, due to funding that they may have received to conduct extensive R&D, but are otherwise asset-poor, with the exception of self-created intangibles, as it allows fundamentally active enterprises to avoid permanent PFIC taint. At the same time, as the current economic climate indicates, measuring assets according to their value may also introduce undesirable volatility in the Asset Test computation to the extent of market volatility underlying asset values.

CFCs as a Result of Downward Attribution

As many taxpayers are aware, the repeal of Code Sec. 958(b)(4) in 2017 caused many foreign corporations to become CFCs due to the so-called downward attribution rules of Code Sec. 318(a)(3).[54] Absent an exception, the assets of these newly minted CFCs would be required under Code Sec. 1297(e) to be measured by their adjusted basis (instead of value) for purposes of the Asset Test. The Final Regulations prevent this result by modifying the definition of a CFC solely for purposes of the Code Sec. 1297(e) measurement rules, such that a foreign corporation that is a CFC solely due to downward attribution is not required to use adjusted basis for purposes of the Asset Test.[55] As we discuss later, the result is not as favorable for foreign corporations that are CFCs other than by reason of the repeal of Code Sec. 958(b)(4).

Tiered Ownership Structures

The Final Regulations provide an expanded framework to determine how the Code Sec. 1297(e) Asset Test measurement requirements are applied in tiered ownership structures (the "Asset Measurement Framework"). The proposed regulations that Treasury released in July 2019 did not foreshadow the Asset Measurement Framework.[56] Thus, Treasury first unveiled the Asset Management Framework in the Final Regulations. While described in the preamble as a clarification, the Asset Measurement Framework has significant implications for tiered structures containing a mix of CFCs/non-CFCs and publicly traded/non-publicly traded entities.[57]

Applying the Asset Test to a Tested Foreign Corporation with Look-Through Subsidiaries

Generally, the Asset Measurement Framework begins by looking to the entity type of the tested foreign corporation. When applying the Asset Test to a tested foreign corporation with one or more look-through subsidiaries, generally the requisite measurement method, which is based on the entity type of the tested foreign corporation, applies to the assets of any look-through subsidiary that the tested foreign corporation takes into account under the Subsidiary Look-Through Rule.[58] This approach is consistent with the statutory language of the Subsidiary Look-Through Rule, which treats a tested foreign corporation as if it "held its proportionate share of the assets of [a look-through subsidiary]."[59]

Accordingly, the general rule of the Asset Measurement Framework follows what appears to be a plain reading of Code Sec. 1297(e). The assets of a publicly traded tested foreign corporation (including assets of a non-CFC look-through subsidiary of the tested foreign corporation) are measured according to their value.[60] Likewise, the assets of a non-publicly traded-CFC tested foreign corporation (including the assets of a non-publicly traded-CFC look-through subsidiary of the tested foreign corporation) are measured according to their adjusted basis.[61] Assets of a non-publicly traded, non-CFC (including assets of a non-publicly traded non-CFC look-through subsidiary of the tested foreign corporation) are generally measured according to value, unless an election is made to use adjusted basis.[62]

However, if a publicly traded tested foreign corporation has a non-publicly traded-CFC look-through subsidiary (other than by virtue of the repeal of Code Sec. 958(b)(4)), the Asset Measurement Framework requires the assets of the look-through subsidiary to be measured using adjusted basis. Similarly, if a non-publicly traded CFC has a publicly traded-CFC look-through subsidiary, the Asset Measurement Framework requires the assets of the look-through subsidiary to be measured using value. In this way, the Asset Management Framework departs from the measurement basis that the entity type of the tested foreign corporation otherwise requires and instead requires a measurement basis that is consistent with the lower-tier subsidiary's entity type (the "Lower-Tier Consistency Rule").[63] This feature of the Asset Management Framework is surprising, as nothing in Code Sec. 1297(e) foreshadows this discontinuity, and can create some unexpected outcomes.

Example 6.

In Example 6, U.S. person A owns 60% of FC, a publicly traded foreign corporation that is also a CFC. U.S. person B owns 1% of FC. FC wholly owns DC1, a domestic corporation, and FS1, a foreign corporation that is also a CFC (as a result of A's 60% indirect ownership) (*see* Figure 6).

DC1 holds $5 of cash and internally created intangibles (all non-passive) with a value of $25 and basis of zero. FS1 holds $20 of cash and internally created intangibles (all non-passive) with a value of $100 and basis of zero. FC's only assets are its stock investment in DC1 and FS1.[64]

FC is a tested foreign corporation with respect to B.[65] The Subsidiary Look-Through Rule applies for purposes of FC's PFIC Tests, and FC is treated as if it directly held the assets of FS1 and DC1. Because FC is publicly traded, the Asset Measurement Framework requires its assets (including those of look-through subsidiaries) to be measured on the basis of value, unless the Lower-Tier Consistency Rule applies.[66] Because FS1 is a CFC not solely due to downward attribution, FS1's assets must be measured using their adjusted basis under the Lower-Tier Consistency Rule.[67] DC1's assets, as assets of a domestic-corporation look-through subsidiary, are measured according to value because FC is publicly traded. Consequently, FC's Asset Test consists of $50 of gross assets (DC1's assets with value of $30 and FS1's assets with adjusted

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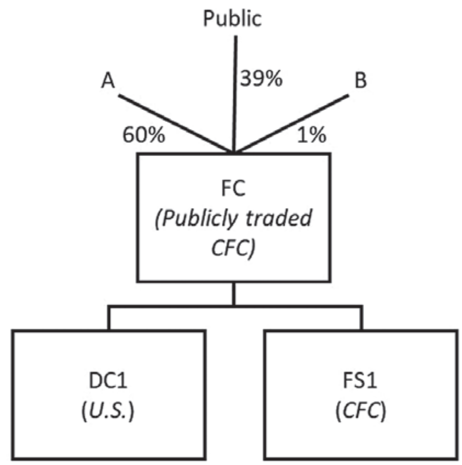
FIGURE 6.



DC1 assets	Value	Basis
Passive	$5	$5
Non-passive	$25	-

FS1 assets	Value	Basis
Passive	$20	$20
Non-passive	$100	-

basis of $20), $25 of which (*i.e.*, 50%) are passive. FC is a PFIC.

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The implications of the Lower-Tier Consistency Rule for structures with CFC look-through subsidiaries are significant. It is common for parent companies of a corporate group to serve as a mere holding company, with lower-tier subsidiaries conducting operating activities of the group. For this reason, intangible assets such as goodwill, know-how, contracts, or other IP may reside at a level below the level of the parent. As Example 6 demonstrates, under the Lower-Tier Consistency Rule, internally created intangibles that reside with a CFC that is a look-through subsidiary will generally not be represented in the Asset Test, potentially distorting this test and resulting in the parent being permanently labeled a PFIC. In the period before the Final Regulations enter into force, foreign parent companies and their advisors should therefore take a close look at how the Asset Test plays out under the Asset Measurement Framework and determine whether any remedial or other action is necessary.

Applying the Asset Test to a Tested Foreign Corporation That Is a Look-Through Subsidiary with Respect to Another Tested Foreign Corporation

To this point, we have considered only the application of the Asset Test to the ultimate foreign parent of a corporate group. However, in tiered ownership structures, the PFIC Indirect Ownership Rules often make the PFIC status of lower-tier foreign corporations relevant. The PFIC status of these corporations may be relevant because the ultimate parent is itself a PFIC, causing stock in the lower-tier foreign corporation to be attributed to U.S. persons owning stock in the parent PFIC (no matter how small their ownership interest).[68] Even if the ultimate parent is not a PFIC, U.S. persons may still be deemed to own stock in lower-tier foreign corporations to the extent they directly or indirectly own at least 50% of the value of the stock of the ultimate parent corporation.[69] Alternatively, the lower-tier foreign corporation may have direct or indirect U.S. owners through a different ownership chain than through the ultimate parent.

The Asset Measurement Framework contains additional consistency and coordination rules that apply to a tested foreign corporation that is also a look-through subsidiary with respect to another tested foreign corporation. To implement these rules, the regulations introduce the concept of a "parent foreign corporation" of a lower-tier subsidiary. The parent foreign corporation is defined as the foreign corporation that directly or indirectly owns all or a part of the lower-tier subsidiary.[70] Thus, a lower-tier subsidiary may have more than one parent foreign corporation.

For purposes of applying the Asset Test to a lower-tier subsidiary of a parent foreign corporation (as the tested foreign corporation), the starting point for determining the measurement basis for the lower-tier subsidiary's assets is the subsidiary's entity type: value must be used if it is publicly traded, and adjusted basis must be used if it is a non-publicly traded CFC.[71]

Returning to Example 6, because FC is a PFIC, FS1 is also a tested foreign corporation with respect to B.[72] Because FS1 is a CFC (and its CFC status is not solely due to downward attribution), FS1 applies the Asset Test using adjusted basis.[73] Accordingly, FS1's total gross assets are only its $20 of cash. FS1 is a PFIC.

If the lower-tier subsidiary of a parent foreign corporation is a foreign corporation that is a non-publicly traded, non-CFC, the measurement basis for the subsidiary's Asset Test (as the tested foreign corporation) must be consistent with the measurement basis of the parent foreign corporation (the "Upper-Tier Consistency Rule").[74] Under the Upper-Tier Consistency Rule, the subsidiary's assets must be measured by value if the parent foreign corporation is publicly traded, or is a non-publicly traded, non-CFC (absent an election to use adjusted basis), and adjusted basis if the parent foreign corporation is a non-publicly traded CFC.[75]

If there is more than one parent foreign corporation of the lower-tier subsidiary (as the tested foreign corporation), the Upper-Tier Consistency Rule applies separately to the assets of the lower-tier subsidiary with respect to each parent foreign corporation.[76] The preamble to and examples in the Final Regulations clarify that different U.S. persons that are deemed to own stock of a tested foreign corporation through different ownership chains will apply the Upper-Tier Consistency Rule separately, with respect to each person's chain of ownership.[77] As a consequence, two U.S. persons indirectly owning the stock of a tested foreign corporation through different ownership chains may be required to apply different asset measurement methods to determine the corporation's PFIC status.

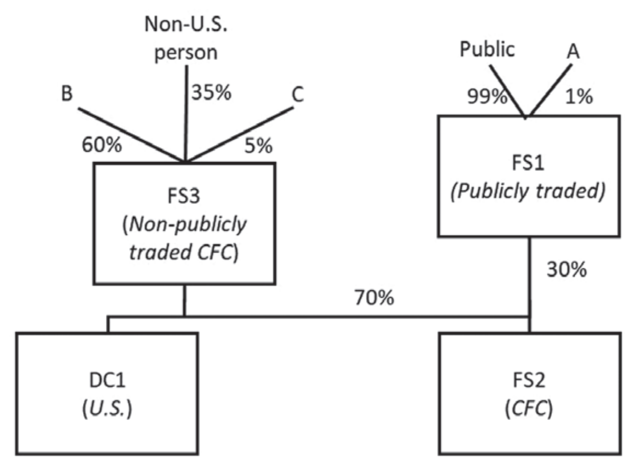
When a U.S. person applies the Asset Test to a lower-tier foreign corporation that is owned through a chain of multiple intermediate foreign corporations, the Upper-Tier Consistency Rule requires looking to any parent foreign corporation in the person's chain of ownership that is either publicly traded or a non-publicly traded CFC.[78]

Example 7 sheds light on the potential complexity that the Asset Measurement Framework may create in tiered ownership structures with multiple chains of ownership.

Example 7.

In Example 7, U.S. person A owns 1% of the stock of FS1, a widely held publicly traded corporation. FS1 owns 30% of the stock of FS2, a non-publicly traded foreign corporation. FS3, a non-publicly traded foreign corporation, owns the remaining 70% of FS2. U.S. person B owns 60% of the stock of FS3. U.S. person C owns 5% of the stock of FS3. FS3 owns 100% of the stock of DC1, a domestic corporation (*see* Figure 7).

FIGURE 7.



As an initial matter, both FS3 and FS2 are CFCs: FS3 is a CFC due to B's 60% direct ownership in FS3, and FS2 is a CFC solely due to downward attribution of 70% of the FS2 stock to DC1.

FS1 is a tested foreign corporation with respect to A. The Subsidiary Look-Through Rule applies for purposes of FS1's Asset Test with respect to FS1's 30% ownership of FS2. Because FS1 is a publicly traded corporation, it applies the Asset Test using value, except when the Asset Measurement Framework provides otherwise.[79] Because FS2 is not publicly traded, and is a CFC solely due to downward attribution, it is treated as a non-publicly traded, non-CFC foreign corporation for purposes of the Asset Measurement Framework. Because FS1 is publicly traded, FS1's 30% share of FS2's assets must be measured according to their value for purposes of FS1's Asset Test.[80]

If FS1 is a PFIC, FS2 is also a tested foreign corporation with respect to A.[81] Because FS2 is not publicly traded, and not treated as a CFC for purposes of the Asset Measurement Framework, it performs the Asset Test using value (assuming no election to use adjusted basis), except when the Asset Measurement

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Framework provides otherwise.[82] The Upper-Tier Consistency Rule requires FS2 to perform the Asset Test using the same method as the parent foreign corporation.[83] As it relates to A, FS1 is a parent foreign corporation. Because FS1 is publicly traded, FS2 must perform the Asset Test with respect to A using value.

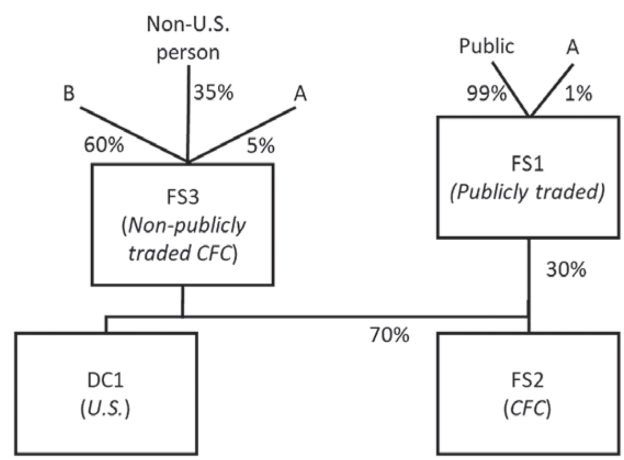
FS3 is a tested foreign corporation with respect to C.[84] The Subsidiary Look-Through Rule applies for purposes of FS3's Asset Test with respect to FS3's 70% ownership of FS2 and 100% ownership of DC1. Because FS3 is a CFC, it must perform the Asset Test using adjusted basis, except when the Asset Measurement Framework provides otherwise.[85] Because FS2 is not publicly traded, and not treated as a CFC for purposes of the Asset Measurement Framework, FS3 must perform the Asset Test with respect to its 70% share of FS2's assets using adjusted basis (*i.e.*, the method required for the parent foreign corporation—FS3).[86] Likewise, FS3 must perform its Asset Test with respect to its 100% share of DC1's assets using adjusted basis.[87]

If FS3 is a PFIC, FS2 is a tested foreign corporation with respect to C.[88] Because FS2 is not publicly traded, and not treated as a CFC for purposes of the Asset Measurement Framework, FS2 must perform the Asset Test on its assets using value unless the Asset Measurement Framework provides otherwise.[89] Because FS2 is also a lower-tier subsidiary of a parent foreign corporation with respect to C (*i.e.*, FS3), the Upper-Tier Consistency Rule applies. Because FS3 is a CFC, the Upper-Tier Consistency Rule requires FS2 to perform the Asset Test with respect to its assets using adjusted basis.[90]

As demonstrated in Example 7 with respect to FS2, the Upper-Tier Consistency Rule may require a person to perform the Asset Test on the assets of a lower-tier corporation using different methods, depending on the parent foreign corporation through which the U.S. person is treating the lower-tier corporation as a tested foreign corporation.[91] The preamble makes this point specifically.[92] Thus, two different U.S. persons (*e.g.*, A and C in Example 7) may arrive at different conclusions in the determination of whether a tested foreign corporation (*e.g.*, FS2) is a PFIC. What isn't entirely clear, however, is what happens when the same U.S. person is treated under the PFIC Indirect Ownership Rules as owning shares of a lower-tier tested foreign corporation through different parent foreign corporations.

We illustrate this fact pattern by modifying the facts of Example 7 as follows.

FIGURE 8.



Example 8. (*See* Figure 8)

As shown in the illustration above, we modify Example 7 by having A hold C's 5% interest in FS3 instead. If both FS1 and FS3 are PFICs, the PFIC Indirect Ownership Rules would attribute 3.8% of FS2 stock to A: 3.5% through A's indirect ownership of FS2 through FS3, and the remaining amount through A's indirect ownership of FS2 through FS1.[93] FS2 would be a tested foreign corporation with respect to A, but through two parent foreign corporations: FS1 and FS3. As described previously, the Upper-Tier Consistency Rule requires FS2's Asset Test to use asset value with respect to A's interest through FS1, and adjusted basis with respect to A's interest through FS3. It is entirely possible that FS2 would be a PFIC when using adjusted basis for the Asset Test and a non-PFIC when using asset value. As a result, A would ostensibly be treated as owning PFIC stock with respect to only the FS2 shares indirectly held through FS3.[94]

Notwithstanding the significant complexity the Asset Measurement Framework may entail, Treasury did not clarify the rationale for the Lower-Tier Consistency Rule and the Upper-Tier Consistency Rule or why they were chosen over alternative approaches. Overall, the Asset Measurement Framework appears to impose consistency on the way in which assets of a foreign corporation are measured when the foreign corporation can be both a look-through subsidiary of an upper-tier foreign corporation and a tested foreign corporation with respect to the same U.S. person. Specifically, the status of a lower-tier foreign corporation as either publicly traded or as a non-publicly traded CFC will dictate the measurement basis of its assets when determining both the PFIC status of the lower-tier foreign corporation and—thanks to the Lower-Tier Consistency Rule—the PFIC status of an upper-tier foreign corporation. When a lower-tier foreign corporation is not publicly traded and is not a CFC, the status of an upper-tier foreign corporation as either publicly traded or as a non-publicly traded CFC will dictate the measurement basis of its assets when determining both the PFIC status of the upper tier foreign corporation and—thanks to the Upper-Tier Consistency Rule—the PFIC status of the lower-tier foreign corporation.

As the prior examples show, the cost of this apparent consistency is that other inconsistencies necessarily arise: different U.S. persons may be compelled to arrive at different conclusions as to a corporation's PFIC status, and an upper-tier tested foreign corporation may measure its assets according to more than one method when it has look-through subsidiaries. It is unclear whether these results are what Congress intended in Code Sec. 1297(e).

The implications of the Asset Measurement Framework are particularly relevant not only for U.S. shareholders of foreign corporations but also for foreign corporations themselves. As a practical matter, foreign corporations frequently undertake some degree of due diligence to ascertain their PFIC status in order to provide the appropriate required disclosures to investors, or to provide PFIC annual information statements to U.S. persons wishing to make QEF elections. The degree to which the Asset Measurement Framework now makes PFIC status determination more dependent on the way in which U.S. persons indirectly own stock will likely make these analyses and disclosure considerations much more complex going forward.

Conclusion

As a whole, the Final Regulations bring welcome clarity to the PFIC regime in general and the application of the PFIC Tests in particular. Many aspects of the regulations, such as the codification of the top-down approach to attributing ownership and the creation of the Partnership Look-Through Rule, are generally helpful and reflect both sound policy rationales and a desire to reduce the administrative burdens associated with the PFIC regime. At the same time, the complexity of the Asset Measurement Framework is likely to present significant challenges for U.S. investors and the foreign corporations that seek to apply this aspect of the regulations, particularly when the U.S. tax departments of these corporations are often small or nonexistent. Tax practitioners working with foreign parented groups should therefore be proactive in raising the Final Regulations with their clients and offering PFIC "check-ups" during the period before the regulations enter into force. After all, Treasury's decision to issue proposed and final regulations in the early years of the TCJA makes it crystal clear that while the TCJA may be the future, the PFIC regime is not in the past.

ENDNOTES

* The views expressed in this column are those of the authors and do not necessarily reflect the views of Ernst & Young LLP or other members of the global EY organization. The authors would like to thank Chris Ocasal, Principal, Ernst & Young LLP, for his helpful input.

1 Notice 88-22, 1988-1 CB 489 (Feb. 26, 1988).

2 *See* T.D. 9936, "Guidance on Passive Foreign Investment Companies," 86 FR 4516 (Jan. 15, 2021). Proposed regulations under Code Secs. 1297 and 1298 were also released (the "2020 Proposed Regulations"). *See* "Guidance on Passive Foreign Investment Companies and the Treatment of Qualified Improvement Property Under the Alternative Depreciation System for Purposes of Sections 250(b) and 951A(d)," 86 FR 4582 (Jan. 15, 2021).

3 *See* T.D. 9936, 86 FR 4516.

4 *See* Reg. §§1.1291-1(j)(4), 1.1297-1(g)(1), 1.1297-2(h), 1.1297-4(g), 1.1297-6(f), 1.1298-2(g), and 1.1298-4(f). For a further discussion, *see* Final Regulations at 4541–4543.

5 The preamble to the 2020 Final Regulations states that a taxpayer may choose to apply the 2020 Final Regulations to all or less than all of the foreign corporations whose shares are owned by the taxpayer, subject to the requirement that once the 2020 Final Regulations are applied to an open tax year with respect to the stock of a particular foreign corporation, they must be applied with respect to that stock consistently for each tax year that follows. For a further discussion, *see* Final Regulations at 4541–4543.

6 *See e.g.*, H.R. Rep. No. 426, 99th Cong., 1st Sess., 405–413 (1985); S. Rep. 313, 99th Cong., 2d Sess. (1986).

7 *See* The Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986, (H.R. 3838, 99th Congress, Public Law 99-514)* (the "1986 Blue Book"), at 1021 (May 15, 1987).

8 Code Secs. 951(b), 957(a). For purposes of satisfying the 10% ownership threshold for a U.S. person to constitute a U.S. shareholder, as well as the 50% ownership threshold for a foreign corporation to constitute a CFC, certain indirect and constructive ownership rules are taken into account. *Id.*

9 P.L. 99-514, §1235(a) (Oct. 22, 1986).

10 *See* 1986 Blue Book, at 1023. The "excess distribution regime" of the PFIC rules (Code Sec. 1291) addresses anti-deferral concerns by requiring every U.S. person who owns stock in a PFIC to pay tax and an interest charge on the deemed deferred tax liability attributable to certain distributions made, or any gain recognized, on the stock. The interest charge has the effect of offsetting U.S. tax benefits derived from deferring income or appreciation in a PFIC. The excess distribution regime addresses character conversion by generally treating gain from the

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disposition of PFIC stock as ordinary income. The PFIC rules contain two elective alternatives to taxation under the excess distribution regime: A full inclusion regime (the "qualified electing fund" or "QEF," regime (Code Secs. 1293 through 1295)), and a "mark-to-market" regime for certain publicly traded PFIC stock (Code Sec. 1296). Generally, the PFIC rules do not apply to a U.S. shareholder (as defined in Code Sec. 951(b)) of a CFC (as defined in Code Sec. 957(a)) under the so-called "PFIC/CFC Overlap Rule" of Code Sec. 1297(d).

[11] Code Sec. 1297(a).

[12] Reg. §§1.1297-1(d)(1)(i) and (ii)(A). An election can be made to use a shorter measuring period than a quarter. *See* Reg. §1.1297-1(d)(1)(ii)(B). If a tested foreign corporation has a short taxable year, the Asset Test is applied by using the measuring dates of the corporation's taxable year that fall within the short year, and by treating the last day of the short year as a measuring date. Reg. §1.1297-1(d)(1)(ii)(C).

[13] Code Sec. 1297(b)(1). FPHCI includes, *inter alia,* dividends, interest, rents, royalties, net gains on the disposition of property generating the aforementioned items of income, and net foreign exchange gains.

[14] *See* Reg. §1.1297-1(c)(1)(i). The Final Regulations clarify that the following exceptions to FPHCI apply for purposes of determining passive income of a tested foreign corporation: exceptions provided in Code Secs. 954(c)(1), (c)(2)(A) (relating to active rents and royalties), (c)(2)(B) (relating to export financing income), (c)(2)(C) (relating to dealers), (c)(4) (relating to sales of certain partnership interests), and (c)(5) (relating to certain commodity hedging transactions). For purposes of determining the applicability of these exceptions, the tested foreign corporation need not be a CFC.

[15] *See e.g.*, Code Sec. 1297(b)(2)(C) (exception for certain dividends, interest, rents or royalties received from related persons); Code Sec. 1298(b)(7) (exception for the treatment of certain stock and dividends of domestic subsidiaries); Code Sec. 1298(b)(2) (start-up exception); Code Sec. 1298(b)(3) (change of business exception); Code Sec. 1297(b)(2)(A) (active banking exception); and Code Sec. 1297(b)(2)(B) (active insurance exception).

[16] Code Sec. 1298(a), Reg. §1.1291-1(b)(7). The PFIC regime does not apply constructive ownership rules (*e.g.*, such as those found in Code Sec. 958(b) of the subpart F regime).

[17] Code Sec. 1298(a)(2)(A), Reg. §1.1291-1(b)(8)(ii)(A). Solely for purposes of determining whether the 50% ownership threshold is satisfied, a person that owns (directly or indirectly) at least 50% of the value of the stock of a domestic corporation is considered to own a proportionate amount (by value) of any stock the domestic corporation directly or indirectly owns. Reg. §1.1291-1(b)(8)(ii)(C).

[18] Code Sec. 1298(a)(2)(B), Reg. §1.1291-1(b)(8)(ii)(B).

[19] Code Sec. 1298(a)(3), Reg. §1.1298-1(b)(8)(iii).

[20] Code Sec. 1298(a)(5), Reg. §1.1298-1(b)(8)(iv).

[21] *See e.g.*, New York City Bar Association, Committee on Taxation of Business Entities, *Report Offering Proposed Guidance Regarding the Passive Foreign Investment Company Rules* (Sept. 21, 2009), at 52–56, *www.nycbar.org/pdf/report/uploads/20071778-ReportRePassiveForeignInvestmentCompanyRules.pdf*.

[22] Reg. §1.1298-1(b)(8)(iv).

[23] The analysis under a bottom-up approach would begin the same as in Example 1: the PFIC portfolio investments that FC2, a non-PFIC, owns would be attributed to FC1 due to FC1's 100% ownership of FC2. Because FP owns 100% of FC1, the PFIC portfolio investments and stock of FC3, a PFIC, are attributed to FP and are then attributed (according to A's 40% interest in FP) to A.

[24] For the general requirements to make a QEF election, *see* Code Sec. 1295, Reg. §1.1295-1, and Proposed Reg. §1.1295-1.

[25] Code Sec. 1298(a)(2)(A), Reg. §§1.1291-1(b)(8)(ii)(A), (b)(8)(iv).

[26] *See* Final Regulations at 4517.

[27] Code Sec. 1297(c). The Final Regulations provide guidance on the application of the Subsidiary Look-Through Rule. *See* Reg. §1.1297-2.

[28] Reg. §1.1297-2(e).

[29] *See* H.R. Conf. Rep. No. 99-841 (1986), 1986-3 CB Vol 4 at II-644.

[30] As a non-look-through subsidiary, the tested foreign corporation would count its stock of the subsidiary as a passive asset, and count dividends it receives from the look-through subsidiary (if any) as passive income. As a look-through subsidiary, the tested foreign corporation would be required to take into account its proportionate share of the gross assets and gross income of the look-through subsidiary (whether or not the income is distributed). The tested foreign corporation's proportionate share of the gross passive assets of a highly leveraged look-through subsidiary may exceed the equity value of the look-through subsidiary that would be taken into account if it were not a look-through subsidiary. Likewise, the tested foreign corporation's proportionate share of the gross passive income of the look-through subsidiary may exceed the dividends (if any) the tested foreign corporation receives and takes into account if the subsidiary were not a look-through subsidiary.

[31] *See* Reg. §§1.952-1(g)(1), 1.954-2(a)(5).

[32] Code Sec. 954(c)(1)(B)(ii), (c)(4).

[33] Reg. §1.1297-2(b)(3).

[34] Reg. §1.1297-2(b)(3). However, the Final Regulations permit the activities of certain affiliates of a tested foreign corporation to be taken into account for purposes of satisfying certain exceptions to FPHCI with respect to items of income of a partnership. *See* Reg. §1.1297-2(e). As a simple example, suppose the tested foreign corporation is a 30% partner in FP, a partnership. FP owns real property and receives rental income. The tested foreign corporation also wholly owns FS, a corporation that, through its employees, manages all activities associated with marketing and maintaining the real estate FP holds, and managing the leases into which FP enters. Rental income is generally passive income under Code Sec. 954(c), but the Final Regulations apply the "active rents" exception in Code Sec. 954(c)(2)(A) for purposes of the PFIC Tests (*see* Reg. §1.1297-1(c)(1)(i)(A)). Generally, whether the active rents exception applies is determined at the FP level. However, for purposes of satisfying the activity requirements of the active rents exception under Reg. §1.954-2(c)(1), the Final Regulations allow the activities employees of FS perform to be taken into account.

[35] Reg. §§1.1297-1(c)(3), (d)(4).

[36] Reg. §1.1297-2(g)(4)(i)(A).

[37] Reg. §1.1297-2(g)(4)(i)(B).

[38] Reg. §1.1297-2(g)(4)(ii).

[39] Final Regulations at 4528.

[40] *Id.*

[41] Reg. §1.1297-2(g)(4)(ii).

[42] The two examples in the Final Regulations demonstrating the Active Partner Test assume the tested foreign corporation and non-25% Partnership have the same amount of assets at each measurement date, and so apply a single computation for the Active Partner Test with no clarification as to how to apply the test at each measurement date. *See* Reg. §1.1297-2(g)(4)(iv).

[43] Reg. §1.1297-2(g)(4)(iii).

[44] The Final Regulations contain other elections, some of which are made by the tested foreign corporation and some of which are made by a U.S. shareholder. *See e.g.*, Reg. §§1.1297-1(d)(1)(iii), 1.1297-4(d)(5).

[45] Final Regulations at 4528.

[46] Without look-through treatment, FC's distributive share of PRS's income is \$40 (10% × \$400), all of which would be passive because it is a partnership that is not a look-through partnership. Because FC's only other source of income is \$1 of non-passive income, it is a PFIC by way of the Income Test. The Asset Test also would cause FC to be a PFIC, since FC's PRS interest would be treated as 100% passive and far exceeds the value of its only non-passive asset.

[47] Because FC received the cash on the last day of the year, it is possible that it had no chance to redeploy that cash into active business activities (or make a distribution to its shareholders). In this regard, the PFIC Tests in general—and the Asset Test in particular—are sensitive to the timing of transactions during a tested foreign corporation's tax year. The Final Regulations provide an election to apply the Asset Test using a measuring period that is shorter than a quarter, which may in certain circumstances alleviate the impact of discrete transactions that have a significant impact on the Asset Test. *See* Reg. §1.1297-1(d)(1)(ii)(B).

[48] Final Regulations at 4528.

[49] Code Sec. 1297(e)(1). The Final Regulations define a publicly traded foreign corporation as a foreign corporation whose stock is regularly traded on an exchange described in Code Sec. 1297(e)(3), other than in *de minimis* quantities,

for at least 20 trading days during a taxable year. Reg. §1.1297-1(f)(7). Exchanges described in Code Sec. 1297(e)(3) include a "national securities exchange [that] is registered with the Securities and Exchange Commission or the national market system established pursuant to section 11A of the Securities and Exchange Act of 1934."

50 Code Sec. 1297(e)(2)(A). The Final Regulations provide that a foreign corporation that is a CFC for some but not all measuring periods for the Asset Test during the taxable year is only treated as a CFC for the measuring periods when it was in fact a CFC. Reg. §1.1297-1(d)(1)(v)(C)(*1*).

51 Code Sec. 1297(e)(2)(B). The Final Regulations provide guidance on making the election to use an asset's adjusted basis instead of value. *See* Reg. §1.1297-1(d)(1)(iii).

52 Code Sec. 1298(e) provides two limited exceptions for CFCs that allow the adjusted basis of the total assets of the CFC to be increased by certain R&D expenses or payments for the use of certain intangible property. Code Sec. 1298(e)(1) allows the total adjusted basis of a CFC's assets to include research and experimental expenditures (as defined in Code Sec. 174) paid or accrued by the CFC during the current tax year and preceding two tax years (net of any reimbursement received by the CFC). Code Sec. 1298(e)(2) allows the total adjusted basis of a CFC's assets to include 300% of the total payments made by a CFC during the tax year for any intangible property (as defined in Code Sec. 367(d)(4)) that is used by the CFC in the active conduct of a trade or business. Code Sec. 1298(e)(2) does not apply to any payments that are made to a non-U.S. related person to the CFC, or if a principal purpose of entering into the license of the intangible is to avoid the tested foreign corporation being a PFIC.

53 In Notice 88-22, Treasury provided that forthcoming regulations would characterize intangibles that produce identifiable amounts of income (*e.g.*, patents and licenses) on the basis of the income derived from the intangible. Goodwill or going-concern value would be identified with a specific income-producing activity of the corporation, and would be characterized as passive or non-passive based on the income derived from the activity. In the preamble to the 2020 Proposed Regulations, Treasury stated that the rules in Notice 88-22 (except when already addressed by the Final Regulations or 2020 Proposed Regulations) continue to be proposed to be finalized as set forth in the Notice. The preamble states that Treasury believes the approach outlined in Notice 88-22 is reasonable for characterizing goodwill for the Asset Test, but other approaches may be more economically accurate for a particular tested foreign corporation. Treasury requested comments on alternative approaches for addressing the treatment of goodwill for purposes of the Asset Test. *See* 2020 Proposed Regulations at 4588.

54 To understand how the repeal of Code Sec. 958(b)(4) caused more foreign corporations to be treated as CFCs, consider the following example. FS1 is a foreign corporation that wholly owns FS2, another foreign corporation, and DC1, a domestic corporation. For purposes of Code Secs. 951(b) (*i.e.*, the definition of a "United States shareholder") and 957 (*i.e.*, the definition of a CFC), former Code Sec. 958(b)(4) provided that "[s]ubparagraphs (A), (B), and (C) of section 318(a)(3) shall not be applied so as to consider a United States person as owning stock [that] is owned by a person who is not a United States person." Under Code Sec. 318(a)(3)(C), if 50% or more of the value of a corporation's stock is owned, directly or indirectly, by or for any person, the corporation is considered as owning the stock owned, directly or indirectly, by the person. Thus, absent Code Sec. 958(b)(4), DC1 is considered as owning 100% of the stock of FS2, making DC1 a U.S. shareholder under Code Sec. 951(b) and FS2 a CFC under Code Sec. 957.

55 For purposes of Code Sec. 1297(e)(2)(A) and Reg. §1.1297-1(d)(1)(v) (which governs the application of Code Sec. 1297(e)), Reg. §1.1297-1(d)(1)(v)(B)(*2*) provides that the term "controlled foreign corporation" has the meaning provided in Code Sec. 957, determined without applying Code Sec. 318(a)(3) so as to consider a U.S. person as owning stock that is owned by a person that is not a U.S. person.

56 "Guidance on Passive Foreign Investment Companies," 84 FR 33120 (July 11, 2019).

57 *See* Final Regulations at 4523.

58 Reg. §§1.1297-1(d)(1)(v)(A), (B)(*1*), (C)(*1*), (C)(*2*)(*iii*).

59 Code Sec. 1297(c), Reg. §1.1297-2(b)(2)(i).

60 Reg. §1.1297-1(d)(1)(v)(A).

61 Reg. §1.1297-1(d)(1)(v)(B)(*1*).

62 Reg. §§1.1297-1(d)(1)(v)(C)(*1*).

63 Reg. §§1.1297-1(d)(1)(v)(A), (B)(*1*), (C)(*2*)(*i*), (C)(*2*)(*ii*).

64 The Final Regulations provide that the stock of a look-through subsidiary is eliminated for purposes of applying the Asset Test to a tested foreign corporation. Reg. §1.1297-2(c)(1)(i).

65 We assume for purposes of this example that the PFIC/CFC Overlap Rule applies to A's 60% ownership of FC.

66 Reg. §1.1297-1(d)(1)(v)(A).

67 Reg. §§1.1297-1(d)(1)(v)(A), (C)(*2*)(*ii*). FS1 would also meet the definition of a CFC (under Code Sec. 957) by way of downward attribution: Code Sec. 958(b) (and Code Sec. 318(a)(3)) treat DC1 as owning 100% of FS1 stock. If FC were instead widely held, such that FS1 would constitute a CFC solely due to downward attribution, the Asset Measurement Framework would not require FS1's assets to be measured using adjusted basis. Instead, under Reg. §§1.1297-1(d)(1)(v)(A) and (C)(2)(iii), because FC is publicly traded, FS1's assets would be measured according to value.

68 Code Sec. 1298(a)(2)(B), Reg. §1.1291-1(b)(8)(ii)(B).

69 Code Sec. 1298(a)(2)(A), Reg. §1.1291-1(b)(8)(ii)(A). In this case, consideration presumably should be given to whether the PFIC/CFC Overlap Rule applies to the U.S. person with respect to the stock of the lower-tier subsidiary.

70 Reg. §1.1297-1(d)(1)(v)(C)(*2*)(*i*).

71 Reg. §§1.1297-1(d)(1)(v)(C)(2)(*i*) and (C)(*2*)(*ii*).

72 Code Sec. 1298(a)(2)(B), Reg. §1.1291-1(b)(8)(ii)(B). We assume for purposes of this example that the PFIC/CFC Overlap Rule applies to A's 60% ownership of FS1.

73 Reg. §1.1297-1(d)(1)(v)(C)(*2*)(*ii*).

74 Reg. §1.1297-1(d)(1)(v)(C)(*2*)(*iii*).

75 Reg. §§1.1297-1(d)(1)(v)(C)(*1*), (*2*)(*iii*).

76 Reg. §1.1297-1(d)(1)(v)(C)(*2*)(*iii*).

77 *See* Final Regulations at 4524 and Reg. §1.1297-1(d)(1)(v)(E), Example 3.

78 Reg. §1.1297-1(d)(1)(v)(C)(*2*)(*iii*).

79 Reg. §1.1297-1(d)(1)(v)(A).

80 Reg. §§1.1297-1(d)(1)(v)(A), (C)(*2*)(*iii*).

81 Code Sec. 1298(a)(2)(B), Reg. §1.1291-1(b)(8)(ii)(B). If FS1 is not a PFIC, because A owns less than 50% of the value of the stock of FS1, the stock of FS2 will not be attributed to A under the PFIC Indirect Ownership Rules. Code Sec. 1298(a)(2)(A), Reg. §1.1291-1(b)(8)(ii)(A).

82 Reg. §1.1297-1(d)(1)(v)(C)(*1*).

83 Reg. §1.1297-1(d)(1)(v)(C)(*2*)(*iii*).

84 We assume here that the PFIC/CFC Overlap Rule applies to B's 60% ownership of FS3.

85 Reg. §1.1297-1(d)(1)(v)(B).

86 Reg. §§1.1297-1(d)(1)(v)(B), (C)(*2*)(*iii*).

87 Reg. §1.1297-1(d)(1)(v)(B).

88 As noted in footnote 84, we assume that the PFIC/CFC Overlap Rule applies to B's 60% ownership of FS3. The application of the PFIC/CFC Overlap Rule to B's 60% ownership of FS3 is not taken into account for purposes of applying the PFIC Indirect Ownership Rules to B's 42% (60% × 70%) indirect interest in FS2. *See* Code Sec. 1298(a)(2)(B), Reg. §1.1291-1(b)(8)(ii)(B). Even if the PFIC/CFC Overlap Rule were taken into account, the PFIC Indirect Ownership Rules would attribute FS2 stock to B because B owns at least 50% of FS3. Accordingly, FS2 is a tested foreign corporation with respect to B. However, on the basis of FS2's status as a CFC by virtue of downward attribution and B's 42% indirect ownership of FS2, for purposes of this example we assume that the PFIC/CFC Overlap Rule applies to B's 42% ownership of FS2.

89 Reg. §1.1297-1(d)(1)(v)(C)(*1*).

90 Reg. §1.1297-1(d)(1)(v)(C)(*2*)(*iii*).

91 *See also* Example 3 in Reg. §1.1297-1(d)(1)(v)(E)(*3*).

92 86 FR 4524.

93 Code Sec. 1298(a)(2)(B), Reg. §1.1291-1(b)(8)(ii)(B).

94 Future guidance may resolve the disparate treatment of shares of a lower-tier subsidiary that a U.S. person indirectly owns through multiple parent foreign corporations by requiring the U.S. person to measure the assets of the lower-tier subsidiary according to the measurement method that applies to the parent foreign corporation with the highest status (*i.e.*, value if there is a parent foreign corporation that is publicly traded; adjusted basis if there is a parent foreign corporation that is a CFC, *etc.*). This approach would at least prevent a U.S. person from being required to perform multiple Asset Tests using different measurement methods.

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