

# INTERNAL REVENUE BULLETIN



## HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

## ADMINISTRATIVE

### **REG-115057-20, page 714.**

These proposed regulations amend regulations under sections 165 and 7508A, interpreting new section 7508A(d) relating to mandatory postponements of time to perform time-sensitive tax acts by reason of a federally declared disaster, and clarifying the definition of federally declared disaster under section 165(i)(5). Under section 7508A(a), the Secretary has discretion to determine which taxpayers are affected by a federally declared disaster and to specify both the time-sensitive acts that are postponed and a period of time that may be disregarded, up to one year, in determining whether such acts are timely performed. The proposed regulations clarify that the phrase “in the same manner as a period specified under [section 7508A(a)]” in section 7508A(d)(1) means that the time-sensitive acts postponed for the mandatory 60-day period are those determined by the Secretary under section 7508A(a). The proposed regulations further provide that the mandatory 60-day period will only apply if the Secretary bases his discretionary determination on a disaster declaration that specifies an incident date. The proposed regulations also clarify that the mandatory 60-day period cannot exceed the one-year limitation provided under section 7508A(a).

## EMPLOYEE PLANS

### **Notice 2021-9, page 678.**

This notice sets forth updates on the corporate bond monthly yield curve, the corresponding spot segment rates for January 2021 used under § 417(e)(3)(D), the 24-month average segment rates applicable for January 2021, and the 30-year Treasury rates, as reflected by the application of § 430(h)(2)(C)(iv).

**Bulletin No. 2021-5**  
**February 1, 2021**

### **Rev. Rul. 2021-3, page 674.**

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code and the Income Tax Regulations thereunder, effective January 1, 2021.

## INCOME TAX

### **REG-111950-20, page 683.**

These proposed regulations provide guidance under sections 1297 and 1298, including rules regarding the treatment of certain income received or accrued by a foreign corporation and assets held by a foreign corporation for purposes of section 1297 and rules on whether a foreign corporation is engaged in the active conduct of an insurance business for purposes of section 1297(b)(2)(B). The proposed regulations also include rules addressing the treatment of qualified improvement property under the alternative depreciation system for purposes of the global intangible low-taxed income and the foreign-derived intangible income provisions.

### **Rev. Proc. 2021-12, page 681.**

This revenue procedure extends to September 30, 2021, the expiration dates relevant to the application of the safe harbors in Rev. Proc. 2020-26, 2020-18 I.R.B. 753, and Rev. Proc. 2020-34, 2020-26 I.R.B. 990.

### **T.D. 9936, page 508.**

These final regulations provide guidance under sections 1291, 1297, and 1298, regarding the determination of ownership in a passive foreign investment company 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 final regulations also provide guidance regarding the exclusion from passive income under section 1297(b)(2)(B) for income derived by a qualifying insurance corporation in the active conduct of an insurance business.

**T.D. 9943, page 577.**

This document contains final regulations that provide additional guidance regarding the limitation on the business interest expense deduction limitation to reflect changes made by the Tax Cuts and Jobs Act and the Coronavirus Aid, Relief, and Economic Security Act. The final regulations provide guidance regarding which taxpayers and trades or businesses are subject to the limitation, and how the limitation applies in consolidated group, partnership, international, and other contexts.

**T.D. 9945, page 627.**

Section 1061 recharacterizes certain net long-term capital gains of a partner that holds one or more applicable partnership interests as short-term capital gains. An applicable partnership interest is an interest in a partnership that is transferred to or held by a taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. The final regulations also amend existing regulations on holding periods to clarify the holding period of a partner's interest in a partnership that includes an applicable partnership interest and/or a profits interest.

# The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

## Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned

against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

### **Part I.—1986 Code.**

This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

### **Part II.—Treaties and Tax Legislation.**

This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

### **Part III.—Administrative, Procedural, and Miscellaneous.**

To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

### **Part IV.—Items of General Interest.**

This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

The contents of this publication are not copyrighted and may be reprinted freely. A citation of the Internal Revenue Bulletin as the source would be appropriate.

# Part I

26 CFR 1.1291-1; 1.1297-1; 1.1297-2; 1.1297-4;  
1.1297-6; 1.1298-2; 1.1298-4

## T.D. 9936

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

#### Guidance on Passive Foreign Investment Companies

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

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

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

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

#### FOR FURTHER INFORMATION

**CONTACT:** Concerning the regulations §§1.1291-0 and 1.1291-1, 1.1297-0 through 1.1297-2, 1.1298-0, 1.1298-2, and 1.1298-4, Christina G. Daniels at (202) 317-6934; concerning the regulations §§1.1297-4 and 1.1297-6, Josephine

Firehock at (202) 317-4932 (not toll-free numbers).

#### SUPPLEMENTARY INFORMATION:

##### Background

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

In addition, on October 2, 2019, the Treasury Department and the IRS published proposed regulations (REG-104223-18) relating to the repeal of section 958(b)(4) by the Tax Cuts and Jobs Act, Pub. L. 115-97, 131 Stat. 2054 (2017) (the “Act”) in the **Federal Register** (84 FR 52398) (the “section 958 proposed regulations”). As in effect before its repeal, section 958(b)(4) provided that section 318(a)(3)(A), (B), and (C) (providing for downward attribution) was not to be applied so as to consider a United States person (as defined in section 7701(a)(30)) as owning stock owned by a person who is not a United States person (a “foreign person”). After the Act repealed section 958(b)(4), stock of a foreign corporation owned by a foreign person could be attributed to a United States person under section 318(a)(3) for various purposes, including for purposes of determining whether the foreign corporation is a controlled foreign corporation within the meaning of section 957 (“CFC”). The section 958 proposed regulations generally made modifications to ensure that the operation of certain rules outside of subpart

F of part III of subchapter N of chapter 1 of subtitle A of the Code (“subpart F”) are consistent with their application before the Act’s repeal of section 958(b)(4). A public hearing on these regulations was not held because there were no requests to speak. This rulemaking finalizes the portion of the section 958 proposed regulations under section 1297 regarding the treatment of foreign corporations for purposes of section 1297(e).<sup>1</sup> See Part III.D.1 of the Summary of Comments and Explanation of Revisions section.

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

#### Summary of Comments and Explanation of Revisions

##### I. Overview

The final regulations retain the basic approach and structure of the proposed regulations, with certain revisions. This Summary of Comments and Explanation of Revisions section discusses those revisions as well as comments received in response to the solicitation of comments in the notice of proposed rulemaking. Comments outside the scope of this rulemaking are generally not addressed but may be considered in connection with the potential issuance of future guidance.

##### II. Comments and Revisions to Proposed §1.1291-1 – Taxation of U.S. persons that are shareholders of section 1291 funds

Section 1298(a) provides attribution rules that apply to the extent the effect is to treat stock of a PFIC as owned by a United States person. These rules apply when a United States person directly or indirectly owns an interest in a PFIC, a

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

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

#### *A. Attribution of ownership through a partnership, S corporation, estate or trust*

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

The only comment received on this proposed rule agreed with the results of the first example but recommended that a different approach be taken with respect to attribution through partnerships. The comment responded to the statement in the preamble that the proposed regulations would have results consistent with an aggregate approach to partnerships by noting that in certain circumstances the proposed rule would deviate from a true aggregation approach. It posited an example in which application of the rule in the proposed regulations would prevent

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

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

#### *B. Application of “top-down” approach*

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

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

between stock of a PFIC held through a partnership (which, in many cases, may be a foreign corporate entity treated as a partnership for U.S. federal income tax purposes as the result of a check-the-box election) and stock of a PFIC held through a corporation.

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

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

down” approach treats individual A as owning its economic share of the PFIC’s stock, while the “bottom-up” approach may not take into account the PFIC stock that is owned through the 5 percent of the tested foreign corporation’s stock that individual A owns directly. Accordingly, the final regulations apply a “top-down” approach to the attribution of ownership through all tiered ownership structures.

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

### C. Ownership attribution through nongrantor trusts

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

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

On December 31, 2013, the Treasury Department and the IRS published final and temporary regulations under several Code sections including section 1291 (78 FR 79602, as corrected at 79 FR 26836) (“2013 temporary and final regulations”). The preamble to those regulations provided that pending further guidance, beneficiaries of estates and nongrantor trusts that hold PFIC stock subject to the section 1291 regime should use a reasonable method to determine their ownership interests in the PFIC. The preamble to those regulations also provided that section 1291 and the principles of subchapter J must be applied in a reasonable manner with respect to estates and trusts, and beneficiaries thereof, to preserve or trigger the tax and interest charge rules under section 1291. Accordingly, the preamble provided that the estate or trust, or the beneficiary thereof, must take excess distributions into account under section 1291 in a reasonable manner, consistent with the general operating rules of subchapter J and that it would be unreasonable for the shareholders of the section 1291 fund to take the position that neither the beneficiaries nor the estate or trust are subject to the tax and interest charge rules under section 1291.

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

### III. Comments and Revisions to Proposed §1.1297-1 – Definition of passive foreign investment company

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

#### A. Definition of passive income

##### 1. In General

Section 1297(b)(1) defines passive income, for purposes of the PFIC rules, as income of a kind that would be foreign personal holding company income (“FPHCI”) under section 954(c), and proposed §1.1297-1(c)(1)(i) provided accordingly that passive income means income of a kind that would be FPHCI under section 954(c)(1). A comment suggested that the cross-reference to section 954(c)(1) should incorporate only those provisions of section 954(c) (and the regulations thereunder) that were in effect in 1986 when section 1297 was enacted and not, for example, section 954(c)(1)(H), relating to income from personal services contracts, or recent revisions to the regulatory rules for active rents and royalties under section 954(c)(2)(C). The Treasury Department and the IRS disagree, and believe that, in view of the original purpose of referencing section 954(c), section 1297 incorporates the law in respect of the referenced provisions—both statutory and regulatory—when it is applied. *Compare* section 951A(d)(3).<sup>2</sup> Therefore, the final regulations do not adopt this comment.

##### 2. PFIC/CFC Overlap Rule and RPII Income

Section 1297(d) provides that, for PFIC purposes, a corporation shall not be

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

treated as a PFIC with respect to a shareholder during the qualified portion of such shareholder's holding period with respect to stock in such corporation during which time the corporation is a CFC ("PFIC/CFC overlap rule"). The qualified portion of a shareholder's holding period generally is the period during which the shareholder is a United States shareholder ("U.S. shareholder"), as defined in section 951(b). Section 951(b) defines a U.S. shareholder, for purposes of the Code, as a U.S. person that owns 10 percent or more of the voting power or value of a foreign corporation. Section 957(a) provides that, for purposes of the Code, a CFC means any foreign corporation more than 50 percent owned (by vote or value, taking into account section 958(b) constructive ownership rules) by U.S. shareholders on any day during the taxable year of the foreign corporation.

In certain circumstances, the subpart F insurance rules lower the CFC ownership threshold requirements used to determine CFC status and eliminate the 10 percent vote or value test for determining U.S. shareholder status that are otherwise applicable for purposes of the Code. Under section 957(b), a special definition of a CFC applies and lowers the more than 50 percent ownership rule to a more than 25 percent ownership rule for taking into account section 953(a) insurance income, but only if the foreign corporation's gross amount of premiums or other consideration in respect of reinsurance or the issuing of insurance or annuity contracts not described in section 953(e)(2) exceeds 75 percent of the gross amount of all premiums or other consideration in respect of all risks. Also, under section 953(c)(1)(B), for purposes of taking into account related party insurance income ("RPII") as defined in section 953(c)(2), the CFC ownership requirement is reduced to a "25 percent or more" requirement. In addition, for purposes of determining RPII, the 10 percent of vote or value test for determining U.S. shareholder status is eliminated. See section 953(c)(1)(A). Instead, for RPII purposes, a U.S. shareholder means any U.S. person that directly or indirectly owns any of the stock of the foreign corporation at any time during the foreign corporation's taxable year. See section 953(c)(1)(A). Constructive ownership

under section 958(b) is not taken into account for this purpose.

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

## *B. Exceptions from passive income*

### *1. Application of Active Banking and Active Insurance Exceptions*

Proposed §1.1297-1(c)(1)(i)(A) provided that section 954(h), which excludes from FPHCI income derived by a CFC in the active conduct of a banking or financing business from customers outside of the United States, applied for purposes of determining PFIC status. The proposed regulations also provided that section 954(i), which excludes from FPHCI certain income derived in the active conduct of an insurance business, did not apply for purposes of determining PFIC status. See proposed §1.1297-1(c)(1)(i)(B). Several comments approved of the application of section 954(h) to the determination of whether income is treated as passive for purposes of section 1297. One comment noted that, in the case of tested foreign corporations with look-through subsidiaries that are domestic corporations, section 954(h)(3)(A)(ii)(I) would result in the section 954(h) exception being inapplicable to active financing income earned by these subsidiaries from transactions with local customers, even though it would otherwise be of a type that would not be passive. The comment suggested that section 954(h) should be applied in the PFIC context by treating income as qualified banking or financing income even if the income is derived from transactions with customers in the United States. Several

comments recommended that the section 954(h) exception continue to apply in the PFIC context in the event that final regulations implementing the active banking exception in section 1297(b)(2)(A) are adopted. Comments also requested that the final regulations apply the section 954(i) insurance exception for purposes of determining PFIC status of an insurance company in a parallel manner as section 954(h).

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

As previously discussed, section 1297(b)(1) provides that, except as otherwise provided in section 1297(b)(2), passive income means any income of a kind that would be FPHCI as defined in section 954(c). The definitions of the categories of FPHCI listed in section 954(c) describe types of gross income, for example interest, dividends, gains from the sale of property and foreign currency gains, as well as exceptions to those definitions. While these definitions and exceptions in some places refer to CFCs, the definitions and exceptions themselves do not require that a foreign corporation be a CFC. By contrast, although sections 954(h) and (i)

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

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

the enactment of sections 954(h) and (i) in 1998 are void of any indication that Congress intended such an interpretation of section 1297(b)(1).<sup>3</sup> The legislative history provides further evidence that section 954(h) was not intended to apply for purposes of section 1297(b)(1); the conference report states that “the conferees intend that a corporation will be considered to be engaged in the active conduct of a banking ... business if the corporation would be treated as so engaged under the regulations proposed under” section 1297(b)(2).<sup>4</sup> Incorporating this standard into section 1297(b)(1) would limit the scope of section 1297(b)(2). Accordingly, given the specialized nature of these exceptions within the subpart F regime, the Treasury Department and the IRS have determined that it is inappropriate to apply them in defining the types of income that are “of a kind” described in section 954(c) (that is, FPHCI) for purposes of section 1297(b)(1).

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

Section 954(h) has been removed from the list of exceptions that are applied to PFICs with respect to section 1297(b)(1). *See* §1.1297-1(c)(1)(i)(A). Despite the conclusion that it is inappropriate to incorporate section 954(h) as an exception to the definition of passive income under section 1297(b)(1), the Treasury Department and the IRS have considered

whether principles of section 954(h) could apply in the context of the rules of section 1297(b)(2)(A). Section 1297(b)(2)(A) provides that passive income does not include any income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in regulations, by any other corporation). Pursuant to this grant of regulatory authority, the 2020 NPRM proposes an active banking exception that incorporates certain principles of section 954(h) in defining other corporations that are eligible to apply this exception in addition to U.S. licensed banks. *See* proposed §1.1297-1(c)(2). The preamble to the 2020 NPRM discusses comments that address issues relating to the potential application of section 954(h) in the PFIC context.

## 2. Treatment of Gains from Certain Transactions

Proposed §1.1297-1(c)(1)(ii) provided that for purposes of the Income Test, categories of income under section 954(c) that are determined by netting gains against losses are taken into account by a corporation on that net basis. However, under the proposed regulations, the net amount of income in each category of FPHCI was calculated separately for each relevant corporation, such that net gains or losses of a look-through subsidiary may not be netted against net losses or gains of another look-through subsidiary or of a tested foreign corporation. *See* proposed §1.1297-1(c)(1)(ii).

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

<sup>3</sup> *See* H.R. Rep. No. 220, 105<sup>th</sup> Cong. 1<sup>st</sup> Sess. 623-28 (July 30, 1997) (discussing adoption of section 1297(d) CFC overlap rule and section 1296 mark-to-market rule; no discussion of contemporaneous adoption of section 954(h)); *id.* at 639-45 (discussing adoption of active financing income (section 954(h)) rule; no suggestion that rules apply for PFIC purposes).

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

The Treasury Department and the IRS have determined that the integrated treatment proposed by the comment with respect to look-through subsidiaries and look-through partnerships is consistent with the statutory language treating the owner of a look-through subsidiary as receiving directly its proportionate share of the income of the subsidiary, and with the policies underlying section 1297(c). Accordingly, §1.1297-1(c)(1)(ii) provides that the net gains or income for a category of FPHCI that is determined by netting gains against losses are determined at the level of a tested foreign corporation taking into account individual items of the tested foreign corporation and its look-through subsidiaries and look-through partnerships. Because these regulations do not adopt an overall look-through approach with respect to all partnerships, netting is not provided with respect to gains and losses derived from partnerships that are not look-through partnerships. For example, netting does not apply to gains and losses that are part of a tested foreign corporation's distributive share from a partnership that is a related person within the meaning of section 954(d)(3) but not a look-through partnership.

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

Section 952(b) excludes from subpart F income the U.S. source income of a CFC that is effectively connected with the conduct by such CFC of a trade or business in the United States ("effectively connected income"). Comments noted that the proposed regulations did not address the treatment of effectively connected income, or the assets held to produce such income, or a foreign corporation or the treatment of income that is attributable to a U.S. permanent establishment, or the assets held to produce such income. The comments noted that section 952(b) can exclude from subpart F income amounts that are FPHCI in order to prevent such amounts from being double-taxed, once directly to the foreign corporation, and a second time to United States shareholders of the foreign corporation, and stated that the PFIC rules should not discriminate against income earned through a U.S. branch rather

than through a domestic subsidiary that may qualify for the special rules of section 1298(b)(7). These comments suggested that the final regulations either characterize such income, and the assets held to produce such income, as non-passive or not include such income for purposes of the Income and Asset Tests.

As noted in Part III.B.1 of this Summary of Comments and Explanation of Revisions, the determination of whether amounts should be taken into account for purposes of the Income Test or the Asset Test is based on whether income would be FPHCI under section 954(c), not whether the income is treated as subpart F income. The PFIC rules address whether income is passive, which is a different question from whether it should be treated as subpart F income. Section 1298(b)(7) does not provide non-passive treatment for all income of domestic subsidiaries, but rather only for income of domestic subsidiaries that meet specified requirements, indicating that Congress did not consider it appropriate to exclude all income of domestic subsidiaries that are subject to U.S. net income taxation from passive income treatment. As a corollary, the limited scope of section 1298(b)(7) implies that a broad exception for effectively connected income is not warranted. Furthermore, section 1293(g)(1)(B)(ii) provides authority to exclude effectively connected income of a PFIC that is subject to U.S. net income taxation from inclusion in the hands of a shareholder of the PFIC that has made a qualified electing fund election, indicating that effectively connected income is otherwise treated as income of a tested foreign corporation for PFIC purposes.

The Treasury Department and the IRS have determined that an exclusion of effectively connected income (and income attributable to a U.S. permanent establishment) from passive income would be inconsistent with the statutory definition of passive income in section 1297(b)(1), with the limited application of section 1298(b)(7) and with the exclusion provided by section 1293(g)(1)(B)(ii), and that the treatment of effectively connected income (and income attributable to a U.S. permanent establishment) is contemplated and appropriately addressed by the existing PFIC rules. Consequently, the final

regulations do not adopt the suggestions in these comments.

### C. Income subject to the related person look-through rule

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

Under the final regulations, for purposes of the Asset Test and Income Test, corporations and partnerships owned in whole or part by a tested foreign corporation are generally classified into one or more of three categories. Lower-tier entities generally are treated as one or more of (i) a look-through subsidiary or look-through partnership (a "look-through entity"), (ii) a related person or (iii) an entity that is neither a look-through entity nor a related person. The rules for look-through entities are discussed in Part IV of this Summary of Comments and Explanation of Revisions. Dividends and the distributive share of income from a lower-tier entity that is neither a look-through entity nor a related person generally are treated as passive income, regardless of whether the income of the lower-tier entity is active or passive in its hands. See §1.1297-1(c)(3). Similarly, ownership interests in such entities are treated as passive assets. See §1.1297-1(d)(4).

For purposes of section 1297(b)(2)(C), the term *related person* has the meaning provided by section 954(d)(3). See section 1297(b)(2) and §1.1297-1(f)(8). Because the ownership threshold required for an entity to be treated as a related person is higher than the ownership threshold required for an entity to be treated as a look-through entity, there may be many entities that qualify as both or solely as look-through entities. However, because section 954(d)(3) has broader attribution rules than the rules that apply for purposes

of determining look-through entity classification, there may be entities that are treated as related persons with respect to a tested foreign corporation but not as look-through entities with respect to that tested foreign corporation.

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

If a partnership is a related person (that is not a look-through entity) with respect to a tested foreign corporation or look-through entity, and therefore subject to these rules, the tested foreign corporation's or look-through entity's distributive share of income from the partnership is treated as passive or non-passive in whole or part based on the activities of the partnership, and the partnership interest is correspondingly treated as passive or non-passive in whole or part. *See* §1.1297-1(c)(4)(vii), (d)(3)(i), and (d)(4). An asset that gives rise to income that is treated as in part passive and in part non-passive pursuant to these rules is subject to the rules that apply to dual-character assets. *See* §1.1297-1(d)(3)(i).

## 1. Treatment of Interest

The proposed regulations provided that, for purposes of the section 1297(b)(2)(C) exception, interest is properly allocable to income of the related person that is not passive income based on the relative portion of the related person's income for its taxable year that ends in or with the taxable year of the recipient that is not passive income. *See* proposed §1.1297-1(c)(3)(i). Comments generally supported the pro rata approach taken in the proposed regulations. One comment noted that the final regulations should clarify that the allocation is based on the ratio of gross non-passive income to gross total income. Another comment that supported the pro rata approach in the proposed regulations recommended that the final regulations address situations in which the related person does not have income during the taxable year of the payment. In such a case, this comment suggested that the final regulations apply the principles of §1.861-9T, which provides rules for allocating and apportioning interest expense, to determine whether the interest payments are allocated to passive or non-passive income of the related person. The comment also requested that the approach using the principles of §1.861-9T to allocate interest when the related person does not have gross income be made available as an alternative method at the election of the tested foreign corporation.

As suggested by the first comment, the final regulations clarify that the ratio for allocating interest to income is based on gross income. *See* §1.1297-1(c)(4)(iii). Similar clarifications are made for the rule for rents and royalties. *See* §1.1297-1(c)(4)(v). The Treasury Department and the IRS have determined that the pro rata approach provided in the proposed regulations is the most straightforward and consistent with the purposes of the section 1297(b)(2)(C) exception if the related person has gross income in the taxable year, and accordingly, the final regulations do not provide a generally applicable election to apply the principles of §1.861-9T in lieu of the general rule. *See* §1.1297-1(c)(4)(iii).

It is anticipated that it will rarely be the case that a related person will not have gross income, because gross income for

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

## 2. Treatment of Dividends

The proposed regulations provided that, for purposes of the section 1297(b)(2)(C) exception, dividends are treated as properly allocable to income of the related person that is not passive income based on the portion of the related payor's current earnings and profits ("E&P") for the taxable year that ends in or with the taxable year of the recipient that is attributable to non-passive income. *See* proposed §1.1297-1(c)(3)(ii).

A comment observed that foreign corporations often do not maintain E&P based on U.S. tax principles. The comment recommended that dividends be treated as al-

located between passive and non-passive amounts based on the ratio of passive to non-passive gross income.

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

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

The Treasury Department and the IRS agree that dividends from related parties should be allocated between passive and non-passive E&P based on the principles

of section 316, which apply generally for purposes of the U.S. international tax rules. Accordingly, the final regulations adopt the recommendation to characterize dividends in accordance with first current and then accumulated E&P of the related payor to which the dividend income is attributable. *See* §1.1297-1(c)(4)(iv)(A). In order to address concerns that foreign corporations that are not CFCs may not maintain E&P based on U.S. tax principles, taxpayers are permitted to allocate E&P in proportion to the ratio of passive gross income to non-passive gross income for the relevant period. *See* §1.1297-1(c)(4)(iv)(B).

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

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

first alternative is to allocate dividends paid out of accumulated E&P based on the ratio of passive to non-passive E&P that is attributable to E&P accumulated in the years in which the payor was related to the recipient. If the payor has been related to the recipient for more than three years, a second alternative is available, which is to allocate dividends paid out of accumulated E&P based on the ratio of passive to non-passive E&P that is attributable to E&P accumulated during a look-back period of the three years before the current taxable year. *See id.*

#### D. Asset test

##### 1. Section 958 Proposed Regulations

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

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

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

of the tested foreign corporation, by adjusted basis, in other cases. The Treasury Department and the IRS understand that taxpayers typically prefer to use value to measure assets of a tested foreign corporation.

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

A comment requested that the proposed regulations be modified to provide that the Asset Test be applied based on value if shares of the tested foreign corporation were publicly traded at any time during the taxable year. The comment asserted that the use of value more appropriately reflects the purposes of the PFIC rules in general, and that the statute requires only non-publicly traded CFCs to use basis for purposes of the Asset Test and otherwise allows a tested foreign corporation to apply the Asset Test based on value. The comment also noted that, due to the repeal of section 958(b)(4), there may be more tested foreign corporations that are CFCs. In such cases, less-than-10-percent shareholders of those tested foreign corporations would be required to use basis rather than value in determining PFIC sta-

tus. The comment requested relief from this result. The comment further noted that publicly traded corporations required to use basis would not be able to take into account goodwill and other self-created business intangibles for purposes of the Asset Test because such items often do not have tax basis.

The Treasury Department and the IRS agree with the concerns expressed by the comment regarding the effects of the repeal of section 958(b)(4). As discussed in Part III.D.1 of this Summary of Comments and Explanation of Revisions, this rulemaking finalizes the portion of the section 958 proposed regulations concerning the definition of the term CFC for purposes of the Asset Test, which accordingly allows use of the value method of measuring assets to the extent permissible under the statute. *See* §1.1297-1(d)(1)(v)(B)(2) (treating foreign corporations that are CFCs solely due to the repeal of section 958(b)(4) as not CFCs for purposes of section 1297(e)). The Treasury Department and the IRS believe that this change may alleviate much of the concern expressed about the proposed rule because the change makes it less likely that a tested foreign corporation will be treated as a CFC that is required to use adjusted basis to measure its assets.

The Treasury Department and the IRS also agree that section 1297(e) favors the use of value as a method to measure assets and that the use of value aligns with the objective of the PFIC rules. As a result, the final regulations expand the definition of publicly traded corporation for purposes of section 1297(e) to include more circumstances in which a tested foreign corporation is treated as a publicly traded foreign corporation. *See* §1.1297-1(f)(7). However, the Treasury Department and the IRS believe that it would be inappropriate to require a corporation to use value for purposes of the Asset Test if it was publicly traded for a de minimis period during its taxable year. Accordingly, the final regulations provide that a publicly traded corporation, which is defined as a corporation that has been publicly traded in more than de minimis amounts for at least twenty trading days (approximately one month) during a taxable year, is required to apply the Asset Test based on value. *See* §1.1297-1(d)(1)(v)(A) and (f)

(7). Pursuant to section 1297(e), a tested foreign corporation that does not qualify as a publicly traded foreign corporation may use value to measure assets as long as it is not a non-publicly traded CFC, but it is not required to do so.

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

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

is a non-publicly traded CFC must use adjusted basis and not value to measure its assets, regardless of whether it is owned by a publicly traded foreign corporation.

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

Revised §1.1297-1(d)(1)(v) provides specific rules for measuring the assets of lower-tier subsidiaries, which in the usual case are expected to be look-through subsidiaries. These rules follow the same hierarchy described in the prior paragraph, except that the method used to measure the assets of a lower-tier subsidiary may be determined either by the status of the lower-tier subsidiary if it is a publicly traded foreign corporation or a non-publicly traded CFC, or by the status of a tested foreign corporation that directly or indirectly owns all or part of the shares of the lower-tier subsidiary (a parent foreign corporation), if the parent foreign corporation has one of those statuses. *See* §1.1297-1(d)(1)(v)(C)(2).

As a general matter, the method used by a parent foreign corporation to measure its assets also must be used to measure the assets of a lower-tier foreign corporation owned in whole or part by that parent foreign corporation. This rule applies both for purposes of determining whether the

parent foreign corporation is a PFIC and for purposes of determining whether the lower-tier foreign corporation is a PFIC. If a tested foreign corporation indirectly owns a lower-tier subsidiary through one or more other foreign corporations, the status of the parent foreign corporation in that chain of corporations that has the highest status in the hierarchy described above governs. *See* §1.1297-1(d)(1)(v)(C)(2)(iii).

This general consistency rule does not apply, however, if the lower-tier foreign corporation has a status for which section 1297(e) mandates a method for measuring assets (that is, it is a publicly traded foreign corporation or non-publicly traded CFC). In such a case, the statutorily mandated method applies to measure the lower-tier foreign corporation's assets, both for purposes of determining whether the parent foreign corporation is a PFIC and for purposes of determining whether the lower-tier foreign corporation is a PFIC. For example, if a tested foreign corporation is a publicly traded foreign corporation, then both its assets and the assets of its lower-tier subsidiaries must be measured on the basis of value, unless a lower-tier subsidiary is a non-publicly traded CFC, in which case the assets of that subsidiary must be measured using adjusted basis. Similarly, if a tested foreign corporation is a non-publicly traded CFC, then both its assets and the assets of its lower-tier subsidiaries must be measured using adjusted basis, unless a lower-tier subsidiary is a publicly traded foreign corporation, in which case the assets of that subsidiary must be measured using value. *See* §1.1297-1(d)(1)(v)(C)(2)(i) and (ii). If a lower-tier tested foreign corporation does not have a status for which section 1297(e) mandates a method for measuring assets, and it is a subsidiary of more than one parent foreign corporation, then U.S. shareholders of the two different parent corporations may be required to use different methods to measure the assets of the lower-tier foreign corporation based on the method used for each respective parent foreign corporation. *See* the last sentence of §1.1297-1(d)(1)(v)(C)(2)(iii) and §1.1297-1(d)(1)(v)(E)(3) (Example 3).

The Treasury Department and the IRS recognize that section 1297(e)(1) requires

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

### 3. Treatment of Working Capital for Purposes of Asset Test

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

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

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

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

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

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

provide an explicit cross-reference to section 1297(b)(2)(C) to clarify that assets that produce income subject to the related person look-through rule are subject to the general and special rules with respect to treatment of assets under §1.1297-1(d), for example related party stock, loans, leases or licenses that produce dividends, interest, rent or royalties that are treated as passive and non-passive under section 1297(b)(2)(C). *See* §1.1297-1(d)(3)(i). Accordingly, assets that give rise to income subject to section 1297(b)(2)(C) generally are treated as a passive or non-passive asset to the extent the income that is received with respect to such asset is treated as passive or non-passive by the tested foreign corporation.

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

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

One comment argued that, for purposes of characterizing stock that does not generate dividends in the current year, a look-back period of two years would be appropriate if the final regulations adopt an approach that characterizes the stock based on the character of hypothetical dividends and uses the proportionate amount of non-passive gross income over the look-back period to determine the character of the dividends. If such an approach is not adopted, the comment recommended that, instead of a look-back period of two years, the stock could be characterized based on dividends paid during the preceding five years or, if shorter, the period during which the subsidiary was a related person under section 954(d)(3).

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

## E. Stapled entities

Proposed §1.1297-1(e) provided that, for purposes of determining whether any stapled entity (as defined in section 269B(c)(2)) is a PFIC, all entities that are stapled entities with respect to each other are treated as one entity. A comment suggested that the definition of stapled entities provided in section 269B(c)(2) and §1.269B-1 could be overbroad and thus lead to planning opportunities for purposes of PFIC testing. Therefore, the comment recommended that the final regulations provide a more restrictive definition for stapled entities so that, for purposes of PFIC testing, single-entity treatment would be limited to situations in which nearly 100 percent of the outstanding equity interests in both entities are stapled to each other. Alternatively, the comment suggested, the Treasury Department and the IRS could issue rules applicable to the holders of stapled interests clarifying the application of the anti-abuse rule in section 1298(b)(4) (which would treat separate classes of stock (or other interests) in a corporation as interests in separate corporations, pursuant to regulations, where necessary to carry out the purposes of the PFIC regime) to such stapled interests by providing that the rule would apply only if unusual features exist and the arrangement would allow avoidance of the PFIC rules. The comment also highlighted the inappropriateness of potentially applying the rule in proposed §1.1297-1(e) to treat a shareholder of an entity that would not be a PFIC, but for the rule, as the shareholder of a PFIC.

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

The Treasury Department and the IRS have determined that it is appropriate to

apply the single entity treatment of proposed §1.1297-1(e) even when not all interests in the stapled entities are stapled because section 269B(c)(2) applies only when controlling interests in the stapled entities are stapled, but that the application of the rule should be limited to apply only to U.S. persons that hold stapled interests and should not affect U.S. persons that directly or indirectly own only one of the stapled entities. Accordingly, the rule in proposed §1.1297-1(e) is modified to apply only if a U.S. person that would be a shareholder of the stapled entities owns stock in all entities that are stapled entities with respect to each other. In this case, the stapled entities are treated as an interest in a single entity for all purposes of the PFIC rules, which may have the effect of causing a stapled entity that would not be a PFIC on a stand-alone basis to be treated as a PFIC when stapled, or the reverse. See §1.1297-1(e). Given these modifications to the rule and the fact that the definition of stapled entities in section 269B(c)(2) already limits stapling to situations in which more than 50 percent in the value of the beneficial ownership in each of the entities consists of stapled interests, the Treasury Department and the IRS have determined that it is not necessary at this time to provide guidance on the application of section 1298(b)(4) or to further limit the interests that can be stapled.

## IV. Comments and Revisions to Proposed §1.1297-2 – Special rules regarding look-through subsidiaries and look-through partnerships

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

### A. Overview

#### 1. Treatment of Income and Assets

Under the final regulations, a tested foreign corporation is treated as directly owning the assets of, and directly deriving the gross income of, a look-through subsidiary or look-through partnership. See §1.1297-2(b)(2) and (b)(3). The tested foreign corporation disregards the equity interest in the look-through entity for pur-

poses of the Asset Test. See §1.1297-2(c)(1)(i) and (c)(3). As discussed in more detail in Part IV.D of this Summary of Comments and Explanation of Revisions, dividends from a lower-tier subsidiary and distributions and the distributive share of income from a lower-tier partnership generally are treated as if they did not exist (“eliminated”) for purposes of the Income Test. See §1.1297-2(c)(2)(i) and (c)(3).

For Income Test purposes, the proposed regulations provided that the disposition of the stock of a look-through subsidiary is treated as the disposition of stock and provided rules for the calculation of gain. See proposed §1.1297-2(f)(1). The final regulations also include rules addressing the disposition of partnership interests in a look-through partnership, which are similar in concept to the rules that apply to the disposition of stock of a look-through subsidiary, and rules addressing the disposition of partnership interests in a partnership described in section 954(c)(4)(B). See §1.1297-2(f)(4). Where both rules could potentially apply, the disposition is subject to the rules of section 954(c)(4). See §1.1297-2(f)(4)(i) and (ii). Consequently, it is anticipated that the sale of interests in a partnership that a tested foreign corporation owns at least 25 percent of by value generally will be subject to section 954(c)(4), and therefore will be treated as a disposition of assets rather than a disposition of the partnership interest, while the sale of interests in a partnership that a tested foreign corporation owns less than 25 percent of by value may or may not be subject to section 954(c)(4) in light of the different 25-percent ownership test in that statutory provision. The effect on the determination of gain under section 954(c)(4) of partnership earnings that have been included in income by the tested foreign corporation but not distributed is beyond the scope of these regulations.

Payments of interest, rent and royalties, and the related debt obligation, lease or license, between the tested foreign corporation and the look-through entity or between look-through entities generally also are eliminated for purposes of both the Income and the Asset Tests, as discussed in Part IV.D of this Summary of Comments and Explanation of Revisions. See §1.1297-2(c)(1)(ii), (c)(2)(ii), and (c)(3). If the obligation is between look-through

entities that are not wholly owned by the tested foreign corporation, a proportionate part of the obligation and income from it is eliminated. *See id.*

## 2. Definition of Look-Through Subsidiary

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

### B. Look-through partnerships

#### 1. Overview

The proposed regulations defined a look-through partnership as a partnership in which the tested foreign corporation owned at least 25 percent in value. *See* proposed §1.1297-1(c)(2)(i), (d)(3)(i), and (f)(1). The preamble to the proposed regulations indicated that the look-through

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

The definition of look-through partnership in the final regulations is revised to more closely align with the definition of look-through subsidiary. Under the final regulations, a look-through partnership is a partnership that would be a look-through subsidiary with respect to the tested foreign corporation if the partnership were a corporation. *See* §1.1297-2(g)(4)(i)(A). Accordingly, as noted by one comment, the taxpayer-favorable rules of section 1297(c) will apply to look-through partnerships, for example by allowing attribution of the activities of other affiliates in determining whether rental or royalty income of the partnership is treated as passive or non-passive. In response to other comments, additional changes have been made to the definition of look-through partnership to allow look-through treatment for certain minority interests in partnerships. *See* §1.1297-2(g)(4)(i)(B). These changes are discussed in Part IV.B.2 of this Summary of Comments and Explanation of Revisions.

The look-through partnership rules were located in proposed §1.1297-1, which provided general rules concerning the Income and Asset Tests. Because look-through treatment for purposes of PFIC

testing is provided in section 1297(c) and §1.1297-2 provides guidance on the application of section 1297(c), the rules in the final regulations concerning look-through partnerships are in §1.1297-2 along with all of the other rules discussing look-through treatment. *See* §1.1297-2(b)(3) and (g)(4).

## 2. Definition of Look-Through Partnership

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

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

The two comments recommending that all partnerships be treated as look-through partnerships noted that partnerships are pass-through entities that are generally treated as aggregates for many purposes throughout the Code and asserted that

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

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

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

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

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

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

A third comment stated that the approach proposed in the proposed regulations has the advantage of certainty and ease of administration because it provides a relatively clear bright-line test and limits the need to obtain information about the

assets and income of a lower-tier partnership that may be difficult for small partners to obtain. The comment also noted that the proposed approach creates greater equivalence between lower-tier entities that have or have not elected to be treated as pass-through entities, but observed that the proposed regulations did not create complete equivalence between such entities because the distributive share from a related partnership was not subject to the same rules as dividends from a related corporation. The final regulations address this concern by providing that the distributive share derived by a tested foreign corporation from a related partnership is subject to rules similar to such dividends. *See* §1.1297-1(c)(4)(vii).

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

The Treasury Department and the IRS recognize that although Congress has mandated a 25-percent threshold in order to treat a corporate subsidiary as a look-through entity, that threshold may not be a good proxy for an active business interest. The Treasury Department and the IRS considered whether the alternatives suggested would better identify an active partnership interest. The final regulations do not adopt any of the alternatives suggested by the third comment but do adopt an approach similar in concept to the

fourth of the alternatives. With respect to the first and third alternatives, the Treasury Department and the IRS have determined that the 25-percent threshold should be the same for lower-tier entities regardless of whether they have elected pass-through treatment for the reasons already discussed. With respect to the second alternative, the Treasury Department and the IRS do not believe that it is appropriate in this context to draw distinctions between entities in the legal form of a partnership and other entities treated as partnerships for U.S. federal income tax purposes.

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

The Treasury Department and the IRS also considered other participation and attribution rules of the Code, including proposed rules addressing when a corporate partner would be attributed the trade or business assets and activities of a partnership for purposes of the active trade or business requirement in section 355(b). *See* 88 FR 26012 (REG-123365-03) (proposing a rule that a partner that owns a meaningful interest in a partnership would be attributed the trade or business assets and activities of the partnership if the partner performs active and substantial management functions for the partnership with respect to the trade or business assets or activities (for example, by making deci-

sions regarding significant business issues of the partnership and regularly participating in the overall supervision, direction, and control of the employees performing the operational functions for the partnership)). However, the Treasury Department and the IRS determined that such a rule would not be appropriate for purposes of section 1297. As stated in a comment, the disadvantage of participation-based tests is that they are factual and potentially subjective, and therefore less administrable. For example, the proposed section 355(b) test described above would be difficult for the IRS to audit in the case of a foreign corporation that is not controlled by U.S. shareholders. Moreover, if the “meaningful interest” requirement applied, look-through treatment might apply only to a small number of partnerships that are not already treated as look-through partnerships. The Treasury Department and the IRS did not consider these approaches to be more appropriate than applying the rules of section 1297 at the partner level as a means of testing whether an investment in a partnership is an active business interest. Accordingly, the definition of look-through partnership is further altered to include certain partnerships in which the tested foreign corporation owns a minority interest if the tested foreign corporation has sufficient active assets and income as determined under the rules of section 1297 apart from the partnership. *See* §1.1297-2(g)(4)(i)(B).

Under the final regulations, a look-through partnership is defined as (i) a partnership that would be a look-through subsidiary if such partnership were a corporation—as discussed in Part IV.B.1 of this Summary of Comments and Explanation of Revisions—or (ii) any other partnership if the tested foreign corporation satisfies the active partner test. *See* §1.1297-2(g)(4)(i). The active partner test is satisfied if the tested foreign corporation would not be a PFIC if both the Income and the Asset Test were applied to it without including its interest in any partnership that would not be a look-through subsidiary if such partnership were a corporation. *See* §1.1297-2(g)(4)(ii). If the tested foreign corporation has no passive assets or income, even a very small active business would allow the interest to qualify as a look-through part-

nership under the active partner test. On the other hand, qualifying under the active partner test can only prevent a partnership interest from tainting an otherwise non-PFIC corporation, rather than be used affirmatively. Because the Treasury Department and the IRS understand that it may be difficult for minority investors in partnerships to obtain the information necessary to apply the Income and Asset Tests taking into consideration the income and assets of a look-through partnership, the final regulations provide an election out of the look-through partnership definition for partnerships that would not be a look-through subsidiary if such partnership were a corporation. *See* §1.1297-2(g)(4)(iii). The final regulations also provide two new examples illustrating the active partner test. *See* §1.1297-2(g)(4)(iv).

### *C. Overlap between section 1297(c) and section 1298(b)(7)*

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

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

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

#### *D. Elimination of certain assets and income for purposes of applying section 1297(a)*

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

#### 1. Treatment of Intercompany Dividends

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

A comment expressed concern that the proposed regulation did not eliminate a payment of a dividend by a look-through subsidiary to a tested foreign corporation that is made out of earnings and profits not attributable to income of the subsidiary previously included in the gross income of the tested foreign corporation for purposes of determining its PFIC status.

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

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

The Treasury Department and the IRS agree that dividends should be treated as paid out of current earnings and profits and then out of accumulated earnings and

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

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

Thus, if a look-through subsidiary with a value of \$1000 earns \$20 that is taken into account by a tested foreign corporation owner, any gain on a sale of the subsidiary's stock for \$1020 will be reduced by \$20 of unremitted earnings. If the subsidiary pays a \$15 dividend before the sale, the receipt of the dividend is disregarded for purposes of the Income Test and a sale of the subsidiary's stock for \$1005 should give rise to the same amount of residual gain. Thus, the \$20 will be taken into account for purposes of the Income Test and will not affect the amount of residual gain regardless of whether a dividend is paid. By contrast, if the look-through subsidiary pays a \$15 dividend out of earnings that do not reflect income taken into account by the tested

foreign corporation, the dividend would reduce the amount of gain on the sale of the look-through subsidiary's stock compared to not paying a dividend because the dividend would reduce unremitted earnings pursuant to §1.1297-2(f). Consequently, if the payment of the dividend were disregarded as requested by the comment, the \$15 dividend would reduce potential future gain but never give rise to corresponding income to the tested foreign corporation for purposes of the Income Test.

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

## 2. Treatment of Intercompany Rents and Royalties

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

Comments supported the approach taken in the proposed regulations with regard to interest. A comment indicated that payments of intercompany rents and royalties raises similar concerns with respect to double counting. Accordingly, the comment requested that, for purposes of applying the Income Test and the Asset

Test, the final regulations extend the elimination rules to payments of intercompany rents and royalties and any associated intangible assets in proportion to the tested foreign corporation's direct and indirect ownership (by value) in the look-through subsidiary or look-through partnership. The Treasury Department and the IRS agree with the comments, and §1.1297-2(c) accordingly extends the rules applicable to debt and interest to rents, royalties, leases, and licenses.

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

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

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

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

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

### *E. Attribution of activities of look-through subsidiaries and look-through partnerships*

#### 1. Scope of Attribution

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

of rent or royalty income received or accrued by a tested foreign corporation (or treated as received or accrued by the tested foreign corporation pursuant to section 1297(c)) that would otherwise be passive income if character were determined based on the activities of the income-earning entity is not passive income if the item would be excluded from FPHCI under section 954(c)(2)(A) and §1.954-2(b)(6), (c), and (d), determined by taking into account the activities performed by the officers and employees of the tested foreign corporation, certain look-through subsidiaries, and certain partnerships in which the tested foreign corporation or one of the look-through subsidiaries is a partner. *See* proposed §1.1297-2(e)(1).

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

Another comment noted that under the rule in the proposed regulations, the income or assets of a look-through subsidiary classified as non-passive in the hands

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

One comment recommended that rules in the proposed regulations be modified to apply the rules for active rents and royalties under section 954(c)(2)(A) as they existed in 1986, as discussed in Part III.A of this Summary of Comments and Explanation of Revisions, and if the regulations were not modified in that manner the activity attribution rules should be revised to take into account the “transition” rules in the 2016 modifications to the active rents and royalties rules. *See* TD 9792 (81 FR 76497) (adding the express requirement to the active development tests in §1.954-2(c)(1)(i) and (d)(1)(i) that the relevant

activities be performed by the lessor’s or licensor’s own officers or staff of employees, and providing a transition rule that the modified active development tests apply only with respect to property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015). The 2016 modifications are taken into account through the cross-reference in §1.1297-1(c)(1)(i)(A) to section 954(c)(2)(A) (relating to active rents and royalties). The Treasury Department and the IRS have determined that no revisions to the PFIC activity attribution rule are necessary, given that the PFIC activity attribution rules clearly apply to take into account the activities of officers and employees of other specified entities whether the rules under section 954(c)(2)(A) apply as modified (in the case of property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015) or the rules under section 954(c)(2)(A) pre-modification apply (because no changes to the property have occurred since September 1, 2015). Accordingly, the comment is not adopted.

## 2. Ownership Threshold for Activity Attribution

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

In response to a request for comments in the preamble to the proposed regulations concerning the appropriate owner-

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

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

The Treasury Department and the IRS disagree that satisfying a 25 percent threshold for ownership of an entity is sufficient to conclude that the entity's business is sufficiently integrated with that of a tested foreign corporation that the entity's activities should be taken into account for purposes of determining the character of income and assets of the tested foreign corporation. However, the

Treasury Department and the IRS agree with the comments that it is generally appropriate to expand the activity attribution rule to attribute activities among members of an affiliated group, determined by applying a more than 50 percent threshold and by including partnerships and U.S. affiliates in which corporate members of the affiliated group satisfy such ownership requirements. Accordingly, the final regulations so provide. See §1.1297-2(e)(1) and (2) (defining qualified affiliates of the affiliated group). However, the Treasury Department and the IRS have determined that because the rule applies for purposes of section 1297(c), which focuses on ownership of at least 25 percent by value, the threshold for inclusion in the group should be determined by value. See §1.1297-2(e)(2)(iv). Moreover, the parent of the affiliated group must also be foreign (a foreign corporation or partnership) in order to apply the activity attribution rule. See §1.1297-2(e)(2)(v). If the parent of the affiliated group were domestic (a U.S. corporation or partnership), then any qualified affiliate that is a foreign corporation (including the tested foreign corporation) would qualify as a controlled foreign corporation, and any U.S. investor with at least a 10 percent ownership interest in the tested foreign corporation would be subject to the subpart F rules rather than the PFIC rules under section 1297(d). Accordingly, an upstream foreign owner of the tested foreign corporation and entities that are held directly or indirectly by such same upstream foreign owner as the tested foreign corporation may be considered qualified affiliates, assuming the requisite ownership percentage requirements are met.

#### *V. Comments and Revisions to Proposed §1.1297-4 – Qualifying insurance corporation*

Section 1297(f) provides that a qualifying insurance corporation ("QIC") is a foreign corporation that (1) would be subject to tax under subchapter L if it were a domestic corporation, and (2) either (A) has applicable insurance liabilities ("AIL") constituting more than 25 percent of its total assets on its applicable financial statement ("AFS") ("the 25 percent test"), or (B) meets an elective alternative

facts and circumstances test which lowers the AIL ratio to 10 percent ("alternative facts and circumstances test"). Proposed §1.1297-4 elaborated on these requirements accordingly.

#### *A. 25 percent test*

##### *1. Applicable Insurance Liabilities*

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

Proposed §1.1297-4(f)(2) provided that with respect to any life or property and casualty insurance business of a foreign corporation, AIL mean (1) occurred losses for which the foreign corporation has become liable but has not paid before the end of the last annual reporting period ending with or within the taxable year, including unpaid claims for death benefits, annuity contracts, and health insurance benefits; (2) unpaid expenses (including reasonable estimates of anticipated expenses) of investigating and adjusted unpaid losses described in (1); and (3) the aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held for future, unaccrued health insurance claims and claims with respect to contracts providing coverage for mortality or morbidity risks, including annuity benefits dependent upon the life expectancy of one or more individuals.

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

unpaid LAE related to both paid and unpaid losses be included in the definition of AIL.

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

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

A comment also requested that special rules be created for financial guaranty insurers and another comment requested a special rule for mortgage guaranty insurers. The first comment recommended that final regulations permit a financial guaranty insurer to include in losses the greater of two amounts: (1) the aggregate amount of reserves (excluding deficiency, contingency, or unearned premium reserves) held for future unaccrued insurance claims, or (2) the average of losses incurred for policies over the previous ten years of the life of the policy, whichever is shorter. The second comment requested that the 25 percent test be waived for a foreign corporation engaged in the business of mortgage insurance and reinsurance if at least 80 percent of its net written premiums are derived from mortgage guaranty insurance (or reinsurance) and its gross investment income is less than 50 percent of its net written premiums as reported on its AFS.

The final regulations do not adopt the suggestion that paid losses or paid LAE be treated as AIL nor the proposed special rules for financial guaranty insurers and mortgage guaranty insurers. These suggestions are contrary to the statute and the intent of Congress. Section 1297(f) is limited to amounts that constitute liabilities, whereas losses and LAE that have been

paid are no longer liabilities and therefore do not qualify as AIL. Further, when losses and LAE are paid, assets are also reduced. It would not be appropriate to include loss and LAE amounts in the numerator of the 25 percent test (or alternative facts and circumstances test), when the corresponding assets are no longer reported on the AFS and included in the denominator. The statute also requires that liabilities include only insurance liabilities and further excludes certain types of insurance liabilities that may be included in a financial statement, such as unearned premium reserves, contingency reserves, and deficiency reserves. *See* section 1297(f)(3)(A); H.Rpt. No. 115-409, 115<sup>th</sup> Cong. 1<sup>st</sup> Sess., at 411; and Conference Rpt.No.115-466, 115<sup>th</sup> Cong. 1<sup>st</sup> Sess., at 670 (“Unearned premium reserves with respect to any type of risk are not treated as applicable insurance liabilities for purposes of the provision.”). Therefore, §1.1297-4(f)(2)(ii) provides that liabilities not within the definition of AIL are not included in the numerator of the 25 percent test (or alternative facts and circumstances test) and also specifies that amounts that are not insurance liabilities (for example, liabilities related to non-insurance products issued by an insurance company that may be treated as debt, such as certain deposit arrangements, structured settlements, and guaranteed investment contracts or GICs) are not AIL. The statute also does not contemplate averaging liabilities over a multi-year period because section 1297(f)(1)(B) provides for an annual calculation by looking to the foreign corporation’s AFS “for the last year ending with or within the taxable year.” Therefore, the final regulations do not include special rules for specialty insurers that would require multi-year averaging or disregard the liability requirement.

Section 1297(f) contemplates that QIC status is determined on an entity-by-entity basis. Therefore, §1.1297-4(f)(2)(i)(D)(2) clarifies that the liabilities eligible to be taken into account in determining AIL include only the liabilities of the foreign corporation whose QIC status is being determined. For example, if a parent and subsidiary both issue insurance contracts to unrelated parties and the AFS is a combined financial statement, the AIL of parent and subsidiary must be separately

determined and each of parent and subsidiary includes only the liabilities from the contracts that it has issued (without regard to the contracts issued by the other party). This rule is consistent with §1.1297-4(f)(2)(i)(D)(1) which provides the general principle that no item may be taken into account more than once.

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

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

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

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

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

#### *B. Alternative facts and circumstances test*

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

#### **1. Predominantly Engaged in an Insurance Business**

Section 1297(b)(2)(B) provides that passive income does not include income derived in the active conduct of an insurance business by a QIC. Section 1297(f)(1)(A) provides that a QIC must be a foreign corporation which would be subject to tax under subchapter L if such corporation were a domestic corporation. Then, for purposes of the alternative facts and circumstances test, section 1297(f)(2)(B)(i) adds another requirement that the foreign corporation be predominantly engaged in an insurance business under regulations provided by the Secretary based upon the applicable facts and circumstances.

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

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

the list of facts and circumstances is an exclusive set of factors.

In response to the comment, the final regulations make clear that the predominantly engaged requirement in the alternative facts and circumstances test is in addition to the subchapter L requirement that more than half the business of the foreign corporation is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. It also deletes the sentence regarding comparable commercial insurance arrangements because the standard was unclear and instead replaces it with a statement that the determination is made upon the character of the business actually conducted in the taxable year. Lastly, it clarifies that the list of facts and circumstances is not exclusive and can include other factors as may be relevant to a specific situation.

#### **2. Runoff-Related Circumstances**

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

A comment recommended that the final regulations remove the requirement that the runoff company have a plan of liquidation, remove the requirement that amounts paid by the runoff company cause the corporation to fail to satisfy the 25 percent test, and add a condition that the foreign corporation has no current plan or intention to enter into any insurance, annuity, or reinsurance contract other than in the case of a contractually obligated renewal.

The comment stated that there is no prevailing practice in the insurance industry for a regulator to supervise a plan of liquidation or termination of a runoff company. The comment further stated that runoff carriers may be part of a larger insurance group, and that management of the runoff business is not necessarily a prelude to liquidation but can be a way for the active insurance businesses to shift their core business segments and maximize their use of capital. In addition, some companies (known as “runoff specialists”) are in the business of acquiring reserve liabilities to profitably manage the settlement and payout of claims until all of the liabilities are exhausted.

The Treasury Department and IRS have considered these comments and believe that the exception from the 25 percent test should not be extended to runoff occurring in the context of the ordinary course of an ongoing business. The Conference Report to the Act describes a company with runoff-related circumstances as “not taking on new insurance business” and “using its remaining assets to pay off claims with respect to pre-existing insurance risks on its books.” See H.R. Rep. No. 115-466, at 671 (2017) (Conf. Rep.). The lower 10 percent threshold (which permits an insurance company to hold assets that are 1,000 percent of its AIL) should be limited to extraordinary circumstances in which the insurance company fails the 25 percent test solely because it is in the process of exiting the insurance business and is required to hold additional capital in excess of the 400 percent of AIL permitted by the 25 percent test due to its business being in runoff.

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

The final regulations retain the requirement in the proposed regulations that the insurance company make claims

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

### 3. Rating-Related Circumstances

Proposed §1.1297-4(d)(4) provided that “rating-related circumstances” means that a foreign corporation’s failure to satisfy the 25 percent test was a result of specific requirements with respect to its capital and surplus that a generally recognized credit rating agency imposes that the foreign corporation must comply with to maintain the minimum credit rating required for it to be classified as secure to write new insurance business for the current year. This condition in the proposed regulations was based upon the premise that although the generally recognized credit rating agencies (A.M. Best, Fitch, Moody’s, and Standard and Poor) may use separate rating codes, the ratings could be classified into “secure” and “vulnerable” categories, and that the rating agencies require reporting entities to maintain a minimum amount of capital appropriate to support its overall business operations in consideration of its size and risk profile.

Comments suggested that the proposed regulation’s reference to “secure” be changed. Some comments suggested that the standard should be revised to reflect only a rating agency’s requirements that are “necessary” to write new business in accordance with the foreign corporation’s regulatory or board supervised business plan. Another comment requested that the term necessary be defined to mean that a foreign corporation complies with the requirements of the credit rating agency to

maintain a rating equivalent to A- by A.M. Best for reinsurers or BBB+ by Standard & Poor’s for all other insurers.

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

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

Several comments requested that additional categories of rating-related circumstances be included under which certain types of entities or businesses would be treated as per se meeting the rating-related circumstances requirement. These businesses include reinsurance that is fully collateralized, mortgage insurance and reinsurance, and financial guaranty insurance. Another comment noted that lines of business that require a higher level of capital as compared to reserves are those that cover risks that are low frequency but high severity, such as catastrophic risk (for example, hurricanes and earthquakes) and financial obligation insurance such as mortgage and financial guaranty insurance.

Comments noted that financial guaranty and mortgage guaranty insurers are generally required to operate as monoline businesses, such that the company does not have the option to pool its financial obligation risks with other types of risks

(whereas pooling of different types of risks can reduce overall risk exposure, and thus capital needs). Comments also noted that the loss experience of mortgage and financial guaranty insurers is closely tied to the economy as a whole, such that insurance liabilities are relatively low when the economy is strong but much higher in times of economic crisis, and that credit rating agencies correspondingly expect such companies to hold additional capital to protect policyholders due to the monoline nature and volatility of the businesses.

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

Financial guaranty insurance is a line of insurance business in which an insurance company guarantees scheduled payments of interest and principal on a bond or other debt security in the event of issuer default. A comment explained that financial guaranty insurance is unique in that the policyholder is effectively paying for use of the financial guaranty insurer's credit rating. For example, if a municipality insures its municipal bond obligations with a financial guarantee insurer, the municipality can charge a lower interest rate on its bond, because the obligation is guaranteed by the insurer's high credit rating. A very high credit rating is thus essential for

a financial guarantee insurer to write new business. Further (and similar to mortgage guaranty insurers) rating agency capital standards for financial guaranty insurers are geared to ensuring capital adequacy in times of crisis and may require a higher level of capital to get the same rating as an insurer with a different portfolio of risks. The combination of enhanced rating agency capital requirements and the need for a very high credit rating to write new business often results in a financial guaranty insurer being required to hold capital such that its current insurance liabilities are less than 25 percent of its assets in low loss years.

The Treasury Department and IRS considered these comments and the circumstances under which an insurance company would need assets in excess of 400 percent of its insurance liabilities in order to obtain the credit rating needed to write new business. As described in comments, companies that may require a higher level of capital as compared to insurance liabilities are companies that provide primarily catastrophic loss coverage and also monoline companies providing mortgage or financial guaranty insurance that experience significant losses on a low frequency but high severity basis. In low loss years, these types of companies may have less than 25 percent insurance liabilities to assets, but the additional assets may be viewed as necessary by rating agencies for the companies to meet insurance obligations in high loss years, and thus to receive the credit rating that the companies require to write the business in their business plan. Thus, the final regulations provide that the rating related circumstances exception is only available to a foreign corporation if it is a company that exclusively provides mortgage insurance or if more than half of the foreign corporation's net written premiums for the annual reporting period (or the average of the net written premiums for the foreign corporation's annual reporting period and the two immediately preceding annual reporting periods) are from insurance coverage against the risk of loss from a catastrophic loss event (that is, a low frequency but high severity loss event). *See* §1.1297-4(d)(4)(i).

The final regulations also provide that a financial guaranty insurance company

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

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

#### 4. Election to Apply Alternative Facts and Circumstance Test

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

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

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

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

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

Some comments asserted that it would be unduly burdensome for certain shareholders to file Form 8621 in order to make the election under section 1297(f)(2). The comments requested that shareholders of publicly traded companies or small shareholders of non-publicly traded companies be deemed to make the election under section 1297(f)(2) without the need for an affirmative filing.

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

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

## *C. Limitations on amount of applicable insurance liabilities*

### 1. Mechanics of the Limitation

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

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

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

ing of the terms “financial statement” and “financial reporting standard.”

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

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

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

## 2. Discounting

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

The Treasury Department and the IRS agree that AIL reported on a financial statement that have been discounted to reflect the time value of money only to the extent required by GAAP or IFRS have been discounted on an economically reasonable basis. Therefore, additional discounting of AIL is not necessary under circumstances in which it is not required under either GAAP or IFRS. For example, IFRS 17 does not require discounting of liabilities under nonlife insurance contracts with terms of one year or less. However, the Treasury Department and the IRS have determined that discounting is required where AIL have not been otherwise discounted on a reasonable basis. Accordingly, the final regulations clarify that, where a financial statement described in §1.1297-4(e)(2) does not discount AIL on an economically reasonable basis, the foreign corporation may meet this requirement by choosing to apply the discounting methods required under either GAAP or IFRS.

## 3. Change of Financial Reporting Standard

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

A comment requested that this rule be removed because taxpayers should not be

required to establish a business purpose for their choice of an accounting standard. In addition, financial reports are prepared to inform a corporation’s stakeholders and regulators of its financial condition, and this function is so significant that a corporation is unlikely to change its accounting standard for tax purposes. The Treasury Department and the IRS have concluded that other rules and limitations provided in the final regulations are sufficient to protect the integrity of the amounts reported on the AFS. Therefore, the final regulations delete the special rule addressing a change of financial reporting standard.

## D. Definition of an insurance business

The proposed regulations defined an insurance business to include the investment activities and administrative services that are required to support (or that are substantially related to) insurance, annuity, or reinsurance contracts issued or entered into by the QIC. See proposed §1.1297-5(c)(2). One comment interpreted this definition as potentially excluding any investment activities in excess of the minimum amount required to meet the QIC’s insurance obligations from the scope of the exception under section 1297(b)(2)(B). The comment requested that the definition be broadened to include all investment activities related to insurance, annuity, or reinsurance contracts issued or entered into by the QIC. Although the definition of an insurance business (now contained in §1.1297-4(f)(8)) has not been changed, it is not intended to provide a maximum threshold for investment assets and income that may qualify for non-passive treatment under section 1297(b)(2)(B). This definition merely requires a sufficient factual relationship between a company’s insurance contracts and its investment activity.

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

Section 1297(b)(2)(B) provides an exclusion from the definition of passive income for income derived in the active conduct of an insurance business by a QIC. Proposed §1.1297-5(b) provided a

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

#### *A. Active conduct of an insurance business*

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

Proposed §1.1297-5(c)(3)(i) provided that active conduct is determined based on all the facts and circumstances. In general, a QIC was treated as actively conducting an insurance business only if the officers and employees of the QIC carried out substantial managerial and operational activities. A QIC's officers and employees were considered to include the officers and employees of an affiliate if the QIC satisfied the control test under proposed §1.1297-5(c)(3)(ii), which incorporated requirements relating to ownership, control and supervision, and compensation.

Comments were generally critical of the proposed active conduct test. Some

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

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

A number of comments requested that an insurance company be treated as engaged in the active conduct of an insurance business even if its day-to-day activities are not performed by employees, so long as its officers and employees adequately supervise the outsourced functions. For example, some comments recommended a management and control test based upon the Limitation on Benefits Article of the 2016 U.S. Model Income Tax Convention (which requires a company's executive officers and senior management employees to exercise day-to-day responsibility for strategic, financial, and operational policy decision-making) or regulations issued by the Bermuda Monetary Authority (which permit outsourcing subject to the insurance company's supervision and oversight). Others proposed that if an entity is treated as an insurance company under subchapter L or is treated as a QIC under section 1297(f), it should be deemed to be engaged in the active conduct of an insurance business without meeting any additional requirements.

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

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

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

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

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

### *B. Qualifying domestic insurance corporations*

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

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

threshold. Accordingly, the 2020 NPRM proposes a new limitation.

The final regulations also clarify that a U.S. insurance company must be a look-through subsidiary in order to qualify as a QDIC. If a QDIC is a look-through subsidiary of a QIC, the QIC's proportionate share of the QDIC's assets that is treated as non-passive may be subject to limitation under the special look-through rule provided in §1.1297-6(d), which is described in Part VI.C of this Summary of Comments and Explanation of Revisions. Because of the renumbering of sections described in Part VI.A of this Summary of Comments and Explanation of Revisions, the QDIC rules are now contained in §1.1297-6(b)(2), (c)(2), and (e)(1) of the final regulations.

### *C. Treatment of income and assets of certain look-through subsidiaries and look-through partnerships held by a QIC*

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

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

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

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

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

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

#### VII. *Comments and Revisions to Proposed §1.1298-4 – Rules for certain foreign corporations owning stock in 25-percent-owned domestic corporations*

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

##### *A. Interaction of the domestic subsidiary rule and section 1298(a)(2) attribution rule*

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

Several comments recommended that the final regulations eliminate the domestic subsidiary attribution rules in proposed §§1.1291-1(b)(8)(ii)(B) and 1.1298-4(e). These comments asserted that Congress intended for stock that is treated as

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

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

tion rules. Therefore, the domestic subsidiary attribution rules are eliminated in the final regulations.

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

##### *B. Revisions to domestic subsidiary anti-abuse rules*

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

##### *1. Qualified Stock Anti-Abuse Rule*

Several comments requested that the qualified stock anti-abuse rule in proposed §1.1298-4(f)(1) be withdrawn. These comments asserted that Congress was aware of the potential for taxpayers to rely on section 1298(b)(7) to avoid PFIC status by treating otherwise passive investments as non-passive and intended for the accumulated earnings tax (“AET”) to mitigate potential abuse. The comments argued that the AET imposed on the tested foreign corporation, the U.S. corporate tax imposed on the domestic subsidiaries, and the withholding tax imposed on dis-

tributions to the tested foreign corporation serve to discourage a tested foreign corporation from artificially overweighting its investment assets held through domestic subsidiaries. Another comment asserted that the qualified stock anti-abuse rule creates a hypothetical PFIC test that supersedes the statute when it causes a tested foreign corporation to be a PFIC in a fact pattern in which the domestic subsidiary rule in section 1298(b)(7) would otherwise cause the tested foreign corporation to not be a PFIC.

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

## 2. Principal Purpose Anti-Abuse Rule

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

One comment noted that the 25-percent-owned domestic corporation is likely to be a holding company without an active trade or business and, thus, the tested foreign corporation would likely be deemed

to have a principal purpose of avoiding PFIC classification. Another comment argued that the standard for deeming a principal purpose of avoiding PFIC status to exist is misguided because a corporation need not be engaged in an active trade or business in order to generate non-passive income. Other comments expressed concern that the principal purpose anti-abuse rule would disallow planning to manage the PFIC risk of start-up companies and active companies undergoing transition.

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

Section 1298(g) provides authority to prevent abuse of the PFIC rules. Moreover, the Treasury Department and the IRS have determined that the comments did not appreciate the underlying facts of the private letter rulings and that the promulgation of the principal purpose anti-abuse rule is not inconsistent with the private letter rulings.

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

on safe harbors to address those concerns is proposed in the 2020 NPRM. See proposed §1.1298-4(e)(2) and (e)(3).

### VIII. *Comments and Revisions Regarding Applicability Dates*

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

#### *A. Applicability dates relating to the PFIC insurance exception*

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

Sections 1.1297-4(g) and 1.1297-6(f) therefore provide that the final PFIC insurance regulations apply to taxable years

beginning on or after January 14, 2021. Taxpayers may choose to apply the final PFIC insurance regulations to any taxable year beginning after December 31, 2017, provided that all of those rules are applied consistently with respect to that tested foreign corporation for the same year and all succeeding taxable years.

#### *B. Applicability dates relating to other rules*

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

The Treasury Department and the IRS agree that the once-a-PFIC, always-a-PFIC rule is implicated, because in some cases these regulations may cause a test-

ed foreign corporation that was previously a PFIC with respect to a shareholder to not satisfy the Asset Test or Income Test going forward and therefore to become a “former PFIC” as defined in §1.1291-9(j)(2)(iv), but the foreign corporation would still be treated as a PFIC with respect to the shareholder by reason of the once-a-PFIC, always-a-PFIC rule. The Treasury Department and the IRS do not agree that taxpayers subject to the once-a-PFIC, always-a-PFIC rule should be permitted to avoid the need to file amended returns or to make an election under section 1298(b)(1) and §1.1298-3 (“purging election”). The possible applicability dates of the final regulations do not include closed years, and the Treasury Department and the IRS do not believe that it would be appropriate for the final regulations to apply in whole or part to closed years for purposes of alleviating the effects of the once-a-PFIC, always-a-PFIC rule. For example, providing the relief requested by commenters would afford a benefit to taxpayers that invested in a tested foreign corporation treated as a section 1291 fund in a now-closed year and continue to hold the stock compared to taxpayers that acquired the stock of the tested foreign corporation at the same time but sold the stock in a now-closed year, which may be viewed as unfair. If the tested foreign corporation would not be treated as a PFIC under the proposed regulations or the final regulations, the taxpayers who sold the stock during a closed year may have been subject to tax under section 1291 on an excess distribution while taxpayers who continue to hold the stock would be spared taxation under section 1291.

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

However, in light of the issues raised by commenters, the Treasury Department and the IRS have concluded that it is appropriate to provide taxpayers with some flexibility in choosing if and when to end PFIC treatment by causing a former PFIC to no longer be subject to the once-a-PFIC, always-a-PFIC rule. Under current law, a shareholder seeking to end PFIC treatment as a result of a change of facts or law would need to make a purging election under section 1298(b)(1) and §1.1298-3(b) or (c) on Form 8621 attached to the shareholder's tax return (including an amended return filed within three years of the due date, as extended under section 6081, of the original return for the election year), or request the consent of the Commissioner to make an election with respect to a closed taxable year under section 1298(b)(1) and §1.1298-3(e) ("late purging election") on Form 8621-A. A timely purging election under section 1298(b)(1) and §1.1298-3(b) or (c) may be made if the tested foreign corporation ceased to qualify as a PFIC under the Income Test and the Asset Test in an open taxable year, but the election would not affect the treatment of the tested foreign corporation as a PFIC in the earliest open year because it takes effect at the end of the year for which the election is made, as described in the next paragraph. If the tested foreign corporation ceased to qualify as a PFIC at the beginning of the earliest open year, the shareholder may request the consent of the Commissioner to make a late purging election, as described in the next paragraph.

When a deemed sale purging election is made, the stock of the former PFIC is deemed sold for its fair market value on the last day of the last taxable year of the tested foreign corporation during which it qualified as a PFIC (the "termination date"). See §1.1298-3(b)(2) and (d). Accordingly, a taxpayer that files a timely deemed sale purging election for an open taxable year is treated as selling the stock of the PFIC at the end of the tested foreign corporation's taxable year, and accordingly the shareholder is subject to the PFIC rules with respect to that stock during its relevant taxable year and any prior open years. If the taxpayer wishes to end PFIC treatment as of its earliest open taxable year, it must request the consent of the

Commissioner to make a late purging election taking effect as of the end of the tested foreign corporation's taxable year in the taxpayer's most recent closed taxable year. For example, if a taxpayer had chosen to apply the proposed regulations to its earliest open taxable year with respect to a tested foreign corporation that has the same taxable year and that qualified as a PFIC in closed taxable years, and the application of the proposed regulations resulted in the tested foreign corporation no longer qualifying as a PFIC, to prevent PFIC treatment from continuing into that earliest open taxable year and beyond the taxpayer would have had to request the consent of the Commissioner to make a late purging election by filing Form 8621-A for the year immediately preceding its first open taxable year. See also §1.1298-3(c) (deemed dividend purging election available if former PFIC was a CFC during its last taxable year that it qualified as a PFIC). The result of both timely and late purging elections with respect to former PFICs is that the shareholder's holding period resets solely for PFIC purposes, such that the shareholder is treated as no longer holding stock of a foreign corporation that was ever a PFIC during the shareholder's holding period, so the once-a-PFIC, always-a-PFIC rule no longer applies.

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

Given these considerations, a taxpayer may choose to apply the final regulations (other than the rules related to the PFIC insurance exception), with respect to a particular tested foreign corporation, to any open taxable year of the taxpayer, pro-

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

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

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

### **Effect on Other Documents**

The eighth (concerning the average value of assets for purposes of the Asset Test), ninth (concerning the characterization of assets for purposes of the Asset

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

## Special Analyses

### *I. Regulatory Planning and Review – Economic Analyses*

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

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

#### *A. Background*

Various provisions of the tax code allow tax on certain sources of income to be deferred, which means that the income is not taxed when it is earned but at some later date, based on specific events or conditions. Tax deferral is advantageous to taxpayers because the taxpayer can in the meantime earn a return on the amount that would otherwise have been paid as tax. Prior to the Tax Cuts and Jobs Act (TCJA), income earned abroad

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

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

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

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

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

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

The Treasury Department and the IRS previously published proposed regulations pertaining to the PFIC regime and

changes due to TCJA (the proposed regulations.) See 84 FR 33120.

### B. Need for the final regulations

The final regulations are needed because many of the terms and calculations required for the determination of PFIC status would benefit from greater specificity. The final regulations provide such details so that taxpayers can readily and accurately determine if their investment is in a PFIC, given the significant tax consequences of owning a PFIC. The regulations further resolve ambiguities in determining ownership of a PFIC and in the application of the PFIC Income and Asset Tests. These final regulations are also needed to respond to comments received on the proposed regulations.

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

### C. Overview

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

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

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

### D. Economic analysis

#### 1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of the final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these final regulations.

#### 2. Summary of Economic Effects

The final regulations provide certainty and consistency in the application of sections 1297 and 1298 of the Internal Revenue Code with respect to passive foreign investment companies and qualifying insurance corporations by providing definitions and clarifications regarding the statute’s terms and rules. In the absence of such guidance, the chances that different U.S. owners (or potential owners) of foreign companies would interpret the statute differentially (either differently from each other or distinct from the intent and purpose of the statute) would be exacerbated. This divergence in interpretations could cause U.S. investors to choose investment vehicles based on different interpretations of the statute rather than on different economic prospects. For example, one investor might undertake an investment opportunity that another investor might forego based on different interpretations of how the income from that investment would be treated under

the Code. When economic investment is not guided by uniform incentives across otherwise similar investors and otherwise similar investments, the resulting pattern of investment will generally be inefficient. Thus, in the context of U.S. investment in foreign corporations, the final regulations help to ensure that similar economic activities, representing similar passive and non-passive attributes, are taxed similarly. The Treasury Department and the IRS expect that the definitions and guidance provided in the final regulations will lead to an improved allocation of investment among U.S. taxpayers, contingent on the overall Code.

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

As a result of the first set of provisions, some corporations that may not have had PFIC status under the baseline may be treated for tax purposes as PFICs under the final regulations. In response to such provisions, some foreign companies that are close to qualifying as a QIC, for example, may take steps to adjust operations to ensure that they meet the QIC qualifications.<sup>5</sup> Other foreign companies may not be able to profitably undertake these actions, possibly because of the business’s structure or the local regulatory environment and thus would now be treated as a PFIC. Yet other foreign companies, particularly those that are not reliant on U.S. investors, may also remain (following these regulations) classified for U.S. tax purposes as PFICs. The Treasury Department and the IRS expect that in these latter two cases, current U.S. owners will largely continue to retain their holdings of these companies but future investors may turn to other foreign corporations that are not classified as PFICs under the final regulations or to domestic investments.

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

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

As a result of the second set of provisions (those that expand opportunities for foreign companies to avoid PFIC status relative to the no-action baseline), some corporations that may have had PFIC status under the baseline may be determined not to be PFICs under the final regulations. This expansion of the pool of non-PFIC investment opportunities can be expected to raise the after-tax return to U.S. investors relative to the no-action baseline and, to the extent that investors increase their investment in foreign non-PFICs as a substitute for domestic investment, U.S. tax revenue may fall. These effects again also change the amount and nature of risk in the affected investors' portfolios and in an undetermined direction.

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

istrative burden that would arise under the final regulations or the no-action baseline because they do not have readily available data or models that capture these aspects in sufficient detail.

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

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

#### a. Treatment of look-through subsidiaries and look-through partnerships

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

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

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

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

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

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

An aggregate approach to LTPs could allow TFCs that hold significant amounts of passive investment assets to purchase sufficient amounts of minority investment interests in active business partnerships so as to increase the TFC's non-passive assets and income to levels that enable the TFC to avoid PFIC status. Thus, the purpose of the PFIC regime could be mean-

ingly defeated, especially if foreign corporate subsidiaries chose to be treated as partnerships for this purpose.

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

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

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

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

#### b. Attribution of activities for look-through entities

The definition of passive income contains exceptions for certain income that is derived in the active conduct of a trade or business or is a gain or loss from the sale of certain business property. Under the look-through rules of the statute and these final regulations, a tested foreign corporation is treated as if it holds its proportionate share of the income and assets of its look-through subsidiaries (LTSS) and look-through partnerships (LTPs), where a 25 percent ownership requirement is needed to define such entities. Further, the passive or non-passive character of the at-

tributed income or assets is determined in the hands of the LTS or LTP. However, for legal or commercial reasons, some businesses structure their organizations to have all employees in one foreign corporation, say FC1, while the assets of the business are held in, and income is received by, another foreign corporation, say FC2. Without attribution of the business activities of FC1 to FC2, the assets and income of the latter corporation do not qualify for an exception from the definition of passive income. This can result in FC1 being designated as a PFIC even though its income and assets would be treated as non-passive if FC1 and FC2 were considered as a single entity.

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

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

Under the second option, activities of LTSS and LTPs could be attributed to a TFC in a manner similar to the look-through rules. The look-through rules attribute assets and income of a look-through entity to its owner on a proportionate share basis. There are some difficulties applying

this concept in the context of attribution of activities. While income and assets can be allocated between owners based on their ownership percentages, activities are not as easily allocated among multiple owners. The purpose of activity attribution, in combination with the look-through rules, is effectively to treat the corporations as a single commercial enterprise; that is, as an affiliated group of corporations. But affiliation in this sense usually demands a recognition of a unified business purpose and combined business activity. The typical thresholds in the Code for treating related parties as members of an affiliated or consolidated or similar group are more than 50 percent and 80 percent thresholds, not 25 percent.

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

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

The final regulations modify the proposed regulations in two respects. First, they extend the application of the provision to other items of income other than rents and royalties that would be excluded from passive income if the income is earned in the active conduct of a trade or business. Second, they expand the types of affiliated entities from which activities could be attributed. Under these rules, an entity is deemed to be engaged in the active conduct of a trade or business by taking into account the activities performed

by the officers and employees of the TFC as well as activities performed by the officers and employees of any qualified affiliate of the tested foreign corporation. For this purpose, a qualified affiliated group is defined using an affiliation standard of more than 50 percent. In addition, the group includes only LTSs and LTPs of the parent entity, and the parent entity must be a foreign corporation or partnership. This rule allows the LTS that holds the relevant assets in the preceding example to avoid PFIC status and extends the attribution rules to activities of sibling and parent companies of the TFC.

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

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

##### a. Description of the PFIC insurance exception

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

and health insurance reserves and unpaid claims with respect to contracts providing coverage for mortality or morbidity risks.

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

##### b. Discounting of applicable insurance liabilities

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

To address the discounting of AIL in situations where the foreign corporation’s AFS was not prepared on the basis of GAAP or IFRS, the proposed regulations provided that in situations where the taxpayer’s AFS does not discount reserves on an economically reasonable basis, then the amount of AIL would be reduced in accordance with the discounting principles that would have applied under GAAP or IFRS.

The foreign corporation could choose whether to apply either GAAP or IFRS for this purpose. In view of comments received, the Treasury and the IRS reconsidered these requirements.

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

As a second alternative, the Treasury Department and the IRS considered capping the amount of AIL at the amounts that would be permitted to a domestic insurance company under the Internal Revenue Code; these amounts would have been discounted according to the relevant rules. This approach would be considerably more burdensome to a foreign corporation than other regulatory alternatives because, as a practical matter, it would require foreign corporations to apply complex U.S. tax rules with which they are likely not familiar. An excessive compliance burden on foreign corporations not subject to U.S. taxation would make it less likely that they would do the work necessary to enable their minority U.S. owners to determine if the corporation is a PFIC. Thus, this alternative was rejected because it was not reasonable to require foreign companies to recalculate insurance liabilities based on U.S. law requirements and it could unduly inhibit U.S. investors from investing in foreign corporations that are legitimate active insurance companies, an activity that is economically beneficial under the intent and purpose of the statute.

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

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

The Treasury Department and the IRS have not estimated the amounts that U.S. shareholders might invest in foreign insurance companies with or without the discounting requirement because they do not have a model with this level of specificity. However, because the rule is quite flexible, the Treasury Department and the IRS project that the discounting requirement will not represent a significant cost burden for foreign corporations and thus will not have any meaningful effect on investment patterns by U.S. shareholders relative to the no-action baseline.

#### c. Issues related to the alternative facts and circumstances test

Under the statute, a foreign corporation that fails the 25 percent AIL-to-total assets test (but satisfies the 10 percent AIL-to-total asset test) may still be treated as a QIC if it satisfies a “facts and circumstances test,” which requires that (1) the corporation is predominantly engaged in an insurance business, and (2) the failure to have AIL in excess of 25 percent of total assets is due solely to runoff-related or rating-related circumstances involving the corpo-

ration’s insurance business. Each of these items would benefit from guidance that provides further clarification of the terms involved.

#### i. Runoff-related circumstances

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

The Treasury Department and the IRS considered whether runoff-related circumstances should be limited to insurance companies that plan to terminate their business operations, as was required under the proposed regulations, or whether it should also include situations in which (1) an insurance company is merely shifting the focus of its business and running off contracts from an “old” business that it had entered into in the past, or (2) an insurance company acquires and manages insurance business that is in runoff, but the company itself does not have a plan of termination. Stated another way, this issue is whether or why an insurance company described in either of these two situations would require assets that are more than four times the company’s AIL. For example, foreign companies facing a planned termination may be required by foreign regulators to hold additional capital and assets relative to their insurance liabilities in order to ensure that those liabilities will be satisfied when the companies are no longer able to rely on new business or new inflows of equity or debt to bolster cash flows from which to pay claims. This additional capital may not be needed by ongoing firms in either of the two situations described above. Unfortunately, no comments on the proposed regulations

presented data or other information that address this issue.

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

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

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

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

## ii. Rating-related circumstances

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

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

The final regulations restrict the application of the provision to a foreign corporation for which more than half of its net written premiums for the annual reporting period (or the average net written premiums over the current year and preceding two years) are from insurance coverage against the risk of loss from a catastrophic event. Such insurance is characterized by relatively frequent “good” years in which

accumulated assets must be accrued as capital and surplus in order to provide sufficient funds to handle the relatively infrequent “bad” years in which losses are exceptionally large. Because unpaid loss reserves qualifying as AIL are limited to amounts that represent losses that have already been incurred prior to the end of the accounting period (whether or not a claim has been made), such reserves do not reflect the unknown future losses of the “bad” years.

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

The final regulations also apply the rating-related circumstances provision to financial guaranty insurance companies.

Financial guaranty insurance is a line of insurance business in which an insurer guarantees scheduled payments of interest and principal on a bond or other debt security in the event of issuer default. The policyholder of a financial guaranty insurer is effectively paying for use of the insurer's credit rating. For example, if a municipality insures its municipal bond obligations with a financial guarantee insurer, the municipality can charge a lower interest rate on its bond, because the obligation is effectively supported by the insurer's high credit rating. A very high credit rating is thus essential for a financial guarantee insurer to write new business. Furthermore (and similar to mortgage guaranty insurers), rating agency capital standards for financial guaranty insurers are geared to ensuring capital adequacy in times of crisis and may require a higher level of capital to obtain the same rating as an insurer with a different portfolio of risks. The combination of enhanced rating agency capital requirements and the need for a very high credit rating to write new business often results in a financial guaranty insurer being required at times to hold assets in excess of 400 percent of current insurance liabilities. The final regulations provide that a financial guaranty insurance company that fails the 25 percent test is deemed to automatically satisfy the rating-related circumstances requirement, but it must still satisfy the 10 percent test in order to be treated as a QIC. The Treasury Department and the IRS project that the final regulations will more accurately identify those insurance businesses whose activities are economically similar to the activities targeted by Congress in creating the PFIC insurance exception and the alternative facts and circumstances election for QIC treatment.

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

### iii. Requirements for making the facts and circumstances election and relief for small shareholders

Under the statute, a U.S. shareholder must make an election in order to treat a

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

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

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

The Treasury Department and the IRS considered not providing such a deemed election by small shareholders but decided

that the reduction in compliance burden that the deemed election would provide outweighed the tax administrative benefit that a requirement for an explicit election would provide. For example, under an explicit election, the IRS would know with certainty that the taxpayer has made the election.

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

### d. Passive income exception for income and assets of QIC look-through entities

Under the statute, passive income does not include income derived in the active conduct of an insurance business by a QIC, and assets held to produce such income are treated as assets that produce non-passive income. The final regulations contain rules to clarify the application of this rule. For example, certain companies structure their insurance operations by placing some or all of their investment assets in one or more lower-tier investment corporations or partnerships while investment managers are employed by the QIC or by a related or unrelated service provider. In these cases, unless there is an attribution of non-passive status to the income and assets of the lower-tier affiliated company, the QIC exclusion granted to income earned by the "active" entity is somewhat meaningless.

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

QIC's insurance business and such assets are available to satisfy liabilities of the QIC's insurance business ("look-through recharacterization rule").

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

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

was not available. A beneficial aspect of the rule, however, was that it treated QICs that chose to place their investment assets in a wholly-owned subsidiary (which would generally be consolidated with the QIC for financial statement purposes) in the same manner as QICs that conducted their insurance operations and held their investment assets in a single corporation.

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

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

Whenever the QIC's subsidiary has liabilities, this rule will likely limit the amount of the subsidiary's assets and income that are treated as non-passive under

the look-through recharacterization rule, in which case the QIC would have a greater value of non-passive assets if it operated instead as a single corporation. However, the value of total assets used in the 25 percent test would also be correspondingly higher in that case, perhaps making it less likely for the foreign insurance company to satisfy the 25 percent test.

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

## 5. Number of Affected Taxpayers

A U.S. person must generally file a separate Form 8621 for each PFIC for which it has an ownership interest. Exceptions currently exist for persons that indirectly own PFIC stock through another U.S. shareholder of a PFIC, unless such persons are required to report PFIC income or need to file a Form 8621 in order to make an election. Further exceptions exist under current rules, including exemptions for tax-exempt entities and for taxable U.S. shareholders owning less than \$25,000 in aggregate PFIC stock (\$50,000 if filing a joint return) that is not owned through another U.S. shareholder of a PFIC or through another PFIC (unless such shareholders are required to report PFIC income or need to file a Form 8621 in order to make an election).

The accompanying table indicates how many persons have filed at least one Form 8621 between 2016 and 2018 based on currently available IRS master files of tax return filings. To date, nearly 62,000 Forms 8621 have been filed for 2018. Over 70 percent of the filings are individuals. Another 27 percent are pass-

through entities, the overwhelming number of which are partnerships, but which also include S corporations, estates, and non-grantor trusts. These pass-through entities primarily have individuals as

partners, shareholders, or beneficiaries, but may also have corporate partners. It is likely there is some double counting whereby both partnerships and partners are filing a Form 8621 for the same

PFIC. C corporations constitute just over one percent of these filings. Just under two percent of Forms 8621 do not identify on the form the filing status of the filer.

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

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

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

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

## II. Paperwork Reduction Act

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

### A. Collections of information under existing tax forms

The collections of information in §1.1297-1(d)(1)(ii)(B), (d)(1)(iii), and (d)(1)(iv) are required to be provided by taxpayers that make an election or revoke an election to use an alternative measuring period or adjusted bases to measure assets for purposes of the Asset Test with respect to a foreign corporation. These collections of information are satisfied by filing Form 8621 or attachments thereto. For purposes of the Paperwork Reduction Act, 44 U.S.C. 3501 et seq. (“PRA”), the reporting burden associated with the collection of information in the Form 8621 will be reflected in the Paperwork Reduction Act Submission associated with that form (OMB control number 1545-1002). If a Form 8621 is not required to be filed, the collections of information under §1.1297-1(d)(1)(ii)(B), (d)(1)(iii), and (d)(1)(iv) are satisfied by attaching a statement to the taxpayer’s return. For purposes of the PRA, the reporting burden associated with these collections of information will be reflected in the Paper-

work Reduction Act Submissions associated with Forms 990-PF and 990-T (OMB control number 1545-0047); Form 1040 (OMB control number 1545-0074); Form 1041 (OMB control number 1545-0092); Form 1065 (OMB control number 1545-0123); and Forms 1120, 1120-C, 1120-F, 1120-L, 1120-PC, 1120-REIT, 1120-RIC, and 1120-S (OMB control number 1545-0123).

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

The collection of information in §1.1297-4(d)(5)(iii) requires a United States person to make an election with respect to an eligible foreign corporation under section 1297(f)(2) by completing the appropriate part of Form 8621 (or successor form) for each taxable year of the United States person in which the election applies. In response to comments, §1.1297-4(d)(5)(iv) generally provides that any United States person that owns stock in a publicly traded foreign corporation eligible for the election with a value of \$25,000 or less (\$50,000 or less if a joint return) is deemed to make the election under section 1297(f)(2) without the need to file Form

8621. This rule is intended to provide relief to small shareholders who may not be aware that an election is required. In addition, §1.1297-4(d)(5)(iii) provides that the election under section 1297(f)(2) may be made on an amended return.

The collection of information in §1.1297-4(d)(5)(iii) is satisfied by filing Form 8621. For purposes of the PRA, the reporting burden associated with the collection of information in the Form 8621 will be reflected in the Paperwork Reduction Act Submission associated with Form 8621 (OMB control number 1545-1002).

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

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

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

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

The current status of the PRA submissions related to the tax forms on which reporting under these regulations will be required is summarized in the following table. The burdens associated with the information collections in the forms are included in aggregated burden estimates for the OMB control numbers 1545-0047 (which represents a total estimated burden time for all forms and schedules for tax-exempt entities of 50.5 million hours and total estimated monetized costs of \$3.59 billion (\$2018)), 1545-0074 (which represents a total estimated burden time for all forms and schedules for individuals of 1.784 billion hours and total estimated monetized costs of \$31.764 billion (\$2017)), 1545-0092 (which represents a total estimated burden time for all forms and schedules for trusts and estates of 307.8 million hours and total estimated

monetized costs of \$9.95 billion (\$2016)), and 1545-0123 (which represents a total estimated burden time for all forms and schedules for corporations of 3.157 billion hours and total estimated monetized costs of \$58.148 billion (\$2017)). The burden estimates provided in the OMB control numbers in the following table are aggregate amounts that relate to the entire package of forms associated with the OMB control number, and will in the future include, but not isolate, the estimated burden of only those information collections associated with these final regulations. These numbers are therefore unrelated to the future calculations needed to assess the burden imposed by these regulations. To guard against over-counting the burden that international tax provisions imposed before the Act, the Treasury Department and the IRS urge readers to recognize that

these burden estimates have also been cited by regulations (such as the foreign tax credit regulations, 84 FR 69022) that rely on the applicable OMB control numbers in order to collect information from the applicable types of filers.

In 2018, the IRS released and invited comment on drafts of Forms 990-PF (Return of Private Foundation or Section 4947(a)(1) Trust Treated as Private Foundation), 990-T (Exempt Organization Business Income Tax Return), 1040 (U.S. Individual Income Tax Return), 1041 (U.S. Income Tax Return for Estates and Trusts), 1065 (U.S. Return of Partnership Income), 1120 (U.S. Corporation Income Tax Return), and 8621 (Return by a Shareholder of a Passive Foreign Investment Co. or Qualified Electing Fund). The IRS received comments only regarding Forms 1040, 1065, and 1120 during the

<sup>6</sup>Upper bound estimates of the number of filers who will file attachments to specific tax forms are derived by multiplying the number of filers shown in the Table in I.D.4. by 10 percent, for each filing status. The Table in I.D.4 shows that there were 43,406 individuals, 16,607 passthrough entities, 739 corporations, and 1,084 unknown filers who filed Form 8621 in 2018 using currently available filings, for a total of 61,836 filers.

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

The Treasury Department and the IRS have not estimated the burden for any

new information collections arising from either the Act or these final regulations. The Treasury Department and the IRS request comment on all aspects of information collection burdens related to the final regulations. In addition, when available,

drafts of IRS forms are posted for comment at <https://apps.irs.gov/app/picklist/list/draftTaxForms.htm>.

Form	Type of Filer	OMB Number(s)	Status
Forms 990	Tax exempt entities (NEW Model)	1545-0047	Approved by OIRA 2/12/2020 until 2/28/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201912-1545-014">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201912-1545-014</a>		
Form 1040	Individual (NEW Model)	1545-0074	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201909-1545-021</a>		
Form 1041	Trusts and estates	1545-0092	Approved by OIRA 5/08/2019 until 5/31/2022.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201806-1545-014</a>		
Form 1065 and 1120	Business (NEW Model)	1545-0123	Approved by OIRA 1/30/2020 until 1/31/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201907-1545-001</a>		
Form 8621	Share-holders	1545-1002	Approved by OIRA 12/31/2018 until 12/31/2021.
	Link: <a href="https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201805-1545-007">https://www.reginfo.gov/public/do/PRAViewICR?ref_nbr=201805-1545-007</a>		

**B. Collections of information generally not included on existing forms**

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

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

The collection of information in §1.1297-4(d)(5)(i) and (ii) is required for a foreign corporation for which a taxpayer makes an election under section 1297(f)(2). In response to comments addressing the notice of proposed rulemaking preceding the final regulations, the Treasury

Department and the IRS have revised the collection of information from foreign corporations with respect to section 1297(f)(2). The collection of information under §1.1297-4(d)(5)(i) and (ii) requires a foreign corporation to provide a statement to a shareholder or make a statement publicly available. In response to comments, §1.1297-4(d)(5)(i) permits a foreign parent corporation to make a publicly available statement on behalf of its subsidiaries.

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

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

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

**III. Regulatory Flexibility Act**

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

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

A U.S. person must generally file a separate Form 8621 for each PFIC for which it has an ownership interest. To date, nearly 62,000 Forms 8621 have been filed for 2018. Over 70 percent of the filings are individuals. Another 27 percent are pass-through entities, the overwhelming number of which are partnerships, but which also include S corporations, estates, and non-grantor trusts. These pass-through entities primarily have individuals as partners, shareholders, or beneficiaries, but may also have corporate partners. It is likely there is some double counting whereby both partnerships and partners are filing a Form 8621 for the same PFIC. C corporations constitute just over one

percent of these filings. Nearly two percent of Forms 8621 do not identify the filing status of the filer.

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

To provide a bound on the impact of these regulations on businesses, the Treas-

ury Department and the IRS calculated the ratio of the PFIC regime tax to (gross) total income for 2013 through 2018 for C corporations that filed the Form 8621. Total income was determined by matching each C corporation filing the Form 8621 to its Form 1120. Ordinary QEF income, QEF capital gains, and mark-to-market income were assumed to be taxed at 35 percent (21 percent for 2018), and the section 1291 tax and interest charge were included as reported. Only those corpora-

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

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

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

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

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

Accordingly, it is hereby certified that the final rule would not have a significant economic impact on a substantial number of small entities. Pursuant to

section 7805(f), the proposed regulations preceding these final regulations (REG-105474-18) were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business. The proposed regulations also solicited comments from the public on both the number of entities affected (including whether specific industries are affected) and the economic impact of this proposed rule on small entities. No comments were received.

#### IV. *Unfunded Mandates Reform Act*

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

or by the private sector in excess of that threshold.

#### V. *Executive Order 13132: Federalism*

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

#### VI. *Congressional Review Act*

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

## Statement of Availability of IRS Documents

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

## Drafting Information

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

## List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

## Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1—INCOME TAXES

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

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

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

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

\* \* \* \* \*

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

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

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

\* \* \* \* \*

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

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

\* \* \* \* \*

Par. 2. Section 1.1291-0 is amended by:

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

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

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

The revisions and additions read as follows:

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

\* \* \* \* \*

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

\* \* \* \* \*

(b) \* \* \*

(8) \* \* \*

(iv) Successive application.

(v) Examples.

(A) Example 1.

(1) Facts.

(2) Results.

(i) Treatment of DC.

(ii) Treatment of A.

(B) Example 2.

(1) Facts.

(2) Results.

(C) Example 3.

(1) Facts.

(2) Results.

(D) Example 4.

(1) Facts.

(2) Results.

\* \* \* \* \*

Par. 3. Section 1.1291-1 is amended by:

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

2. Adding new paragraph (b)(8)(iv).

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

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

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

6. Revising paragraph (j)(3).

7. Adding paragraph (j)(4).

The revisions and additions read as follows:

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

\* \* \* \* \*

(b) \* \* \*

(8) \* \* \*

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

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

(A) *Example 1—(1) Facts.* A is a United States person who owns 49% of the stock of FC1, a foreign corporation that is not a PFIC, and separately all of the stock of DC, a domestic corporation that is not an S corporation. DC, in turn, owns the remaining 51% of the stock of FC1, and FC1 owns 100 shares of stock in a PFIC that is not a controlled foreign corporation (CFC) within the meaning of section 957(a). The remainder of the PFIC's shares are owned by unrelated foreign persons.

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

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

owning all 100 shares of PFIC stock held by FC1. However, because 51 shares of the PFIC stock held by FC1 are indirectly owned by DC under paragraph (b)(8)(ii)(A) of this section, pursuant to the limitation imposed by paragraph (b)(8)(ii)(C)(2) of this section, only the remaining 49 shares of the PFIC stock are considered as indirectly owned by A under paragraph (b)(8) of this section.

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

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

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

(2) *Results.* Under paragraph (b)(8)(iii)(A) and (b)(8)(iv) of this section, for purposes of determining whether B is a shareholder of FC3, B is considered to actually own 40% (40% x 100%) of the stock of FC1 and 20% (40% x 50%) of the stock of FC2, and thus is not considered to own 50% or more of the stock of FC1 or FC2. Under paragraphs (b)(8)(ii)(A) and (b)(8)(iv) of this section, B is not considered to own any stock of FC3 indirectly through FC1 or FC2.

(D) *Example 4—(I) Facts.* The facts are the same as in paragraph (b)(8)(v)(C)(I) of this section (the facts in *Example 3*), except that FP owns only 80% of FC1 and B also directly owns 20% of FC1.

(2) *Results.* Under paragraph (b)(8)(iii)(A) and (b)(8)(iv) of this section, for purposes of determining whether B is a shareholder of FC3, B is considered to own 32% (40% x 80%) of the stock of FC1 and 20% (40% x 50%) of the stock of FC2. Because B directly owns 20% of FC1, B is considered to actually own 52% (32% + 20%) of the stock of FC1 in total. Under paragraphs (b)(8)(ii)(A) and (b)(8)(iv) of this section, B is considered to own 26% (52% x 50%) of the stock of FC3 indirectly through FC1, and thus is a shareholder of FC3 for purposes of the PFIC provisions. B is not considered to own any stock of FC3 indirectly through FC2.

\* \* \* \* \*

(j) \* \* \*

(3) Except as otherwise provided in paragraph (j)(4) of this section, para-

graphs (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)(iv) and (b)(8)(v)(A), (B), (C), and (D) of this section apply for taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such paragraphs for any open taxable year beginning before January 14, 2021, provided that, with respect to a tested foreign corporation, the shareholder consistently applies such paragraphs and the provisions of §1.1297-1 (except that consistent treatment is not required with respect to §1.1297-1(c)(1)(i)(A)), 1.1297-2, 1.1297-4, 1.1297-6, 1.1298-2, and 1.1298-4 for such year and all subsequent years.

Par. 4. Section 1.1297-0 is amended by revising the introductory text and adding entries for §§1.1297-1, 1.1297-2, 1.1297-4, 1.1297-5, and 1.1297-6 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, 1.1297-5, and 1.1297-6.

*§1.1297-1 Definition of passive foreign investment company.*

- (a) Overview.
- (b) Dividends included in gross income.
  - (1) General rule.
  - (2) Example.
    - (i) Facts.
    - (ii) Results.
  - (c) Passive income.
    - (1) Foreign personal holding company income.
      - (i) General rule.
      - (ii) Determination of gross income or gain on a net basis for certain items of foreign personal holding company income.
    - (iii) Amounts treated as dividends.
  - (2) [Reserved].
  - (3) Passive treatment of dividends and distributive share of partnership income.
  - (4) Exception for certain interest, dividends, rents, and royalties received from a related person.

- (i) In general.
- (ii) Ordering rule.
- (iii) Allocation of interest.
- (iv) Allocation of dividends.
  - (A) In general.
  - (B) Dividends paid out of current earnings and profits.
  - (C) Dividends paid out of accumulated earnings and profits.
  - (v) Allocation of rents and royalties.
  - (vi) Determination of whether amounts are received or accrued from a related person.
    - (vii) Allocation of distributive share of income from related partnership.
- (d) Asset test.
  - (1) Calculation of average annual value (or adjusted bases).
    - (i) General rule.
    - (ii) Measuring period.
      - (A) General rule.
      - (B) Election to use alternative measuring period.
      - (C) Short taxable year.
    - (iii) Adjusted basis election.
    - (iv) Time and manner of elections and revocations.
      - (A) Elections.
      - (B) Revocations and subsequent elections.
        - (v) Method of measuring assets.
          - (A) Publicly traded foreign corporations.
          - (B) Non-publicly traded controlled foreign corporation.
            - (I) In general.
            - (2) Controlled foreign corporation determination.
              - (C) Other foreign corporations.
                - (I) In general.
                - (2) Lower-tier subsidiaries.
                  - (i) Lower-tier subsidiaries that are publicly traded foreign corporations.
                  - (ii) Lower-tier subsidiaries that are non-publicly traded controlled foreign corporations.
                    - (iii) Other lower-tier subsidiaries.
    - (E) Examples.
      - (I) Example 1.
        - (i) Facts.
        - (ii) Results.
      - (2) Example 2.
        - (i) Facts.
        - (ii) Results.
      - (3) Example 3.

- (i) Facts.
- (ii) Results.
- (2) [Reserved].
- (3) Dual-character assets.
  - (i) General rule.
  - (ii) Special rule when only part of an asset produces income.
  - (iii) Special rule for stock that previously produced income that was excluded from passive income under section 1297(b)(2)(C).
  - (iv) Example.
    - (A) Facts.
    - (B) Results.
- (4) Passive treatment of stock and partnership interests.
  - (5) Dealer property.
  - (e) Stapled stock.
  - (f) Definitions.
    - (1) Measuring date.
    - (2) Measuring period.
    - (3) Non-passive asset.
    - (4) Non-passive income.
    - (5) Passive asset.
    - (6) Passive income.
    - (7) Publicly traded foreign corporation.
    - (8) Related person.
    - (9) Tested foreign corporation.
  - (g) Applicability date.
    - (1) In general.
    - (2) Paragraph (d)(1)(v)(B)(2) of this section.

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

- (a) Overview.
- (b) General rules.
  - (1) Tested foreign corporation's ownership of a corporation.
  - (2) Tested foreign corporation's proportionate share of the assets and income of a look-through subsidiary.
    - (i) Proportionate share of subsidiary assets.
    - (ii) Proportionate share of subsidiary income.
      - (A) General rule.
      - (B) Partial year.
    - (iii) Coordination of section 1297(c) with section 1298(b)(7).
    - (3) Tested foreign corporation's proportionate share of the assets and income of a look-through partnership.
      - (i) Proportionate share of partnership assets.

- (ii) Proportionate share of partnership income.
  - (A) General rule.
  - (B) Partial year.
  - (4) Examples.
    - (i) Example 1.
      - (A) Facts.
      - (B) Results.
    - (j) LTS.
    - (2) TFC.
      - (ii) Example 2.
        - (A) Facts.
        - (B) Results.
      - (iii) Example 3.
        - (A) Facts.
        - (B) Results.
    - (c) Elimination of certain intercompany assets and income.
      - (1) General rule for asset test.
        - (i) LTS stock.
        - (ii) LTS obligation.
      - (2) General rule for income test.
        - (i) LTS stock.
        - (ii) LTS obligation.
      - (3) Partnerships.
        - (4) Examples.
          - (i) Example 1.
            - (A) Facts.
            - (B) Results.
          - (j) LTS.
          - (2) TFC.
            - (ii) Example 2.
              - (A) Facts.
              - (B) Results.
            - (iii) Example 3.
              - (A) Facts.
              - (B) Results.
            - (iv) Example 4.
              - (A) Facts.
              - (B) Results.
            - (v) Example 5.
              - (A) Facts.
              - (B) Results.
          - (j) Asset test.
          - (2) Income test.
          - (3) Treatment of intangible and rental property.
          - (d) Related person determination for purposes of section 1297(b)(2)(C).
            - (1) General rule.
            - (2) Example.
              - (i) Facts.
              - (ii) Results.
          - (e) Treatment of activities of certain look-through subsidiaries and look-through partnerships for purposes of certain exceptions.

- (1) General rule.
- (2) Qualified affiliate.
  - (3) Examples.
    - (i) Example 1.
      - (A) Facts.
      - (B) Results.
    - (j) Qualified affiliates.
      - (2) FS1 and FS2.
      - (3) FS4.
        - (ii) Example 2.
          - (A) Facts.
          - (B) Results.
        - (iii) Example 3.
          - (A) Facts.
          - (B) Results.
      - (f) Gain on disposition of a look-through subsidiary or look-through partnership.
        - (1) [Reserved].
        - (2) Amount of gain taken into account from disposition of look-through subsidiary.
        - (3) Characterization of residual gain as passive income.
        - (4) Gain taken into account from disposition of 25%-owned partnerships and look-through partnerships.
          - (i) Section 954(c)(4) partnerships.
          - (ii) Look-through partnerships.
        - (5) Examples.
          - (i) Example 1.
            - (A) Facts.
            - (B) Results.
          - (ii) Example 2.
            - (A) Facts.
            - (B) Results.
          - (iii) Example 3.
            - (A) Facts.
            - (B) Results.
        - (g) Definitions.
          - (1) Direct LTS obligation.
          - (2) Indirect LTS obligation.
          - (3) Look-through subsidiary.
          - (4) Look-through partnership.
            - (i) In general.
            - (ii) Active partner test.
              - (A) Partnership interest under asset test.
              - (B) Partnership income under income test.
        - (iii) Election.
        - (iv) Examples.
          - (A) Example 1.
            - (j) Facts.
            - (2) Results.
              - (i) Active partner test with respect to partnership interest.

(ii) Active partner test with respect to partnership income.

(iii) Qualification of look-through partnership.

(B) Example 2.

(1) Facts.

(2) Results.

(i) Active partner test with respect to partnership interest.

(ii) Active partner test with respect to partnership income.

(iii) Failure to qualify as look-through partnership.

(5) LTS debt.

(6) LTS lease.

(7) LTS license.

(8) LTS obligation.

(9) LTS stock.

(10) Qualified affiliate.

(11) Residual gain.

(12) TFC obligation.

(13) Unremitted earnings.

(h) Applicability date.

\* \* \* \* \*

#### *§1.1297-4 Qualifying insurance corporation.*

(a) Scope.

(b) Qualifying insurance corporation.

(c) 25 percent test.

(d) Election to apply the alternative facts and circumstances test.

(1) In general.

(2) Predominantly engaged in an insurance business.

(i) In general.

(ii) Facts and circumstances.

(iii) Examples of facts indicating a foreign corporation is not predominantly engaged in an insurance business.

(3) Runoff-related circumstances.

(4) Rating-related circumstances.

(5) Election.

(i) In general.

(ii) Information provided by foreign corporation.

(iii) Time and manner for making the election.

(iv) Deemed election for small shareholders in publicly traded companies.

(A) In general.

(B) Publicly traded stock.

(v) Options.

(6) Stock ownership.

(e) Rules limiting the amount of applicable insurance liabilities.

(1) In general.

(2) General limitation on applicable insurance liabilities.

(3) Discounting.

(4) [Reserved].

(5) [Reserved].

(f) Definitions.

(1) Applicable financial statement.

(i) GAAP statements.

(ii) IFRS statements.

(iii) Regulatory annual statement.

(iv) [Reserved].

(2) Applicable insurance liabilities.

(i) In general.

(ii) Amounts not specified in paragraph (f)(2)(i) of this section.

(3) Applicable insurance regulatory body.

(4) Applicable reporting period.

(5) Financial guaranty insurance company.

(6) Financial statements.

(i) In general.

(ii) [Reserved].

(iii) [Reserved].

(7) Generally accepted accounting principles or GAAP.

(8) Insurance business.

(9) International financial reporting standards or IFRS.

(10) Mortgage insurance company.

(11) Total assets.

(g) Applicability date.

*§1.1297-5* [Reserved].

#### *§1.1297-6 Exception from the definition of passive income for active insurance income.*

(a) Scope.

(b) Exclusion from passive income of active insurance income.

(c) Exclusion of assets for purposes of the passive asset test under section 1297(a)(2).

(d) Treatment of income and assets of certain look-through subsidiaries and look-through partnerships for purposes of the section 1297(b)(2)(B) exception.

(1) General rule.

(2) Limitation.

(3) Examples.

(i) Example 1: QIC holds all the stock of an investment subsidiary.

(A) Facts.

(B) Result.

(C) Alternative Facts.

(1) Facts.

(2) Result.

(ii) Example 2: QIC holds all the stock of an operating subsidiary.

(A) Facts.

(B) Result.

(e) Qualifying domestic insurance corporation.

(1) General rule.

(2) [Reserved].

(3) [Reserved].

(f) Applicability date.

Par. 5. Sections 1.1297-1 and 1.1297-2 are added to read as follows:

#### *§1.1297-1 Definition of passive foreign investment company.*

(a) *Overview.* This section provides rules concerning the income test set forth in section 1297(a)(1) and the asset test set forth in section 1297(a)(2). Paragraph (b) of this section provides a rule relating to the definition of gross income with respect to certain dividends that are excluded from gross income under section 1502 for purposes of section 1297. Paragraph (c) of this section provides rules relating to the definition of passive income for purposes of section 1297. Paragraph (d) of this section provides rules relating to the asset test of section 1297. See §§1.1297-2 and 1.1297-6 for additional rules concerning the treatment of the income and assets of a corporation subject to look-through treatment under section 1297(c). Paragraph (e) of this section provides rules relating to the determination of passive foreign investment company (PFIC) status for stapled entities. Paragraph (f) of this section provides definitions applicable for this section, and paragraph (g) of this section provides the applicability date of this section.

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

(2) *Example—(i) Facts.* USP is a domestic corporation that owns 30% of TFC, a foreign corporation. The remaining 70% of TFC is owned by FP, a foreign corporation that is unrelated to USP. TFC owns 25% of the value of USS1, a domestic corporation. USS1 owns 80% of the value of USS2, a domestic corporation. USS1 and USS2 are members of an affiliated group (as defined in section 1504(a))

filing a consolidated return. USS2 distributes a dividend to USS1 that is excluded from USS1's income pursuant to §1.1502-13 for purposes of determining the U.S. Federal income tax liability of the affiliated group of which USS1 and USS2 are members.

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

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

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

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

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

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

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

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

(2) [Reserved].

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

(4) *Exception for certain interest, dividends, rents, and royalties received*

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

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

(iii) *Allocation of interest.* For purposes of section 1297(b)(2)(C), interest that is received or accrued, as applicable based on the recipient's method of accounting, from a related person is allocated to income of the related person that is not passive income in proportion to the ratio of the portion of the related person's non-passive gross income for its taxable year that ends with or within the taxable year of the recipient to the total amount of the related person's gross income for the taxable year. If the related person does not have gross income for the taxable year that ends with or within the taxable year of the recipient, the interest is either allocated to income of the related person that is not passive income to the extent the related person's deduction for the interest would be allocable to non-passive income of the related person under the principles of §§1.861-9 through 1.861-13T, applied in a reasonable and consistent manner taking into account the general operation of the PFIC rules and the purpose of sec-

tion 1297(b)(2)(C) or, alternatively, at the election of the tested foreign corporation is treated as allocated entirely to passive income.

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

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

(C) *Dividends paid out of accumulated earnings and profits.* To the extent that a dividend from a related person is treated as paid out of the related person's accumulated earnings and profits, the dividend is treated as paid ratably out of accumulated earnings and profits of the related person for prior taxable years (beginning with the most recently accumulated) that are attributable to passive income and to

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

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

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

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

(d) *Asset test*—(1) *Calculation of average annual value (or adjusted bases)*—(i) *General rule.* For purposes of section 1297, the calculation of the average per-

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

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

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

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

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

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

(B) *Revocations and subsequent elections.* An election described in paragraph (d)(1)(ii)(B) or (d)(1)(iii) of this section made pursuant to paragraph (d)(1)(iv)(A)

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

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

(B) *Non-publicly traded controlled foreign corporation*—(1) *In general.* For purposes of section 1297, the assets of a controlled foreign corporation that is

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

(2) *Controlled foreign corporation determination.* For purposes of section 1297(e)(2)(A) and this paragraph (d)(1)(v), the term *controlled foreign corporation* has the meaning provided in section 957, determined without applying subparagraphs (A), (B), and (C) of section 318(a)(3) so as to consider a United States person as owning stock which is owned by a person who is not a United States person.

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

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

es of applying section 1297(a)(2) to the lower-tier subsidiary as a tested foreign corporation, and for purposes of applying section 1297(a)(2) to a parent foreign corporation with respect to the assets of the lower-tier subsidiary.

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

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

more than one parent foreign corporation, this rule applies separately to measure the assets of the lower-tier subsidiary with respect to each parent foreign corporation.

(D) [Reserved].

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

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

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

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

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

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

(ii) *Results.* For purposes of applying section 1297 to TFC2, the results are the same as in paragraph (d)(1)(v)(E)(2)(ii) (the results in Example 2). For purposes of applying section 1297 to FS2 as a tested foreign corporation with respect to A, the assets of FS2 must be measured using the same method

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

(2) [Reserved].

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

(ii) *Special rule when only part of an asset produces income.* For purposes of section 1297, when only a portion of an asset produces income during a taxable year or a portion of a taxable year, the asset is treated as two assets for that period, one of which is characterized as a passive asset or a non-passive asset based on the income that it produces, and one of which is characterized based on the income that it is held to produce. The value (or adjusted basis) of the asset is allocated between the

two assets pursuant to the method that most reasonably reflects the uses of the property. In the case of real property, an allocation based on the physical use of the property generally is the most reasonable method.

(iii) *Special rule for stock that previously produced income that was excluded from passive income under section 1297(b)(2)(C).* Stock with respect to which no dividends are received during a taxable year, but with respect to which dividends were received during one or both of the prior two taxable years, is characterized based on the relative portion of the dividends received that was passive or non-passive. If the dividends were in whole excluded from passive income under section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section, the stock is treated as a single non-passive asset. If the dividends were in part excluded from passive income under section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section, the stock is treated as two assets, one of which is a passive asset and one of which is a non-passive asset. The value (or adjusted basis) of the stock is allocated between the two assets in proportion to the average percentage of aggregate dividends received in the prior two taxable years that were characterized as passive income and the average percentage of aggregate dividends received in the prior two years that were characterized as non-passive income, for the previous two taxable years pursuant to section 1297(b)(2)(C) and paragraph (c)(4)(iv) of this section. If the tested foreign corporation did not receive any dividends from the stock for the current taxable year or within either of the prior two taxable years of the tested foreign corporation, then the stock is treated as a passive asset.

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

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

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

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

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

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

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

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

(4) Under paragraph (c)(4)(v) of this section, the rent received from FP throughout Year 3 is characterized as 100% passive income. Under paragraph (c)(1)(i)(A) of this section and section 954(c)(2)(A), the rent received from the unrelated person is characterized as 100% non-passive income. Accordingly, under paragraph (d)(3)(i) of this section, the 40% of the office building rented to FP has a value of 25%  $(\$100x \times 4) / ((\$100x \times 4) + (\$300x \times 4))$  of the value of the office building and that 25% is a passive asset, and the 60% of the office building rented to the unrelated person has a value of 75%  $(\$300x \times 4) / ((\$100x \times 4) + (\$300x \times 4))$  of the value of the office building and is a non-passive asset for purposes of applying section 1297(a)(2) to determine whether TFC is a PFIC.

(4) *Passive treatment of stock and partnership interests.* For purposes of section 1297(a)(2), shares of stock in a corporation that is not a look-through subsidiary (as defined in §1.1297-2(g)(3)) and partnership interests in a partnership that is not a look-

through partnership (as defined in §1.1297-2(g)(4)) with respect to a tested foreign corporation for a taxable year or portion thereof are treated as passive assets for the taxable year or relevant portion thereof, except to the extent the stock or partnership interest is treated as a dual-character asset under section 1297(b)(2)(C) and paragraph (d)(3) of this section because it produces both passive and non-passive income, or the stock or partnership interest produces solely non-passive income for the taxable year under section 1297(b)(2)(C) and paragraph (c)(4) of this section or under paragraph (d)(5) of this section.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(b) *General rules—(1) Tested foreign corporation's ownership of a corporation.* For purposes of section 1297(c) and this section, the principles of section 958(a) and the regulations in this chapter under

that section applicable to determining direct or indirect ownership by value apply to determine a tested foreign corporation's percentage ownership (by value) in the stock of another corporation. These principles apply whether an intermediate entity is domestic or foreign.

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

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

account only the activities of the subsidiary except as provided in paragraph (e) of this section. See paragraph (d) of this section for rules determining whether a person is a related person for purposes of applying section 1297(b)(2)(C) in the case of income received or accrued by a subsidiary that is treated as received directly by a tested foreign corporation pursuant to this paragraph (b)(2).

(B) *Partial year.* When a corporation is not a look-through subsidiary with respect to a tested foreign corporation for an entire taxable year of the tested foreign corporation, the tested foreign corporation may be treated as if it received directly its proportionate share of the gross income or loss of the first corporation for each measuring period in the year for which the first corporation is a look-through subsidiary, if the conditions in paragraph (g)(3)(ii)(B) of this section are satisfied. In such case, a tested foreign corporation's proportionate share of a look-through subsidiary's gross income or loss is determined based on the tested foreign corporation's percentage ownership (by value) (as determined under paragraph (b)(1) of this section) of the look-through subsidiary on the relevant measuring date.

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

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

(i) *Proportionate share of partnership assets.* For each measuring period (as defined in §1.1297-1(f)(2)), a tested foreign corporation is treated as if it held its proportionate share of each asset of

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

(ii) *Proportionate share of partnership income—(A) General rule.* A tested foreign corporation is treated as if it received directly its proportionate share of any item of gross income or loss of a partnership that is a look-through partnership with respect to the tested foreign corporation for the taxable year of the tested foreign corporation. The exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in section 954(c) that are based on whether income is derived in the active conduct of a business or whether a corporation is engaged in the active conduct of a business apply to such income only if the exception would have applied to exclude the income from passive income or foreign personal holding company income in the hands of the partnership, determined by taking into account only the activities of the partnership except as provided in paragraph (e) of this section. See paragraph (d) of this section for rules determining whether a person is a related person for purposes of applying section 1297(b)(2)(C) in the case of income received or accrued by a partnership that is treated as received directly by a tested foreign corporation pursuant to this paragraph (b)(3).

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

(ii)(B) of this section would be satisfied if the partnership were a corporation.

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

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

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

(2) *TFC.* Under paragraph (b)(1) of this section and pursuant to the principles of section 958(a), TFC owns 80% of the value of LTS and indirectly owns 20% of the value of FS. Under paragraph (b)(2) of this section, in determining whether TFC is a PFIC under section 1297(a), TFC is treated as if it held 80% of each of LTS's assets on each of the measuring dates in its taxable year and received directly 80% of the gross income of LTS for the taxable year. However, because TFC indirectly owns less than 25% of FS, FS is not a look-through subsidiary with respect to TFC and, therefore, TFC is treated as if it held a 20% interest in the stock of FS (and not the assets of FS), and received 80% of any dividends paid from FS to LTS (and not any income of FS).

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

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

(g)(3) of this section, if information about the gross income of LTS for each of the first three quarters of its taxable year is not available to TFC, then LTS is not a look-through subsidiary with respect to TFC.

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

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

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

(ii) *LTS obligation.* For purposes of section 1297(a)(2), a tested foreign cor-

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

(2) *General rule for income test—(i) LTS stock.* For purposes of section 1297(a)(1), a tested foreign corporation does not take into account dividends derived with respect to LTS stock, including dividends that the tested foreign corporation is treated as receiving on a measuring date pursuant to section 1297(c) and

paragraph (b)(2) or (b)(3) of this section; provided that, notwithstanding the foregoing, a tested foreign corporation takes into account dividends that are attributable to income that was not treated as received directly by the tested foreign corporation pursuant to paragraph (b)(2) of this section. For this purpose, the rules of §1.1297-1(c)(4)(iv)(A) apply to determine the earnings and profits from which a dividend is paid, substituting the term "look-through subsidiary" for "related person."

(ii) *LTS obligation.* For purposes of section 1297(a)(1), a tested foreign corporation does not take into account its proportionate share of interest, rents, or royalties derived with respect to direct or indirect LTS obligations or TFC obligations. The tested foreign corporation's proportionate share of interest, rents, or royalties is the amount of the item multiplied by the tested foreign corporation's percentage ownership (by value) in each relevant look-through subsidiary.

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

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

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

first quarter of the taxable year, LTS received a \$20x dividend from FS.

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

(2) *TFC.* Under paragraph (c)(1)(i) of this section, for purposes of applying section 1297(a)(2) to TFC, TFC's assets do not include the stock of LTS. Under paragraph (b)(2)(ii)(A) of this section, for purposes of applying section 1297(a)(1) to TFC, TFC is treated as receiving directly the income of LTS. Because TFC indirectly owns less than 25% of FS, FS is not a look-through subsidiary with respect to TFC and, therefore, TFC's assets include the value of TFC's 20% interest in the stock of FS and do not include 20% of FS's assets. Similarly, TFC is treated as if it received \$16x (80% x \$20x) of the \$20x dividend paid from FS to LTS (and not any income of FS). Because the dividend constitutes gross income to LTS (although it is eliminated for purposes of applying section 1297(a)(1) to LTS), TFC is treated as receiving the dividend from FS directly under paragraph (b)(2)(ii)(A) of this section. Because the dividend is from a subsidiary that is not a look-through subsidiary with respect to TFC, paragraph (c)(2)(i) of this section does not apply to eliminate the \$16x dividend for purposes of section 1297(a).

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

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

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

dates. During the first quarter of the taxable year, LTS1 received \$5x of interest on the loan, which was paid in cash.

(B) *Results.* The results are the same as in paragraph (c)(4)(i)(B) of this section (the results in *Example 1*), except that TFC's assets also do not include the stock of LTS2. Similarly, although TFC would be treated under paragraph (b)(2) of this section as owning \$80x (40% x \$200x) of the LTS1 loan to LTS2, under paragraph (c)(1)(ii) of this section TFC does not take into account its proportionate share of an indirect LTS obligation and accordingly, TFC does not take into account \$24x (30% x \$80x) of the loan to LTS2. As a result, TFC's assets include only \$56x (\$80x-\$24x) of the LTS1 loan to LTS2. Furthermore, although TFC would be treated under paragraph (b)(2) of this section as receiving \$2x (40% x \$5x) of the interest received by LTS1 from LTS2, under paragraph (c)(2)(ii) of this section TFC does not take into account its proportionate share of interest with respect to an indirect LTS obligation and thus, TFC does not take into account \$0.60x (30% x \$2x) of the interest received by LTS1. Accordingly, TFC's income includes only \$1.40x (\$2x-\$0.60x) of the interest from LTS2. Furthermore, TFC's assets include \$2x (40% x \$5x) of LTS1's cash received from LTS2.

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

(B) *Results.* Under paragraph (c)(1)(i) and (ii) of this section, for purposes of applying section 1297(a), TFC's assets do not include the stock of LTS1, the interests in FPS owned by TFC directly and through LTS1, any of the loan by FPS to TFC, or any of the loan by LTS1 to FPS. Similarly, under paragraph (c)(2)(i) and (ii) of this section, TFC's income does not include any of the \$30x of interest received by FPS from TFC, any of the \$15x of interest received by LTS1 from FPS, or any of the \$60x of distributions received by TFC and LTS1 from FPS. However, on each of the measuring dates, TFC's assets include \$27x ((50% x \$30x) + (80% x 50% x \$30x)) of the \$30 of cash received by FPS from TFC and \$12x (80% x \$15x) of the \$15x of cash received by LTS1 from FPS. Moreover, on the last measuring date of the taxable year, TFC's assets include \$18x ((50% x \$20x) + (80% x 50% x \$20x)) of the \$20x (\$80x - \$60x) of cash received by FPS from the unrelated person and retained by FPS and \$54x ((50% x \$60x) + (80% x 50%

x \$60x)) of the \$60x cash received by FPS from the unrelated person and distributed. Furthermore, TFC's income includes \$72x ((50% x \$80x) + (80% x 50% x \$80x)) of the \$80x of income received by FPS from an unrelated person.

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

(B) *Results—(1) Asset test.* Under paragraph (c) of this section, for purposes of applying section 1297(a)(2) to TFC's final measuring period, the following analysis applies. TFC's assets do not include the stock of LTS1 and LTS2. Similarly, TFC's assets include only \$1,000x (\$5,000x license - (80% x \$5,000x)) of the license to LTS1. However, TFC's assets include the entire \$500x of cash it received from LTS1 as a result of the royalty. Moreover, although TFC would be treated under paragraph (b)(2) of this section as owning \$1,600x (80% x \$2,000x) of the LTS1 sub-license to LTS2, under paragraph (c)(1)(ii) of this section TFC does not take into account its proportionate share of an indirect LTS obligation, and accordingly TFC does not take into account \$960x (60% x \$1,600x) of LTS1's sub-license to LTS2. As a result, TFC's assets include \$640x (\$1,600x - \$960x) of the sub-license. In addition, TFC's assets include \$160x (80% x \$200x) of LTS1's cash received from LTS2 as a result of the royalty to LTS1. Similarly, although TFC would be treated under paragraph (b)(2) of this section as owning \$2,400x (60% x \$4,000x) of the LTS2 lease to LTS1, under paragraph (c)(1)(ii) of this section TFC does not take into account \$1,920x (80% x \$2,400x) of the LTS2 building lease, and accordingly, its assets include \$480x (\$2,400x - \$1,920x) of the lease. TFC's assets also include \$240x (60% x \$400x) of LTS2's cash received from LTS1 as a result of the rental payment to LTS2.

(2) *Income test.* Under paragraph (c)(2)(ii) of this section, because TFC does not take into account its proportionate share of a direct LTS obligation, TFC's income includes only \$100x (\$500x royalty - (80% x \$500x)) of the royalties from LTS1. Furthermore, although TFC would be treated under paragraph (b)(2) of this section as receiving \$160x (80% x \$200x)

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

(3) *Treatment of intangible and rental property.* For purposes of determining whether the intangible property that TFC owns and the building that TFC is treated as owning under paragraph (b)(2) of this section is held in the production of passive income, the activities performed by TFC and its qualified affiliates with respect to the property are taken into account under paragraphs (c)(1)(ii) and (e) of this section. Because TFC is the common parent of the affiliated group (as determined under paragraph (e) (2) of this section) that includes LTS1 and LTS2, LTS1 and LTS2 are qualified affiliates of TFC and the activities of their officers and employees with respect to the intangible property and building are taken into account to determine whether the building and intangible property would be treated as passive assets.

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

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

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

(ii) *Results.* Pursuant to section 1297(c) and paragraph (b)(2) of this section, TFC is treated as receiving directly \$30x of the dividend income received by FS1. FS2 is a related person (within the meaning of section 954(d)(3)) with respect to FS1 for purposes of section 1297(b)(2)(C) because FS1 owns more than 50% of the vote of FS2. FS2 is not a related person (within the meaning of section 954(d)(3)) with respect to TFC for purposes of section 1297(b)(2)(C) because TFC indirectly does not own more than 50% of the vote or value of the FS2 stock. Under paragraph (d)(1) of this section, for purposes of determining whether the dividend income received by FS1 is subject to the exception in section 1297(b)(2)(C) for purposes of testing the PFIC status of TFC, the dividend is treated as received from a related person because FS1 and FS2 are related persons within the meaning of section 1297(b)(2)(C). Therefore, to the extent the dividend income received by FS1 would be properly allocable to income of FS2 that is not passive income, the dividend income that TFC is treated as receiving under section 1297(c) and paragraph (b)(2)(ii) of this section is treated as non-passive income (as defined in §1.1297-1(f)(4)).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(i) *Example 1—(A) Facts.* USP is a domestic corporation that directly owns 20% of the outstanding stock of FS1. The remaining 80% of the outstanding stock of FS1 is directly owned by a foreign

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

(B) *Results—(1) Qualified affiliates.* FS1 is the common parent of the affiliated group (as determined under paragraph (e)(2) of this section) that includes FS2, FS3, and FS4 because (i) FS1 owns more than 50% by value of FS2 and FS3, (ii) FS2 owns more than 50% by value of FS4, and (iii) FS2, FS3, and FS4 would be look-through subsidiaries with respect to FS1 if FS1 were the tested foreign corporation. Accordingly, each of FS1, FS2, FS3 and FS4 are qualified affiliates (as determined under paragraph (e)(2) of this section) with respect to the other members of the group for purposes of determining whether FS1, FS2, FS3, or FS4 is a PFIC.

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

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

(ii) *Example 2—(A) Facts.* The facts are the same as in paragraph (e)(3)(i)(A) of this section (the facts in *Example 1*), except that FS2 also owns real property that is leased to a person that is not a related person, and the officers and employees of FS2 in Country A engage in activities that would allow rental income received by FS2 with respect to its

real property to qualify for the exception in section 954(c)(2)(A) and §1.954-2(b)(6) and (c)(1)(iv), relying on the rule in §1.954-2(c)(2)(ii) that provides that an organization is substantial in relation to rents if active leasing expenses equal or exceed 25% of adjusted leasing profit. However, the active leasing expenses of FS1 are less than 25% of its adjusted leasing profit, which includes the rental income of FS4 treated as received directly by FS1 as well as the rental income of FS2 treated as received directly by FS1.

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

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

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

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

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

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

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

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

1298(b)(3), and §1.1298-2 is determined under section 954(c)(4).

(ii) *Look-through partnerships.* In the case of a look-through partnership that is not described in paragraph (f)(4)(i) of this section, the principles of paragraphs (f)(2) and (f)(3) of this section apply to determine the amount and characterization of gain derived from a tested foreign corporation's direct or indirect (through a look-through subsidiary or look-through partnership) disposition of partnership interests of the look-through partnership that is taken into account by the tested foreign corporation for purposes of section 1297(a)(1), section 1298(b)(3), and §1.1298-2.

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

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

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

sold at a loss. Under paragraph (f)(3) of this section, \$58.50x of the residual gain is non-passive income ( $\$78x \times (\$150x/\$200x)$ ) and \$19.50x is passive income ( $\$78x \times (\$50x/\$200x)$ ).

(ii) *Example 2—(A) Facts.* The facts are the same as in paragraph (f)(5)(i)(A) of this section (the facts in *Example 1*), except that in Year 1, TFC purchased 15 shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the first day of Year 3, TFC purchased an additional 15 shares of FS stock, representing 15% of the stock of FS, from an unrelated person, and on the last day of Year 4, TFC recognizes gain of \$10x of the sale of 15 shares of FS stock purchased in Year 1, and gain of \$60x on the sale of the other 15 shares of FS stock purchased in Year 3.

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

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

(B) *Results.* The results are the same as in paragraph (f)(5)(ii)(B) of this section (the results in *Example 2*) with respect to the 15 shares acquired in Year 3 (\$40x of residual gain attributable to the 15 shares acquired in Year 3). For purposes of applying section 1297(a)(1) to TFC for Year 4, TFC must also take into account \$10x of residual gain with respect to the 15 shares acquired in Year 1. As provided by paragraph (f)(2) of this section, the residual gain equals the amount by which the \$10x gain recognized on the sale of those 15 shares exceeds the unremitted earnings with respect to those shares. The unremitted earnings with respect to the 15 shares acquired in Year 1 are \$0x, the amount by which the pro rata share of aggregate income (\$20x) taken into account by TFC with respect to those 15 shares of FS stock under section 1297(c) and paragraph (b)(2) of this section in Years 3 and 4 exceeds the aggregate pro rata amount of dividends with respect to those 15 shares of FS stock (\$20x) received by TFC from FS in Year 2. Total residual gain therefore is \$50x ( $\$40x + \$10x$ ). Under paragraph (f)(3) of this section, \$37.50x of the residual gain is non-passive income ( $\$50x \times (\$150x/\$200x)$ ) and \$12.50x is passive income ( $\$50x \times (\$50x/\$200x)$ ).

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

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

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

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

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

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

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

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

mined under paragraph (b)(1) of this section) on the relevant measuring dates can be established; and

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

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

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

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

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

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

partnership described in paragraph (g)(4)(i)(A) of this section. For purposes of the preceding sentence, the active partner test is applied on the measuring date (as defined in §1.1297-1(f)(1)) or for the taxable year, as applicable using the same period that was used under paragraph (g)(3)(ii) of this section.

(iii) *Election.* For any taxable year, an election may be made with respect to a partnership described in paragraph (g)(4)(i)(B) of this section to not apply the provisions of this paragraph (g)(4) to such partnership.

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

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

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

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

graph (g)(4)(ii)(A) of this section with respect to the income of FPS.

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

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

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

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

(iii) *Failure to qualify as look-through partnership.* TFC satisfies the active partner test in paragraph (g)(4)(ii)(A) of this section but does not satisfy the active partner test in paragraph (g)(4)(ii)(B) of this section. Therefore, FPS does not qualify as a look-through partnership. Under paragraph (b)(3)(iii) of this section, TFC's share of income with respect to FPS is treated as passive income for purposes of section 1297 and TFC's \$100x interest (10% x \$1000x) in FPS is treated as a passive asset for purposes of section 1297.

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

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

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

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

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

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

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

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

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

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

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

### **§1.1297-4 Qualifying insurance corporation.**

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

poses of the 25 percent test described in paragraph (c) of this section and the alternative facts and circumstances test described in paragraph (d) of this section. Paragraph (f) of this section provides definitions that apply for purposes of this section. Paragraph (g) of this section provides the applicability date of this section.

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

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

(2) Satisfies—

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

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

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

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

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

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

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

statement for the applicable reporting period.

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

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

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

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

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

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

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

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

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

(C) Low loss exposure.

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

(i) Was engaged in the process of terminating its pre-existing, active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)) under the supervision of its applicable insurance regulatory body or pursuant to any court-ordered receivership proceeding (liquidation, rehabilitation, or conservation) and fails to satisfy the 25 percent test because the corporation is required to hold additional assets due to its business being in runoff;

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

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

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

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

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

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

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

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

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

(iii) *Time and manner for making the election.* Except as provided in paragraph (d)(5)(iv), the election described in paragraph (d)(1) of this section may be made by a United States person who owns stock in the foreign corporation by completing the appropriate part of Form 8621 (or successor form) for each taxable year of the United States person in which the election applies. A United States person must attach the Form 8621 (or successor form) to its original or amended Federal income tax return for the taxable year of the United States person to which the elec-

tion relates. A United States person can attach the Form 8621 (or successor form) to an amended return for the taxable year of the United States person to which the election relates if the United States person can demonstrate the reason for not filing the form with its original return was due to reasonable cause.

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

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

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

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

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

United States person owned stock in the foreign corporation.

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

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

(2) *General limitation on applicable insurance liabilities.* The amount of applicable insurance liabilities may not exceed any of the amounts described in paragraphs (e)(2)(i) to (iii) of this section. This paragraph (e)(2) applies after applying paragraph (e)(3) of this section.

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

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

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

(3) *Discounting.* If an applicable financial statement or a financial statement described in paragraph (e)(2) of this section is prepared on the basis of an accounting method other than GAAP or IFRS and does not discount applicable insurance

liabilities on an economically reasonable basis, the amount of applicable insurance liabilities may not exceed the amount of applicable insurance liabilities on the financial statement reduced by applying the discounting methods that would apply under either GAAP or IFRS to the insurance or annuity contracts to which the applicable insurance liabilities at issue relate. The foreign corporation may choose whether to apply either GAAP or IFRS discounting methods for this purpose.

(4) [Reserved].

(5) [Reserved].

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

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

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

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

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

(iv) [Reserved].

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

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

(B) Unpaid loss adjustment expenses (including reasonable estimates of anticipated loss adjustment expenses) associated with investigating, defending, settling,

and adjusting paid losses, unpaid reported losses, and incurred but not reported losses (of the type described in paragraph (f)(2)(i)(A) of this section) as of the financial statement end date; and

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

(D) Provided, however, that—

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

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

(3) [Reserved].

(ii) *Amounts not specified in paragraph (f)(2)(i) of this section.* Amounts not specified in paragraph (f)(2)(i) of this section are not applicable insurance liabilities. For example, the term applicable insurance liability does not include any amount held by an insurance company as a deposit liability that is not an insurance liability, such as a funding agreement, a guaranteed investment contract, premium or other deposit funds, structured settlements, or any other substantially similar contract issued by an insurance company. The term applicable insurance liabilities also does not include the amount of any reserve for a life insurance or annuity contract the payments of which do not depend on the life or life expectancy of one or more individuals.

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

(4) *Applicable reporting period.* The term *applicable reporting period* is the last annual reporting period for a financial

statement ending with or within the taxable year of a U.S. person owning stock in a foreign corporation, within the meaning of paragraph (d)(6) of this section.

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

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

(ii) [Reserved].

(iii) [Reserved].

(7) *Generally accepted accounting principles or GAAP.* The term *generally accepted accounting principles or GAAP* means United States generally accepted accounting principles described in standards established and made effective by the Financial Accounting Standards Board.

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

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

(10) *Mortgage insurance company.* For purposes of this section, *mortgage insur-*

*ance company* means any insurance company whose sole business is to insure or reinsure against a lender's loss of all or a portion of the principal amount of a mortgage loan upon default of the mortgagor.

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

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

#### **§1.1297-5 [Reserved].**

#### **§1.1297-6 Exception from the definition of passive income for active insurance income.**

(a) *Scope.* This section provides rules pertaining to the exception from passive income under section 1297(b)(2)(B) for income derived in the active conduct of an insurance business and rules related to certain income of a qualifying domestic insurance corporation. Paragraph (b) of this section provides a general rule that excludes from passive income certain income of a qualifying insurance corporation (QIC), as defined in §1.1297-4(b), and certain income of a qualifying domestic insurance corporation. Paragraph (c) of this section provides rules excluding certain assets for purposes of the passive asset test under section 1297(a)(2). Paragraph (d) of this section provides rules concerning the treatment of income and assets of certain look-through subsidiaries and look-through partnerships of a QIC. Paragraph (e) of this section provides rules relating to qualifying domestic insurance corporations. Paragraph (f) of this section provides the applicability date of this section.

(b) *Exclusion from passive income of active insurance income.* For purposes of

section 1297 and §1.1297-1, passive income does not include—

(1) Income that a QIC derives in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)); and

(2) Income of a qualifying domestic insurance corporation.

(c) *Exclusion of assets for purposes of the passive asset test under section 1297(a)(2).* For purposes of section 1297 and §1.1297-1, passive assets (as defined in §1.1297-1(f)(5)), do not include—

(1) Assets of a QIC available to satisfy liabilities of the QIC related to its insurance business (as defined in §1.1297-4(f)(8)), if the QIC is engaged in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)); and

(2) Assets of a qualifying domestic insurance corporation.

(d) *Treatment of income and assets of certain look-through subsidiaries and look-through partnerships for purposes of the section 1297(b)(2)(B) exception—*

(1) *General rule.* For purposes of applying paragraphs (b)(1) and (c)(1) of this section, a QIC is treated as receiving the income or holding the assets of a look-through subsidiary or look-through partnership to the extent provided in section 1297(c) and §1.1297-2(b)(2) or §1.1297-2(b)(3). Subject to the limitation of paragraph (d)(2) of this section, a QIC's proportionate share of the income or assets of a look-through subsidiary or look-through partnership may be treated as earned or held directly by the QIC, and thus as non-passive under paragraphs (b)(1) and (c)(1) of this section, if the requirements of those paragraphs are satisfied.

(2) *Limitation.* A QIC that is engaged in the active conduct of an insurance business (within the meaning of section 1297(b)(2)(B)) may not treat its proportionate share of the income or assets of a look-through subsidiary or look-through partnership as non-passive to the extent that it exceeds the greater of—

(i) The QIC's proportionate share of the income or assets, respectively, of the look-through subsidiary or look-through partnership multiplied by a fraction, the numerator of which is the net equity value of the interests held by the QIC in the look-through subsidiary or look-through part-

nership, and the denominator of which is the value of the QIC's proportionate share of the assets of the look-through subsidiary or look-through partnership; and

(ii) The QIC's proportionate share of the income or assets, respectively, of the look-through subsidiary or look-through partnership that are treated as non-passive in the hands of the look-through subsidiary or look-through partnership.

(3) *Examples.* The following examples illustrate the rules of this section.

(i) *Example 1: QIC holds all the stock of an investment subsidiary—(A) Facts.*

(1) F1 is a foreign corporation. In Year 1, F1 meets the definition of a QIC under section 1297(f) and §1.1297-4 and is engaged in the active conduct of an insurance business within the meaning of section 1297(b)(2)(B). Throughout Year 1, F1 owns all the stock of F2, a foreign corporation that is not a QIC and is engaged solely in the investment of passive assets. The stock of F2 is an asset that is available to satisfy liabilities of F1 related to its insurance business within the meaning of paragraph (c)(1) of this section. The assets of F1 are measured on the basis of value under §1.1297-1(d)(1)(v)(C).

(2) Throughout Year 1, F2 owns assets with a value of \$1,000x and adjusted bases of \$500x, all of which are treated as passive in the hands of F2. F2 has outstanding debt with a principal amount of \$250x. On the financial statement end date of F1's applicable financial statement, the net equity value of the F2 stock held by F1 is \$750x. In Year 1, F2 earned \$100x of income that is treated as passive in the hands of F2.

(B) *Result—(1)* Because F1 owns all of the stock of F2, F2 is a look-through subsidiary of F1 within the meaning of §1.1297-2(g)(3). Under section 1297(c) and §1.1297-2(b)(2), F1 is treated as if it held 100% of the assets of F2 and received directly 100% of the income of F2. Under paragraph (d)(1) of this section, because F1 is engaged in the active conduct of an insurance business and the stock of F2 is an asset that is available to satisfy the insurance liabilities of F1, F1 treats its proportionate share of the income and assets of F2 as non-passive. The amount of income and assets that is treated as non-passive is subject to the limitation of paragraph (d)(2) of this section.

(2) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's income that is treated as non-passive cannot exceed the greater of two amounts: \$75x, which is F1's proportionate share of F2's income (\$100x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is \$750x, divided by the value of F1's proportionate share of F2's assets, which is \$1,000x); and zero, which is F1's proportionate share of the income of F2 that is treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of F2's income, \$75x is treated as non-passive, and \$25x is treated as passive.

(3) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that is treated as non-passive cannot exceed the greater of two amounts: \$750x, which is F1's pro-

portionate share of F2's assets (\$1,000x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is \$750x, divided by the value of F1's proportionate share of F2's assets, which is \$1,000x); and zero, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2, \$750x is treated as non-passive, and \$250x is treated as passive.

(C) *Alternative facts—(1) Facts.* The facts are the same as in paragraph (d)(3)(i)(A) of this section (paragraph (A) of this Example 1), except that the assets of F1 are measured on the basis of adjusted basis under §1.1297-1(d)(1)(v)(C) pursuant to a valid election under §1.1297-1(d)(1)(iii).

(2) *Result.* The result with respect to F1's proportionate share of the income of F2 is the same as in paragraph (d)(3)(i)(B)(2) of this section (paragraph (B)(2) of this Example 1). Because the assets of F1 are measured on the basis of adjusted basis under §1.1297-1(d)(1)(v)(C), F1's proportionate share of the passive assets of F2 is equal to \$500x (100% of \$500x adjusted bases). Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that may be treated as non-passive cannot exceed the greater of two amounts: \$375x, which is F1's proportionate share of F2's passive assets (\$500x) multiplied by 75% (the net equity value of the F2 stock held by F1, which is \$750x, divided by the value of F1's proportionate share of F2's assets, which is \$1,000x); and zero, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2, \$375x is treated as non-passive, and \$125x is treated as passive.

(ii) *Example 2: QIC holds all the stock of an operating subsidiary—(A) Facts.*

(1) F1 is a foreign corporation. In Year 1, F1 meets the definition of a QIC under section 1297(f) and §1.1297-4 and is engaged in the active conduct of an insurance business within the meaning of section 1297(b)(2)(B). Throughout Year 1, F1 owns all the stock of F2, a foreign corporation engaged in a manufacturing business that is not a QIC. The stock of F2 is an asset that is available to satisfy liabilities of F1 related to its insurance business within the meaning of paragraph (c)(1) of this section. The assets of F1 are measured on the basis of value under §1.1297-1(d)(1)(v)(C).

(2) Throughout Year 1, F2 owns assets with a value of \$1,200x, of which \$1,000x is treated as non-passive and \$200x is treated as passive in the hands of F2. F2 has outstanding debt of \$600x. On the financial statement end date of F1's applicable financial statement, the net equity value of the F2 stock held by F1 is \$600x. In Year 1, F2 earned \$120x of income, of which, in the hands of F2, \$100x is treated as non-passive and \$20x is treated as passive.

(B) *Result—(1)* Because F1 owns all the stock of F2, F2 is a look-through subsidiary of F1 within the meaning of §1.1297-2(g)(3). Under section 1297(c) and §1.1297-2(b)(2), F1 is treated as if it held 100% of the assets of F2 and received directly 100% of the income of F2. Under paragraph (d)(1) of this section, because F1 is engaged in the active conduct of an insurance business and the stock of

F2 is an asset that is available to satisfy the insurance liabilities of F1, F1 treats its proportionate share of the income and assets of F2 as non-passive. The amount of income and assets that is treated as non-passive is subject to the limitation of paragraph (d)(2) of this section.

(2) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's income that is treated as non-passive cannot exceed the greater of two amounts: \$60x, which is F1's proportionate share of F2's income (\$120x) multiplied by 50% (the net equity value of the F2 stock held by F1, which is \$600x, divided by the value of F1's proportionate share of F2's assets, which is \$1,200x); and \$100x, which is F1's proportionate share of the income of F2 that is treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of F2's income, \$100x is treated as non-passive, and \$20x is treated as passive.

(3) Under paragraph (d)(2) of this section, the amount of F1's proportionate share of F2's assets that is treated as non-passive cannot exceed the greater of two amounts: \$600x, which is F1's proportionate share of F2's income (\$1,200x) multiplied by 50% (the net equity value of the F2 stock held by F1, which is \$600x, divided by the value of F1's proportionate share of F2's assets, which is \$1,200x); and \$1,000x, which is F1's proportionate share of the assets of F2 that are treated as non-passive in the hands of F2. Therefore, for the purpose of characterizing F1's proportionate share of the assets of F2, \$1,000x is treated as non-passive, and \$200x is treated as passive.

(e) *Qualifying domestic insurance corporation—(1) General rule.* A domestic corporation (or a foreign corporation that is treated as a domestic corporation pursuant to a valid section 953(d) election and that computes its reserves as a domestic insurance company would under subchapter L) is a qualifying domestic insurance corporation if it is—

(i) Subject to tax as an insurance company under subchapter L of the Internal Revenue Code;

(ii) Subject to federal income tax on its net income; and

(iii) A look-through subsidiary of a tested foreign corporation.

(2) [Reserved].

(3) [Reserved].

(f) *Applicability date.* The rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. A shareholder may choose to apply such rules for any open taxable year beginning after December 31, 2017 and before January 14, 2021, provided that, with respect to a tested foreign corporation, it consistently applies the provisions of this section and §1.1297-4, for such year and all subsequent years.

- Par. 7. Section 1.1298-0 is amended by:
1. Revising the introductory text.
  2. Adding entries for §§1.1298-2 and 1.1298-4 in numerical order.

The revision and additions read as follows:

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

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

\* \* \* \* \*

**§1.1298-2 Rules for certain corporations changing businesses.**

- (a) Overview.
- (b) Change of business exception.
- (c) Special rules.
- (d) Disposition of stock in a look-through subsidiary or partnership interests in a look-through partnership.
- (e) Application of change of business exception.
- (f) Examples.
  - (1) Example 1.
    - (i) Facts.
    - (ii) Results.
  - (2) Example 2.
    - (i) Facts.
    - (ii) Results.
- (g) Applicability date.

\* \* \* \* \*

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

- (a) Overview.
- (b) Treatment of certain foreign corporations owning stock in a 25-percent-owned domestic corporation.
  - (1) General rule.
  - (2) Qualified stock and second-tier domestic corporation.
- (c) Indirect ownership of stock through a partnership.
- (d) Section 531 tax.
  - (1) Subject to section 531 tax.
  - (2) Waiver of treaty benefits.
    - (i) Tested foreign corporation that files, or is required to file, a Federal income tax return.

(ii) Tested foreign corporation that is not required to file a Federal income tax return.

- (e) Anti-abuse rule.
  - (1) General rule.
  - (2) [Reserved].
  - (3) [Reserved].
- (f) Applicability date.

Par. 8. Section 1.1298-2 is added to read as follows:

**§1.1298-2 Rules for certain corporations changing businesses.**

(a) *Overview.* This section provides rules under section 1298(b)(3) and 1298(g) that apply to certain foreign corporations that dispose of one or more active trades or businesses for purposes of determining whether a foreign corporation is treated as a passive foreign investment company (PFIC). Paragraph (b) of this section provides a rule that applies to certain foreign corporations that dispose of one or more active trades or businesses. Paragraph (c) of this section provides special rules. Paragraph (d) of this section provides a rule for the treatment of the disposition of the stock of a look-through subsidiary (as defined in §1.1297-2(g)(3)) or partnership interests in a look-through partnership (as defined in §1.1297-2(g)(4)). Paragraph (e) of this section provides guidance on when a tested foreign corporation can apply the change of business exception. Paragraph (f) provides examples illustrating the application of the rules in this section. Paragraph (g) provides the applicability date for this section.

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

- (1) Neither the corporation (nor any predecessor) was a PFIC for any prior taxable year;
- (2) Either—
  - (i) Substantially all of the passive income of the corporation for the taxable year is attributable to proceeds from the disposition of one or more active trades or businesses; or
  - (ii) Following the disposition of one or more active trades or businesses, substantially all of the passive assets of the corporation on each of the measuring dates that occur during the taxable year and after the

disposition are attributable to proceeds from the disposition; and

(3) The corporation reasonably does not expect to be and is not a PFIC for either of the first two taxable years following the taxable year.

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

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

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

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

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

(d) *Disposition of stock of a look-through subsidiary or partnership interests in a look-through partnership.* For purposes of paragraph (b) of this section, the proceeds from a tested foreign cor-

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

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

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

(1) *Example 1—(i) Facts.* (A) USP owns 15% of the outstanding stock of TFC. TFC owns 30% of the outstanding stock of FS. FS operates an active trade or business and 100% of its assets are used in the active trade or business. The value of FS's non-passive assets (as defined in §1.1297-1(f)(3)) is \$900x; the value of FS's passive assets (which include cash and cash equivalents) is \$100x. TFC has not been treated as a PFIC for any taxable year before Year 1 and has no predecessor. In addition to holding the FS stock, TFC directly conducts its own active trade or business. The value of TFC's non-passive assets (other than FS stock) is \$50x; the value of TFC's passive assets (other than FS stock and assets received during Year 1) is \$30x. TFC earns \$1x of non-passive income (as defined in §1.1297-1(f)(4)) from its directly conducted active trade or business.

(B) On January 1, Year 1, TFC sells all of its FS stock for \$300x. The residual gain computed under §1.1297-2(f)(1) on the sale of the FS stock is \$10x.

Under §1.1297-2(f)(3), \$9x of residual gain is characterized as non-passive income and \$1x of residual gain is characterized as passive income. TFC earned \$5x of passive income from the investment of the proceeds from the disposition of the FS stock during each quarter of Year 1, and TFC maintained those earnings (\$20x in total) as well as the disposition proceeds in cash for the remainder of the year. TFC reinvests the proceeds of the FS stock sale in an active trade or business during Year 2, and, thus, TFC is not a PFIC in Year 2 and Year 3. Less than 75% of TFC's gross income in Year 1 is passive income ( $(\$20x + \$1x)/(\$10x + \$20x + \$1x) = 68\%$ ). However, subject to the application of section 1298(b)(3) and this section, TFC would be a PFIC in Year 1 under section 1297(a)(2) because the proceeds from the sale of the FS stock (\$300x) together with TFC's other passive assets exceed 50% of TFC's total assets on each quarterly measuring date. For example, on the first quarterly measuring date TFC's ratio of passive assets to total assets is  $(\$300x + \$30x + \$5x)/(\$300x + \$30x + \$5x + \$50x)$  and on the fourth quarterly measuring date TFC's ratio of passive assets to total assets is  $(\$300x + \$30x + \$20x)/(\$300x + \$30x + \$20x + \$50x)$ , each of which exceeds 87%. Therefore, TFC chooses to apply the change of business exception in paragraph (b) of this section to Year 1.

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

(B) TFC would also not be treated as a PFIC in Year 1 by reason of section 1298(b)(3) and paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, because the over 91% of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets. For example, on the first quarterly measuring date TFC's ratio of passive assets attributable to the proceeds of the disposition of FS's active trade or business to its total passive assets is 91% ( $\$305x/(\$305x + \$30x)$ ), and the same ratio for the fourth quarterly measuring date is 91.4% ( $\$320x/(\$320x + \$30x)$ ).

(C) Under paragraph (e) of this section, TFC cannot claim the section 1298(b)(3) exception in relation to the income attributable to the proceeds of the FS stock sale in Year 2 because TFC already claimed the exception for Year 1.

(2) *Example 2—(i) Facts.* The facts are the same as in paragraph (f)(1)(i) of this section (the facts in *Example 1*), except that during the first quarter of Year 1, TFC earned only \$4x of passive income (\$1x per quarter) from the investment of the proceeds from the disposition of the FS stock and earned \$12x of passive income (\$3x per quarter) from its other passive assets and maintained such earnings in cash for the remainder of the year.

(ii) *Results.* The results are the same as in paragraph (f)(1)(ii) of this section (the facts in *Example 1*), except that under paragraph (c)(1) of this section, the passive income considered attributable to proceeds from a disposition of one or more active trades or businesses is \$4x (from investment of disposition proceeds). Because 24% ( $\$4x/(\$4x + \$12x + \$1x)$ ) of TFC's passive income for Year 1 is attributable to proceeds of the disposition of FS's active trade or business, and 24% does not constitute substantially all of TFC's passive income for Year 1, TFC does not qualify for the exception from treatment as a PFIC in section 1298(b)(3) and paragraph (b)(2)(i) of this section for Year 1. However, under paragraphs (b)(2)(ii) and (d) of this section, more than \$300x (\$300x disposition proceeds + amounts earned from investment of disposition proceeds) of TFC's passive assets held on each quarterly measuring date after the disposition is considered attributable to the disposition of an active trade or business. Because TFC reasonably does not expect to be a PFIC in Year 2 and Year 3, and TFC is not, in fact, a PFIC for those years, TFC will not be treated as a PFIC in Year 1 by reason of paragraph (b) of this section, based on the satisfaction of the condition in paragraph (b)(2)(ii) of this section, assuming that the average 89% of TFC's passive assets on the quarterly measuring dates during Year 1 following the disposition of the stock of FS that is attributable to proceeds of the disposition of FS's active trade or business constitutes substantially all of its passive assets.

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

Par.9. Section 1.1298-4 is added to read as follows:

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

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

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

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

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

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

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

(ii) *Tested foreign corporation that is not required to file a Federal income tax*

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

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

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

(e) *Anti-abuse rule—(1) General rule.* Paragraph (b) of this section does not apply with respect to qualified stock in a second-tier domestic corporation owned by a 25-percent-owned domestic corporation if a principal purpose for the formation of, acquisition of, or holding of stock of the 25-percent-owned domestic corporation or the second-tier domestic corporation, or for the capitalization or other funding of the second-tier domestic corporation, is to hold passive assets (as defined in §1.1297-1(f)(5)) through the second-tier domestic corporation to avoid classification of the tested foreign corporation as a PFIC.

(2) [Reserved].

(3) [Reserved].

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

2, and 1.1298-2 for such year and all subsequent years.

Sunita Lough,  
*Deputy Commissioner for Services  
and Enforcement.*

Approved: November 19, 2020

David J. Kautter,  
*Assistant Secretary of the Treasury  
(Tax Policy).*

(Filed by the Office of the Federal Register on January 14, 2021, 8:45 a.m., and published in the issue of the Federal Register for January 15, 2020, 85 F.R. 4516)

## T.D. 9943

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

#### Additional Guidance Regarding Limitation on Deduction for Business Interest Expense

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that provide additional guidance regarding the limitation on the deduction for business interest expense under section 163(j) of the Internal Revenue Code (Code) to reflect amendments made by the Tax Cuts and Jobs Act and the Coronavirus Aid, Relief, and Economic Security Act. Specifically, the regulations address the application of the limitation in contexts involving passthrough entities, regulated investment companies (RICs), and controlled foreign corporations. The regulations also provide guidance regarding the definitions of real property development, real property redevelopment, and syndicate. The regulations affect taxpayers that have business interest expense, particularly passthrough entities, their

partners and shareholders, as well as foreign corporations and their United States shareholders. The regulations also affect RICs that have business interest income, RIC shareholders that have business interest expense, and corporations that are members of a consolidated group.

DATES: *Effective date:* The regulations are effective on January 13, 2021.

*Applicability dates:* For dates of applicability, see §§1.163-15(b), 1.163(j)-1(c)(4), 1.163(j)-2(k), 1.163(j)-6, 1.163(j)-7(m), 1.163(j)-10(f), 1.469-11(a)(1) and (4), and 1.1256(e)-2(d).

FOR FURTHER INFORMATION CONTACT: Concerning §1.163-15, or 1.163(j)-2(d)(3), Nathaniel Kupferman, (202) 317-4855, or James Williford, (202) 317-3225; concerning §1.163(j)-1(b)(1)(iv), §1.163(j)-2(b)(3)(iii) or (iv) or §1.163(j)-10, John B. Lovelace, (202) 317-5357; concerning §1.163(j)-1(b)(22) or (b)(35), Steven Harrison, (202) 317-6842, or Michael Chin, (202) 317-6842; concerning §1.163(j)-6, §1.469-4 or §1.469-9, Vishal Amin, Brian Choi, or Jacob Moore, (202) 317-5279; concerning §1.163(j)-7, Azeka J. Abramoff, (202) 317-3800, or Raphael J. Cohen, (202) 317-6938; concerning §1.1256(e)-2, Pamela Lew, (202) 317-7053 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

#### Background

##### I. Statutory Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under sections 163 (in particular, section 163(j)), 469, and 1256(e) of the Code. Section 163(j) was amended by Public Law 115-97, 131 Stat. 2054 (December 22, 2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA), and the Coronavirus Aid, Relief, and Economic Security Act, Public Law 116-136, 134 Stat. 281 (March 27, 2020) (CARES Act). Section 13301(a) of the TCJA amended section 163(j) by removing prior section 163(j)(1) through (9) and adding section 163(j)(1) through (10). The provisions of section 163(j) as amended by section

13301 of the TCJA are effective for taxable years beginning after December 31, 2017. The CARES Act further amended section 163(j) by redesignating section 163(j)(10), as amended by the TCJA, as new section 163(j)(11), and adding a new section 163(j)(10) providing special rules for applying section 163(j) to taxable years beginning in 2019 or 2020.

Section 163(j) generally limits the amount of business interest expense (BIE) that can be deducted in the current taxable year (sometimes referred to in this preamble as the current year). Under section 163(j)(1), the amount allowed as a deduction for BIE is limited to the sum of (1) the taxpayer's business interest income (BII) for the taxable year; (2) 30 percent of the taxpayer's adjusted taxable income (ATI) for the taxable year (30 percent ATI limitation); and (3) the taxpayer's floor plan financing interest expense for the taxable year (in sum, the section 163(j) limitation). As further described later in this Background section, section 163(j)(10), as amended by the CARES Act, provides special rules relating to the 30 percent ATI limitation for taxable years beginning in 2019 or 2020. Under section 163(j)(2), the amount of any BIE that is not allowed as a deduction in a taxable year due to the section 163(j) limitation is treated as business interest paid in the succeeding taxable year.

The section 163(j) limitation applies to all taxpayers, except for certain small businesses that meet the gross receipts test in section 448(c) of the Code and certain trades or businesses listed in section 163(j)(7) (excepted trades or businesses). More specifically, section 163(j)(3) provides that the section 163(j) limitation does not apply to any taxpayer that meets the gross receipts test under section 448(c), other than a tax shelter prohibited from using the cash receipts and disbursements method of accounting under section 448(a)(3). Under section 163(j)(7), the excepted trades or businesses are the trade or business of providing services as an employee, electing real property businesses, electing farming businesses, and certain regulated utility businesses.

Section 163(j)(4) provides special rules for applying section 163(j) in the case of passthrough entities. Section 163(j)(4)(A) requires that the section 163(j) limitation

be applied at the partnership level, and that a partner's ATI be increased by the partner's share of excess taxable income, as defined in section 163(j)(4)(C), but not by the partner's distributive share of income, gain, deduction, or loss. Section 163(j)(4)(B) provides that the amount of partnership BIE exceeding the section 163(j)(1) limitation is carried forward at the partner level as excess business interest expense (EBIE). Section 163(j)(4)(B)(ii) provides that EBIE allocated to a partner and carried forward is available to be deducted in a subsequent year only to the extent that the partnership allocates excess taxable income to the partner. As further described later in this Background section, section 163(j)(10), as amended by the CARES Act, provides a special rule for EBIE allocated to a partner in a taxable year beginning in 2019. Section 163(j)(4)(B)(iii) provides rules for the adjusted basis in a partnership of a partner that is allocated EBIE. Section 163(j)(4)(D) provides that rules similar to the rules of section 163(j)(4)(A) and (C) apply to S corporations and S corporation shareholders.

Section 163(j)(5) and (6) define "business interest" and "business interest income," respectively, for purposes of section 163(j). Generally, these terms include interest expense and interest includible in gross income that is properly allocable to a trade or business (as defined in section 163(j)(7)) and do not include investment income or investment expense within the meaning of section 163(d). The legislative history states that "a corporation has neither investment interest nor investment income within the meaning of section 163(d). Thus, interest income and interest expense of a corporation is properly allocable to a trade or business, unless such trade or business is otherwise explicitly excluded from the application of the provision." H. Rept. 115-466, at 386, fn. 688 (2017).

Section 163(j)(8) defines ATI as the taxable income of the taxpayer (1) computed without regard to items not properly allocable to a trade or business; BIE and BII; net operating loss (NOL) deductions; deductions for qualified business income under section 199A; and deductions for depreciation, amortization, and depletion with respect to taxable years beginning before January 1, 2022, and (2) computed

with such other adjustments as provided by the Secretary of the Treasury or his delegate (Secretary).

As noted previously, section 163(j)(1) includes floor plan financing interest in computing the amount of deductible business interest. Section 163(j)(9) defines "floor plan financing interest" and "floor plan financing indebtedness." These provisions allow taxpayers incurring interest expense for the purpose of securing an inventory of motor vehicles held for sale or lease to deduct the full expense without regard to the section 163(j) limitation.

Under section 163(j)(10)(A)(i), the amount of BIE that is deductible under section 163(j)(1) for taxable years beginning in 2019 or 2020 is computed using 50 percent, rather than 30 percent, of the taxpayer's ATI for the taxable year (50 percent ATI limitation). A taxpayer may elect not to apply the 50 percent ATI limitation to any taxable year beginning in 2019 or 2020, and instead apply the 30 percent ATI limitation. This election must be made separately for each taxable year. Once the taxpayer makes the election, the election may not be revoked without the consent of the Secretary. See section 163(j)(10)(A)(iii).

Sections 163(j)(10)(A)(ii)(I) and 163(j)(10)(A)(iii) provide that, in the case of a partnership, the 50 percent ATI limitation does not apply to partnerships for taxable years beginning in 2019, and the election to not apply the 50 percent ATI limitation may be made only for taxable years beginning in 2020, and may be made only by the partnership. Under section 163(j)(10)(A)(ii)(II), however, a partner treats 50 percent of its allocable share of a partnership's EBIE for 2019 as BIE in the partner's first taxable year beginning in 2020 that is not subject to the section 163(j) limitation (50 percent EBIE rule). The remaining 50 percent of the partner's allocable share of the partnership's EBIE remains subject to the section 163(j) limitation applicable to EBIE carried forward at the partner level. A partner may elect out of the 50 percent EBIE rule.

Section 163(j)(10)(B)(i) allows a taxpayer to elect to substitute its ATI for the last taxable year beginning in 2019 (2019 ATI) for the taxpayer's ATI for a taxable year beginning in 2020 (2020 ATI) in determining the taxpayer's section 163(j)

limitation for the taxable year beginning in 2020.

Section 163(j)(11) provides cross-references to provisions requiring that electing farming businesses and electing real property businesses excepted from the section 163(j) limitation use the alternative depreciation system (ADS), rather than the general depreciation system, for certain types of property. The required use of ADS results in the inability of these electing trades or businesses to use the additional first-year depreciation deduction under section 168(k) for those types of property.

## II. *Published Guidance*

On April 16, 2018, the Department of the Treasury (Treasury Department) and the IRS published Notice 2018-28, 2018-16 I.R.B. 492, which described regulations intended to be issued under section 163(j). On December 28, 2018, the Treasury Department and the IRS (1) published proposed regulations under section 163(j), as amended by the TCJA, in a notice of proposed rulemaking (REG-106089-18) (2018 Proposed Regulations) in the **Federal Register** (83 FR 67490), and (2) withdrew the notice of proposed rulemaking (1991-2 C.B. 1040) published in the **Federal Register** on June 18, 1991 (56 FR 27907 as corrected by 56 FR 40285 (August 14, 1991)) to implement rules under section 163(j) before its amendment by the TCJA. On September 14, 2020, the Treasury Department and the IRS published final regulations under section 163(j) and other sections in the **Federal Register** (85 FR 56686) (T.D. 9905) to finalize most sections of the 2018 Proposed Regulations.

Concurrently with the publication of T.D. 9905, the Treasury Department and the IRS published additional proposed regulations under section 163(j) in a notice of proposed rulemaking (REG-107911-18) in the **Federal Register** (85 FR 56846) (2020 Proposed Regulations) to provide additional guidance regarding the section 163(j) limitation in response to certain comments received in response to the 2018 Proposed Regulations and to reflect the amendments made by the CARES Act. The 2020 Proposed Regulations provided proposed rules: for allocating interest ex-

pense associated with debt proceeds of a partnership or S corporation to supplement the rules in §1.163-8T regarding the allocation of interest expense for purposes of section 163(d) and (h) and section 469 (proposed §§1.163-14 and 1.163-15); amending the definition of ATI and permitting certain RICs to pay section 163(j) interest dividends (proposed §1.163(j)-1); amending the rules for applying section 163(j)(4) to partnerships and S corporations (proposed §1.163(j)-6); re-proposing the proposed rules for applying the section 163(j) limitation to foreign corporations and United States shareholders (proposed §1.163(j)-7) and to foreign persons with effectively connected income (proposed §1.163(j)-8); amending the definition of real property trade or business (proposed §1.469-9); amending the rules for determining tax shelter status and providing guidance on the election to use 2019 ATI to determine 2020 section 163(j) limitation (proposed §§1.163(j)-2 and 1.1256(e)-2); and amending the corporate look-through rules as applicable to tiered structures (proposed §1.163(j)-10).

All written comments received in response to the 2020 Proposed Regulations are available at [www.regulations.gov](http://www.regulations.gov) or upon request. After consideration of the comments received, this Treasury decision adopts most of the 2020 Proposed Regulations as revised in response to the comments, which are described in the Summary of Comments and Explanation of Revisions section. The Treasury Department and the IRS plan to finalize other portions of the 2020 Proposed Regulations separately, to allow additional time to consider the comments received.

On April 27, 2020, the Treasury Department and the IRS published Revenue Procedure 2020-22, 2020-18 I.R.B. 745, to provide the time and manner of making a late election, or withdrawing an election, under section 163(j)(7)(B) to be an electing real property trade or business or under section 163(j)(7)(C) to be an electing farming business for taxable years beginning in 2018, 2019, or 2020. Revenue Procedure 2020-22 also provides the time and manner of making or revoking elections provided by the CARES Act under section 163(j)(10) for taxable years beginning in 2019 or 2020. These elections are: (1) to not apply the 50 percent ATI limitation

under section 163(j)(10)(A)(iii); (2) to use the taxpayer's 2019 ATI to calculate the taxpayer's section 163(j) limitation for any taxable year beginning in 2020 under section 163(j)(10)(B); and (3) for a partner to elect out of the 50 percent EBIE rule under section 163(j)(10)(A)(ii)(II).

## Summary of Comments and Explanation of Revisions

### I. Overview

The Treasury Department and the IRS received approximately 20 written comments in response to the 2020 Proposed Regulations. Most of the comments addressing the 2020 Proposed Regulations are summarized in this Summary of Comments and Explanation of Revisions section. However, comments merely summarizing or interpreting the 2020 Proposed Regulations generally are not discussed in this preamble. Additionally, comments outside the scope of this rulemaking are generally not addressed in this Summary of Comments and Explanation of Revisions section.

The Treasury Department and the IRS continue to study comments on certain issues related to section 163(j), including issues that are beyond the scope of the final regulations, and may discuss those comments if future guidance on those issues is published.

The final regulations retain the same basic structure as the 2020 Proposed Regulations, with the revisions described in this Summary of Comments and Explanation of Revisions section.

### II. Notice 89-35 and Comments on and Changes to Proposed §1.163-15: Debt Proceeds Distributed From Any Taxpayer Account or From Cash

Section 1.163-15 of the 2020 Proposed Regulations supplemented the rules in §1.163-8T, temporary regulations issued prior to TCJA, regarding debt proceeds distributed from any taxpayer account or from cash proceeds. Consistent with section VI of Notice 89-35, 1989-1 C.B. 675, proposed §1.163-15 provided that taxpayers may treat any expenditure made from an account of the taxpayer, or from cash, within 30 days before or after debt proceeds are deposited in any account of

the taxpayer, or received in cash, as made from such proceeds. Section 1.163-14 of the 2020 Proposed Regulations related to sections I-V of Notice 89-35. The Treasury Department and the IRS received no comments with respect to proposed §1.163-15. Accordingly, the final regulations adopt this section unchanged. Additional consideration is being given to §1.163-14, which is not being finalized in these final regulations; thus Notice 89-35 remains in effect.

### III. Comments on and Changes to §1.163-1: Definitions

#### A. Adjustments to Tentative Taxable Income

Part III.A.1.a of this Summary of Comments and Explanation of Revisions section provides an overview of the negative adjustments to tentative taxable income in §1.163(j)-1(b)(1)(ii)(C) through (E) and the alternative computations for those negative adjustments in proposed §1.163(j)-1(b)(1)(iv)(B) and (E). Part III.A.1.b of this Summary of Comments and Explanation of Revisions section provides an overview of the special rules in §1.163(j)-1(b)(1)(iv)(A), (C), and (D) for the application of §1.163(j)-1(b)(1)(ii)(C) through (E). Part III.A.2 of this Summary of Comments and Explanation of Revisions section summarizes the comments received on §1.163(j)-1(b)(1)(ii)(C) through (E) and the alternative computations in proposed §1.163(j)-1(b)(1)(iv)(B) and (E). Part III.A.3 of this Summary of Comments and Explanation of Revisions section summarizes the comments received on the special rules in §1.163(j)-1(b)(1)(iv)(A), (C), and (D).

In response to comments received, the final regulations provide a number of clarifications to the ATI computation and provide new examples demonstrating their application.

#### 1. Overview

a. Section 1.163(j)-1(b)(1)(ii)(C) through (E) and Proposed §1.163(j)-1(b)(1)(iv)(B) and (E)

Section 1.163(j)-1(b)(43) provides that tentative taxable income is the

amount to which adjustments are made in computing ATI. Section 1.163(j)-1(b)(1)(i) provides for certain additions to tentative taxable income in computing ATI. For example, §1.163(j)-1(b)(1)(i)(D) provides that, subject to the rule in §1.163(j)-1(b)(1)(iii), any depreciation under section 167, section 168, or former section 168 for taxable years beginning before January 1, 2022, is added back to tentative taxable income to compute ATI. Section 1.163(j)-1(b)(1)(i)(E) and (F) provide similar rules for amortization and depletion, respectively.

Section 1.163(j)-1(b)(1)(ii) provides for certain subtractions from (or negative adjustments to) tentative taxable income in computing ATI. For example, §1.163(j)-1(b)(1)(ii)(C) provides that, if property is sold or otherwise disposed of, the greater of the allowed or allowable depreciation, amortization, or depletion of the property for the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group) for taxable years beginning after December 31, 2017, and before January 1, 2022 (such years, the EBITDA period), with respect to such property is subtracted from tentative taxable income. Section 1.163(j)-1(b)(1)(ii)(D) provides that, with respect to the sale or other disposition of stock of a member of a consolidated group by another member, the investment adjustments under §1.1502-32 with respect to such stock that are attributable to deductions described in §1.163(j)-1(b)(1)(ii)(C) are subtracted from tentative taxable income. Section 1.163(j)-1(b)(1)(ii)(E) provides that, with respect to the sale or other disposition of an interest in a partnership, the taxpayer's distributive share of deductions described in §1.163(j)-1(b)(1)(ii)(C) with respect to property held by the partnership at the time of such sale or other disposition is subtracted from tentative taxable income to the extent such deductions were allowable under section 704(d). See the preamble to T.D. 9905 for a discussion of the rationale for these adjustments.

The preamble to T.D. 9905 noted that, in the 2018 Proposed Regulations, §1.163(j)-1(b)(1)(ii)(C) incorporated a "lesser of" standard. In other words, the lesser of (i) the amount of gain on the sale or other disposition of property, or (ii) the

amount of depreciation deductions with respect to such property for the EBITDA period, was required to be subtracted from tentative taxable income to determine ATI. As explained in the preamble to T.D. 9905, commenters raised several questions and concerns regarding this "lesser of" standard. T.D. 9905 removed the "lesser of" approach due in part to concerns that this approach would be more difficult to administer than the approach reflected in T.D. 9905.

However, the Treasury Department and the IRS recognize that, in certain cases, the "lesser of" approach might not create administrative difficulties for taxpayers. Thus, the 2020 Proposed Regulations permitted taxpayers to choose whether to compute the amount of their adjustment upon the disposition of property, member stock, or partnership interests using a "lesser of" standard. See proposed §1.163(j)-1(b)(1)(iv)(B) and (E). The Treasury Department and the IRS requested comments on the "lesser of" approach, including how such an approach should apply to dispositions of member stock and partnership interests. The comments received on the "lesser of" approach are summarized in part III.A.2 of this Summary of Comments and Explanation of Revisions section.

#### b. Section 1.163(j)-1(b)(1)(iv)(A) through (D)

Section 1.163(j)-1(b)(1)(iv) provides special rules for the application of §1.163(j)-1(b)(1)(ii)(C) through (E). Section 1.163(j)-1(b)(1)(iv)(A)(1) provides that, for purposes of §1.163(j)-1(b)(1)(ii)(C) through (E), the term "sale or other disposition" does not include a transfer of an asset to an acquiring corporation in a transaction to which section 381(a) of the Code applies, except as otherwise provided in §1.163(j)-1(b)(1)(iv)(A). Section 1.163(j)-1(b)(1)(iv)(A)(2) provides that, for purposes of §1.163(j)-1(b)(1)(ii)(C) and (D), the term "sale or other disposition" excludes all intercompany transactions, within the meaning of §1.1502-13(b)(1)(i). This provision reflects the general treatment of a consolidated group as a single entity for purposes of section 163(j). Section 1.163(j)-1(b)(1)(iv)(A)(3) provides

that, notwithstanding any other rule in §1.163(j)-1(b)(1)(iv)(A) (including the rule regarding section 381(a) transactions), any transaction in which a member leaves a consolidated group is treated as a "sale or other disposition" for purposes of §1.163(j)-1(b)(1)(ii)(C) and (D), unless the transaction is an acquisition described in §1.1502-13(j)(5)(i)(A).

Section 1.163(j)-1(b)(1)(iv)(B) provides that, for purposes of §1.163(j)-1(b)(1)(ii)(C) through (E), the amount of a consolidated group's adjustment under §1.163(j)-1(b)(1)(ii)(C) is computed by reference to the depreciation, amortization, or depletion deductions of the group. The 2020 Proposed Regulations added §1.163(j)-1(b)(1)(iv)(B)(2) to clarify the computation under proposed §1.163(j)-1(b)(iv)(E)(1) for consolidated groups.

Section 1.163(j)-1(b)(1)(iv)(C) provides successor asset rules for certain intercompany transactions. More specifically, if deductions described in §1.163(j)-1(b)(1)(ii)(C) are allowed or allowable to a consolidated group member (S), the depreciable property or S's stock is transferred to another member (S1), and the transferor's basis in the S1 stock received in the intercompany transaction is determined, in whole or in part, by reference to its basis in the transferred property or S stock, then the S1 stock is treated as a successor asset for purposes of the negative adjustments to tentative taxable income upon the disposition of member stock.

Section 1.163(j)-1(b)(1)(iv)(D) contains anti-duplication rules. For example, §1.163(j)-1(b)(1)(iv)(D)(2) provides that depreciation, amortization, or depletion deductions allowed or allowable for a corporation for a consolidated return year of a group are disregarded in applying §1.163(j)-1(b)(1)(iv)(D) to a separate return year of that corporation. Section 1.163(j)-1(b)(1)(iv)(D)(2) also provides an example in which S deconsolidates from a consolidated group (Group 1) (thereby triggering an adjustment under §§1.163(j)-1(b)(1)(ii)(D) and 1.163(j)-1(b)(1)(iv)(A)(3)) and then sells the depreciable property. The example states that no further adjustment is required under §1.163(j)-1(b)(1)(ii)(C) upon the asset disposition with regard to the amounts included in Group 1.

2. Comments on §1.163(j)-1(b)(1)(ii)(C) through (E) and Proposed §1.163(j)-1(b)(1)(iv)(B) and (E)

a. Adoption of a “lesser of” standard

Several commenters contended that the final regulations should continue to allow taxpayers to choose whether to compute the amount of their adjustment upon the disposition of property, member stock, or partnership interests using a “lesser of” standard, as in proposed §1.163(j)-1(b)(1)(iv)(B) and (E). Commenters asserted that such an approach would ameliorate the adverse impact of the subtractions from tentative taxable income in §1.163(j)-1(b)(1)(ii)(C) through (E). One commenter further asserted that a “lesser of” option is preferable to the approach in T.D. 9905 because the latter could create an incentive for taxpayers to retain assets solely because the adverse tax consequences of disposing of the assets outweigh the cost of keeping the assets.

The Treasury Department and the IRS agree with these comments, and the final regulations retain a “lesser of” option for purposes of the negative adjustments to tentative taxable income in §1.163(j)-1(b)(1)(ii)(C) through (E). The final regulations also update the special rules in §1.163(j)-1(b)(1)(iv)(A), (C), and (D) to add cross-references to the “lesser of” computations in §1.163(j)-1(b)(1)(iv)(B) and (E).

b. Modification of the “lesser of” standard

Several commenters also recommended modifications to the “lesser of” rules in proposed §1.163(j)-1(b)(1)(iv)(B) and (E). For example, one commenter stated that the proposed “lesser of” approach is likely to be less accurate for dispositions of member stock or partnership interests than for asset dispositions because the gain prong of the “lesser of” computation in either case is based on the gain in the member stock or partnership interests, respectively, rather than on the gain that would be recognized on the sale of the underlying assets.

The Treasury Department and the IRS received recommendations regarding several alternative approaches. Under one

alternative, the negative adjustment under the gain prong of the “lesser of” computation for dispositions of member stock or partnership interests would equal the amount of the negative adjustment if the assets of the subsidiary or partnership were sold. However, the commenter acknowledged that this “deemed asset sale” approach could create unnecessary administrative difficulties and lead to valuation disputes by requiring asset valuations upon dispositions of member stock or partnership interests.

Among other alternative approaches, a commenter recommended that the gain prong of the “lesser of” computation for dispositions of member stock should be based on the excess of tax depreciation over economic depreciation with respect to the underlying assets. The commenter based this approach on the theory that only stock gain that reflects non-economic depreciation should give rise to a negative basis adjustment. The commenter who recommended this approach suggested several different computational methods for this alternative approach, but acknowledged that this approach likely would not be appropriate for certain types of assets (for example, real estate or purchased goodwill) because metrics that might be used under this approach, such as earnings and profits basis or book value, would not be a good proxy for fair market value for such assets. Another commenter recommended revising the proposed “lesser of” computation for dispositions of partnership interests such that certain negative adjustments would be made at the partnership level and others would be made at the partner level.

After considering these comments, the Treasury Department and the IRS have determined that the proposed “lesser of” computations strike a proper balance between accuracy and administrability. In particular, as one commenter noted, there would be unnecessary administrative complexity under the first suggested alternative approach. This complexity includes the need for separate asset valuations that would be costly and may be subject to dispute, resulting in additional controversy between taxpayers and the IRS. The second proposed approach would require an accurate determination of economic depreciation. However, as the commenter

acknowledged, there is no single, simple method for accurately determining economic depreciation. Additionally, with regard to economic depreciation, different types of assets depreciate at different rates, and some assets, such as land or certain improvements to land, may not depreciate at all. As a result, basing the gain prong of the “lesser of” computation on non-economic depreciation would create less certainty, and would not clearly be a more accurate approach, than the proposed “lesser of” standard. Requiring certain adjustments at the partner level and other adjustments at the partnership level also would add further complexity to the “lesser of” computations.

Thus, the final regulations adopt the approach in proposed §1.163(j)-1(b)(1)(iv)(B) and (E). However, the Treasury Department and the IRS acknowledge that gain on upper-tier member stock generally becomes further removed from asset gain at each additional tier within a consolidated group. Therefore, for purposes of the “lesser of” computation in §1.163(j)-1(b)(1)(iv)(E)(2), the final regulations provide that the only stock gain that is relevant is the gain that is deemed recognized on the stock of the member holding the item of property (or the stock of a successor).

The Treasury Department and the IRS appreciate the comments received on the proposed “lesser of” rules and will continue to consider these comments for purposes of potential future guidance.

c. Limitation of negative adjustments to tax benefit from adding back depreciation, amortization, and depletion deductions to tentative taxable income

The additions to tentative taxable income for depreciation, amortization, and depletion deductions during the EBITDA period (see §1.163(j)-1(b)(1)(i)(D) through (F), respectively) do not necessarily increase a taxpayer’s ability to deduct BIE. For example, the taxpayer’s section 163(j) limitation already may be sufficiently high to permit a deduction of all of the taxpayer’s BIE even without such additions to tentative taxable income.

Commenters have stated that, in such a situation, the adjustments in §1.163(j)-1(b)(1)(ii)(C) through (E) and proposed §1.163(j)-1(b)(1)(iv)(B) and (E) could in-

appropriately decrease the amount of the taxpayer's BIE deduction in the year the property, member stock, or partnership interest is sold because the taxpayer derived no benefit from the adjustment under §1.163(j)-1(b)(1)(i)(D) through (F) in a prior taxable year. The commenters asserted that this detrimental outcome is inconsistent with both congressional intent and the statement in the preamble to T.D. 9905 that §1.163(j)-1(b)(1)(ii)(C) through (E) and proposed §1.163(j)-1(b)(1)(iv)(B) and (E) are intended to ensure that the positive adjustment to tentative taxable income for depreciation deductions results in a timing benefit. See part II.A.5 of the Summary of Comments and Explanation of Revisions in the preamble to T.D. 9905. Moreover, if a taxpayer that did not benefit from a positive adjustment under §1.163(j)-1(b)(1)(i)(D) through (F) were required to reduce its tentative taxable income in the year of disposition, the negative adjustment could put the taxpayer in a worse position than if the depreciation, amortization, or depletion deductions were not added back to tentative taxable income in the first place. The commenters thus recommended providing that a negative adjustment under §1.163(j)-1(b)(1)(ii)(C) through (E) and proposed §1.163(j)-1(b)(1)(iv)(B) and (E) is required only to the extent the prior-year addback under §1.163(j)-1(b)(1)(i)(D) through (F) resulted in an increase in deductible BIE.

The Treasury Department and the IRS agree with this recommendation. Thus, the final regulations provide that a negative adjustment to tentative taxable income under §1.163(j)-1(b)(1)(ii)(C) through (E) or §1.163(j)-1(b)(1)(iv)(B) or (E) is reduced to the extent the taxpayer establishes that the additions to tentative taxable income under §1.163(j)-1(b)(1)(i)(D) through (F) in a prior taxable year did not result in an increase in the amount allowed as a deduction for BIE for such year. The final regulations also provide examples illustrating the application of this rule.

#### d. Capitalized depreciation

T.D. 9905 provides that, for the additions to tentative taxable income in §1.163(j)-1(b)(1)(i), amounts of depreciation, amortization, or depletion that are capitalized under section 263A of the

Code (collectively, capitalized depreciation) during the taxable year are deemed to be included in the computation of the taxpayer's tentative taxable income for such year, regardless of when the capitalized amount is recovered. See §1.163(j)-1(b)(1)(iii). Thus, a taxpayer makes a positive adjustment to tentative taxable income under §1.163(j)-1(b)(1)(i)(D) through (F) when the taxpayer capitalizes the depreciation, amortization, or depletion, rather than later when the capitalized amount is recovered (for example, through cost of goods sold).

Commenters requested clarification regarding the application of §§1.163(j)-1(b)(1)(ii)(C) through (E) and 1.163(j)-1(b)(1)(iv) to capitalized depreciation. For example, commenters asked whether the adjustments in §1.163(j)-1(b)(1)(ii)(C) and proposed §1.163(j)-1(b)(iv)(B) and (E) occur upon the disposition of the depreciated property or upon the disposition of the property into which the depreciation was capitalized. A commenter asked the same question regarding the application of the successor asset rules in §1.163(j)-1(b)(1)(iv)(C). A commenter also requested clarification as to how the negative adjustments in §1.163(j)-1(b)(1)(ii)(D) and proposed §1.163(j)-1(b)(1)(iv)(E)(2) apply to capitalized depreciation because there are no basis adjustments under §1.1502-32 when depreciation is capitalized.

The Treasury Department and the IRS have determined that a negative adjustment under §1.163(j)-1(b)(1)(ii)(C) or proposed §1.163(j)-1(b)(1)(iv)(B) or (E) would be required upon the sale or other disposition of property with respect to which depreciation, amortization, or depletion was allowed or allowable during the EBITDA period, because it is the allowed or allowable depreciation, amortization, or depletion of that property that is added back to tentative taxable income. The final regulations have been modified accordingly. For the same reason, the final regulations also clarify that the successor asset rules in §1.163(j)-1(b)(1)(iv)(C) would apply if such property subsequently were transferred to another member (S1) in an intercompany transaction in which the transferor receives S1 stock. The Treasury Department and the IRS are continuing to consider how the negative adjustments in §1.163(j)-1(b)(1)(ii)(D)

and proposed §1.163(j)-1(b)(1)(iv)(E)(2) apply to capitalized depreciation.

A commenter also expressed concern that, if a taxpayer does not elect to apply T.D. 9905 retroactively, then capitalized depreciation arising in taxable years beginning before November 13, 2020, would not be added back to tentative taxable income, but negative adjustments under §1.163(j)-1(b)(1)(ii)(C) through (E) still would be required for any "allowable" depreciation, including capitalized depreciation, if the relevant property, member stock, or partnership interest were disposed of in a year to which T.D. 9905 applies. The commenter thus recommended that negative adjustments under §1.163(j)-1(b)(1)(ii)(C) through (E) and proposed §1.163(j)-1(b)(1)(iv)(B) and (E) not apply to capitalized depreciation amounts that were incurred in a taxable year that began before November 13, 2020, unless the taxpayer included a positive adjustment reflecting such amounts in calculating its tentative taxable income.

As discussed in part III.A.2.c of this Summary of Comments and Explanation of Revisions section, the final regulations adopt the recommendation that a negative adjustment to tentative taxable income under §1.163(j)-1(b)(1)(ii)(C) through (E) and proposed §1.163(j)-1(b)(1)(iv)(B) and (E) be reduced to the extent the taxpayer establishes that the additions to tentative taxable income under §1.163(j)-1(b)(1)(i)(D) through (F) in a prior taxable year resulted in no increase in deductible BIE in that year. If a taxpayer does not elect to apply T.D. 9905 retroactively, the taxpayer will have no additions to tentative taxable income under §1.163(j)-1(b)(1)(i)(D) through (F) in a prior taxable year (and, thus, no increase in deductible BIE in that year) with respect to capitalized depreciation. Because the final regulations already address the commenter's concern, the Treasury Department and the IRS have not incorporated the commenter's specific recommendation.

#### e. Dispositions by consolidated groups

The final regulations also revise §§1.163(j)-1(b)(1)(iv)(A)(2), 1.163(j)-1(b)(1)(iv)(B)(2), and 1.163(j)-1(b)(1)(iv)(E) to clarify that the amount of gain taken into account by a consolidated

group upon a “sale or other disposition” includes the net gain the group would take into account, including as a result of intercompany transactions. One commenter contended that this clarification is needed to ensure that the amount of gain taken into account by a consolidated group for purposes of the negative adjustments in proposed §§1.163(j)-1(b)(1)(iv)(B)(2) and 1.163(j)-1(b)(1)(iv)(E) is the same regardless of whether the property, member stock, or partnership interest is sold in an intercompany transaction before leaving the group (that is, to achieve single-entity treatment of the group). For example, assume that S would recognize \$100 of gain upon the sale of property to a nonmember. However, rather than sell the property directly to a nonmember, S first might sell the property to member B and recognize \$60 of gain, and B then could sell the property to the nonmember and recognize an additional \$40 of gain. In either case, the group would recognize a net gain of \$100 in relation to the property, and that same \$100 should be relevant in determining the amount of any negative adjustment to ATI.

### 3. Comments on §1.163(j)-1(b)(1)(iv)(A), (C), and (D)

#### a. Section 1.163(j)-1(b)(1)(iv)(A)

Commenters questioned why, under the rules for deconsolidating transactions in §1.163(j)-1(b)(1)(iv)(A)(3), the exception to “sale or other disposition” treatment is limited to whole-group acquisitions described in §1.1502-13(j)(5)(i)(A) and does not also include whole-group acquisitions that take the form of reverse acquisitions, as described in §1.1502-13(j)(5)(i)(B). The Treasury Department and the IRS did not intend this exception to exclude transactions described in §1.1502-13(j)(5)(i)(B), and the final regulations revise §1.163(j)-1(b)(1)(iv)(A)(3) to correct this typographical error.

The Treasury Department and the IRS received another comment regarding the exceptions to “sale or other disposition” treatment for whole-group acquisitions in §1.163(j)-1(b)(1)(iv)(A)(3) and for section 381 transactions in §1.163(j)-1(b)(1)(iv)(A)(I) (see the summary in part III.A.1.b of this Summary of Comments

and Explanation of Revisions section). The commenter noted that the tax law generally treats the successor in a section 381 transaction (and the acquiring group in a whole-group acquisition) as stepping into the shoes of the acquired entity (or group). However, the commenter also noted that §1.163(j)-1(b)(1)(iv)(A) does not expressly provide that the acquiring entity (or group) steps into the shoes of the acquired entity (or group) for purposes of the negative adjustments in §§1.163(j)-1(b)(1)(ii)(C) through (E) and 1.163(j)-1(b)(1)(iv)(B) and (E). The commenter recommended clarifying this point.

The Treasury Department and the IRS agree with the commenter. Thus, the final regulations clarify this point by expressly stating that the acquiring corporation in a section 381 transaction and the surviving group in a transaction described in §1.1502-13(j)(5)(i) is treated as a successor to the distributor or transferor corporation or the terminating group, respectively, for purposes of §§1.163(j)-1(b)(1)(ii)(C) through (E) and 1.163(j)-1(b)(1)(iv)(B) and (E) of this section.

A commenter also noted that the “lesser of” computation for dispositions of member stock in proposed §1.163(j)-1(b)(1)(iv)(E)(2) could be misconstrued as overriding the rules for negative adjustments to a group’s tentative taxable income in the case of deconsolidating transactions subject to §1.163(j)-1(b)(1)(iv)(A)(3). Under this erroneous interpretation, if a sale or other disposition resulted in a deconsolidation, the “lesser of” computation would apply solely with respect to the member stock that was sold, even though the deconsolidation rules in §1.163(j)-1(b)(1)(iv)(A)(3) would treat the transaction as a disposition of all of the departing member’s stock. Thus, the “lesser of” computation would not reflect the full amount of gain recognized upon the complete disposition of the departing member’s stock.

The Treasury Department and the IRS did not intend the “lesser of” rule in proposed §1.163(j)-1(b)(1)(iv)(E)(2) to override the rules for deconsolidating transactions. The regulations under section 163(j) generally treat a consolidated group as a single entity; thus, the rules for deconsolidations in §1.163(j)-1(b)(1)(iv)(A)(3) treat the date of a member’s deconsolida-

tion as the appropriate time to make adjustments to tentative taxable income with regard to all of that member’s stock. Thus, the final regulations clarify §1.163(j)-1(b)(1)(iv)(A)(3) to provide that any transaction in which a member leaves a consolidated group is treated as a taxable disposition of all stock of the departing member held by any member of the consolidated group for purposes of §1.163(j)-1(b)(1)(ii)(C) and (D) and §1.163(j)-1(b)(1)(iv)(B), (E)(I), and (E)(2), unless the transaction is described in §1.1502-13(j)(5)(i).

A commenter also suggested that nonrecognition transactions in which a member leaves a consolidated group should not be treated as a “sale or other disposition” for purposes of the negative adjustments in §1.163(j)-1(b)(1)(ii)(C) and (D) and proposed §1.163(j)-1(b)(1)(iv)(B) and (E). The final regulations do not accept this comment because, under the single-entity theory of consolidated groups in the section 163(j) regulations, such negative adjustments should be made when a member deconsolidates, regardless of the form of the deconsolidation transaction, other than in a whole-group acquisition described in §1.1502-13(j)(5)(i). In other words, because the section 163(j) regulations generally treat a consolidated group as a unified taxpayer, any adjustments to ATI related to property should occur when the item of property leaves the group. This result should be consistent whether the property is disposed of directly by a group member or whether the property leaves the group upon the deconsolidation of a member.

The Treasury Department and the IRS also received a comment that the gain prong of the proposed “lesser of” computation could yield unintended results for certain nonrecognition transactions. Under T.D. 9905, dispositions are treated as “sales or other dispositions” for purposes of the negative adjustments under §1.163(j)-1(b)(1)(ii)(C) through (E) unless an express exception applies. As previously discussed in this part III.A.3.a of this Summary of Comments and Explanation of Revisions section, T.D. 9905 provides exceptions for section 381 transactions and whole-group acquisitions. However, T.D. 9905 does not provide an exception to “sale or other disposition” treatment for other nonrecognition transactions, such as

transactions to which section 351 or section 721 applies.

The commenter noted that the “lesser of” computations in proposed §1.163(j)-1(b)(1)(iv)(B) and (E) could be construed to suggest that a taxpayer would have no negative adjustment under these provisions if the taxpayer transferred an asset in a transaction to which section 351 or section 721 applies. The Treasury Department and the IRS did not intend the proposed “lesser of” computations to create additional exceptions to “sale or other disposition” treatment for purposes of the negative adjustments required under §1.163(j)-1(b)(1)(ii)(C) through (E). Thus, the final regulations clarify that the disposition of property, member stock, or partnership interests in a transaction other than a deconsolidation (the treatment of which is addressed in §1.163(j)-1(b)(1)(iv)(A)(3)) that is a non-recognition transaction other than a section 381 transaction is treated as a taxable disposition for purposes of the gain prong of the “lesser of” computation.

#### b. Section 1.163(j)-1(b)(1)(iv)(C)

As noted in part III.A.1.b of this Summary of Comments and Explanation of Revisions section, the successor asset rules in §1.163(j)-1(b)(1)(iv)(C) apply to certain intercompany transactions. For example, assume that S (a member of the P group) acquires a depreciable asset and fully depreciates the asset under section 168(k). P then contributes its S stock to S1 (another member of the P group) in exchange for S1 stock in a transaction to which section 351 applies. In this case, the S1 stock is a successor asset to the S stock. Moreover, if P sells its S1 stock to a third party in a transaction that causes both S1 and S to deconsolidate, the transaction is treated as a taxable disposition of both the S1 stock and the S stock for purposes of §§1.163(j)-1(b)(1)(ii)(C) and (D) and 1.163(j)-1(b)(1)(iv)(B) and (E). See §1.163(j)-1(b)(1)(iv)(A)(3). In that case, both the actual sale of the S1 stock and the disposition of the S stock on its deconsolidation pursuant to §1.163(j)-1(b)(1)(iv)(A)(3) could produce negative adjustments to ATI. Application of the anti-duplication rule in §1.163(j)-1(b)(1)(iv)(D) effectively would mean that the total subtraction from ATI would equal the greater of the two stock gains (if any).

One commenter agreed with this reading of the regulations but suggested that an example would be helpful to clarify the interaction of these multiple rules. The Treasury Department and the IRS agree with this suggestion, and the final regulations include an example illustrating the operation of these rules.

#### c. Section 1.163(j)-1(b)(1)(iv)(D)

Commenters have stated that the anti-duplication rule in §1.163(j)-1(b)(1)(iv)(D)(2) is unclear, does not properly support the example in that paragraph, and does not take into account the exception to the deconsolidation rule in §1.163(j)-1(b)(1)(iv)(A)(3). For example, a commenter stated that it is unclear whether the operative rule, which does not reference §1.163(j)-1(b)(1)(ii)(C), actually supports the conclusion in the example, which references §1.163(j)-1(b)(1)(ii)(C). Another commenter requested clarification that the anti-duplication rule in §1.163(j)-1(b)(1)(iv)(D)(2) does not apply to a whole-group acquisition, which is not treated as a “sale or other disposition” for purposes of §1.163(j)-1(b)(1)(ii)(C) through (E). See §1.163(j)-1(b)(1)(iv)(A)(3).

The Treasury Department and the IRS agree with these comments and have revised §1.163(j)-1(b)(1)(iv)(D)(2) to clarify the application of this provision. The Treasury Department and the IRS also have clarified the application of §1.163(j)-1(b)(1)(iv)(D)(1), including by clarifying that the paragraph contains two separate rules, rather than one rule and one example.

A commenter also requested examples illustrating the application of the anti-duplication rule in §1.163(j)-1(b)(1)(iv)(D) when the taxpayer’s negative adjustment under the “lesser of” computation is based on gain recognized rather than on depreciation deductions taken during the EBIT-DA period. The final regulations add an example to §1.163(j)-1(b)(1)(viii) to illustrate the application of this rule.

#### B. Dividends from Regulated Investment Company (RIC) Shares

If a RIC has certain items of income or gain, part I of subchapter M and other Code provisions provide rules under

which a RIC may pay dividends that a shareholder in the RIC may treat in the same manner (or a similar manner) as the shareholder would treat the underlying item of income or gain if the shareholder realized it directly. Like the preamble to the 2020 Proposed Regulations, this preamble refers to this treatment as “conduit treatment.” The 2020 Proposed Regulations provide rules under which a RIC that earns BII may pay section 163(j) interest dividends. The total amount of a RIC’s section 163(j) interest dividends for a taxable year is limited to the excess of the RIC’s BII for the taxable year over the sum of the RIC’s BIE for the taxable year and the RIC’s other deductions for the taxable year that are properly allocable to the RIC’s BII. The 2020 Proposed Regulations provide that a RIC shareholder that receives a section 163(j) interest dividend may treat the dividend as interest income for purposes of section 163(j), subject to holding period requirements and other limitations. The Treasury Department and the IRS received one comment requesting that the proposed rules providing this treatment be finalized. These final regulations adopt those proposed rules.

A few commenters requested that conduit treatment be extended to funds other than RICs, such as foreign regulated investment funds and foreign money market funds, so that investors in those funds may treat earnings from those funds as interest income to the extent the earnings can be traced to interest income of the funds. These final regulations do not adopt these recommendations. The Treasury Department and the IRS received similar recommendations in response to the 2018 Proposed Regulations, and they were not adopted in T.D. 9905. As explained in the preamble to T.D. 9905, there are significant differences between the rules governing income inclusions in respect of passive foreign investment companies (PFICs), such as foreign money market funds, and RICs. These significant differences would require a different mechanical approach if conduit treatment were extended to PFICs and present additional policy considerations. The Treasury Department and the IRS continue to study this comment and these issues.

Another commenter requested that conduit treatment be extended to allow

shareholders in real estate investment trusts (REITs) to treat REIT dividends as interest income, to the extent that the income earned by the REIT is interest income. The Treasury Department and the IRS continue to consider this comment.

#### *IV. Comments on and Changes to Proposed §1.163(j)-6: Application of the Business Interest Expense Deduction Limitations to Partnerships and Subchapter S Corporations*

##### A. Overview

Section 1.163(j)-6 provides rules for applying section 163(j) to partnerships, S corporations and their owners. As described in this part IV of the Summary of Explanation of Revisions section, the Treasury Department and the IRS continue to study aspects of proposed §1.163(j)-6. Accordingly, the final regulations reserve on §§1.163(j)-6(e)(6) (partnership deductions capitalized by a partner), (h)(4) (partner basis adjustments upon liquidating distributions), (h)(5) (partnership basis adjustments upon partner dispositions), (j) (tiered partnerships), and (l)(4)(iv) (S corporation deductions capitalized by an S corporation shareholder). These paragraphs of the 2020 Proposed Regulations are retained in proposed form and may be relied on to the extent provided in the Applicability Dates section of this preamble.

##### B. Trading Partnerships

The 2020 Proposed Regulations addressed the application of section 163(j) to partnerships engaged in a trade or business activity of trading personal property (including marketable securities) for the account of owners of interests in the activity, as described in §1.469-1T(e)(6) (trading partnership). Specifically, the 2020 Proposed Regulations included a rule requiring a partnership engaged in a trading activity (i.e., trade or business activities described in section 163(d)(5)(A)(ii) and illustrated in Revenue Ruling 2008-12, 2008-1 C.B. 520 (March 10, 2008)) to bifurcate its interest expense from the trading activity between partners that are passive investors (taxpayers that do not materially participate in the activ-

ity within the meaning of section 469) in the trading activity and all other partners, and subject only the portion of the interest expense that is allocable to the non-passive investors to limitation under section 163(j) at the partnership level. The portion of interest expense from the trading activity allocable to passive investors is subject to limitation under section 163(d) at the partner level, as provided in section 163(d)(5)(A)(ii). Accordingly, proposed §1.163(j)-1(c)(1) and (2) include rules applicable to trading partnerships that modify the definitions of BII and BIE to effectuate this bifurcation.

In addition, proposed §1.163(j)-6(d)(4) requires that a trading partnership bifurcate all of its other items of income, gain, loss and deduction from its trading activity between partners that are passive investors and all other partners. The portion of the partnership's other items of income, gain, loss or deduction from its trading activity properly allocable to the passive investors in the partnership will not be taken into account at the partnership level as items from a trade or business for purposes of applying section 163(j) at the partnership level. Instead, all such partnership items properly allocable to passive investors will be treated as items from an investment activity of the partnership, for purposes of sections 163(j) and 163(d).

As stated in the preamble to 2020 Proposed Regulations, this approach, in order to be effective, presumes that a trading partnership generally will possess knowledge regarding whether its individual partners are passive investors in its trading activity. Because no rules currently exist requiring a partner to inform the partnership whether the partner has grouped activities of the trading partnership with other activities of the partner outside of the partnership, the 2020 Proposed Regulations include a revision to the section 469 activity grouping rules to provide that any activity described in section 163(d)(5)(A)(ii) may not be grouped with any other activity of the partner, including any other activity described in section 163(d)(5)(A)(ii).

In response to the decision to bifurcate interest expenses from a trading activity, one commenter stated that the bifurcation approach was inconsistent with section 163(j)(5). According to the comment, the

statute does not support the partnership having BIE for some partners and investment interest expense for others. Rather, once a partnership determines that it is investment interest expense that same interest expense cannot also be BIE of the partnership. The commenter read section 163(j) to mean that if a partnership is engaged in a trade or business that is not a passive activity and with respect to which certain owners do not materially participate, then the interest expense allocable to the partnership's trade or business is investment interest and section 163(j) does not apply to any of the interest expense.

Alternatively, the commenter recommended that, to the extent the Treasury Department and the IRS determine that materially participating partners should be subject to limitation under either section 163(d) or section 163(j), a rule similar to that for corporate partners should be adopted. Under such a rule, a trading partnership would treat all of its interest expense as investment interest expense at the partnership level with respect to all of its partners, and the interest expense allocable to a non-passive investor would be recharacterized as BIE by such non-passive investor. This approach, according to the commenter, would achieve a similar result as the proposed bifurcation approach while eliminating the administrative complexities associated with a partnership having to determine whether each of its partners is materially participating.

As stated in the preamble to the 2020 Proposed Regulations, the Treasury Department and the IRS considered treating all interest expense of a trading partnership as investment interest expense but concluded that it was inconsistent with the intent of section 163(j) to limit BIE of a partnership. The commenter's alternative approach also is inconsistent with the statute because it ignores the fact that the trading partnership is engaged in trade or business and, therefore, any BIE should be subject to section 163(j). Such an approach would further diverge from the application of section 163(j), particularly with respect to business interest carryforwards. Partnership BIE that is limited under section 163(j)(4) is carried forward by the partner as EBIE and is not treated as paid or accrued in succeeding taxable years until the partner receives

ETI from the same partnership. Under the commenter's approach, the partner, if subject to section 163(j), would treat the interest expense as paid or accrued in the succeeding tax year under section 163(j) (2) without requiring an allocation of ETI or excess BII (EBII) from the partnership. The bifurcation approach in the 2020 Proposed Regulations, and in these final regulations, preserves the partnership-level application of section 163(j) for those partners who are non-passive investors in the trade or business of the partnership as well as the carryover rules applicable at the partner-level.

Another commenter suggested an alternative under which section 163(j) would be applied at the partnership level and any EBIE would be allocated to the partners. Any direct or indirect partner that is a non-passive investor in the partnership's trading activity would continue to apply the rules of section 163(j) to the EBIE received from the partnership. For partners who did not materially participate in the partnership's trading activity, any allocated EBIE from the partnership would be fully deductible subject to any partner-level section 163(d) limitation. Under this approach, any EBIE received by a passive investor would be treated as paid or accrued in the current year and not subject to the carryover rules under section 163(j)(4)(B). The Treasury Department and the IRS do not adopt this comment as the approach is inconsistent with the statutory language and intent of section 163(j) (5) because the second sentence of section 163(j)(5) specifically states that BIE shall not include investment interest expense.

Several commenters opposed the revision of the grouping rule under section 469 to prohibit the grouping of trading activities. Proposed §1.469-4(d)(6) provides that a trading activity described in section 163(d)(5)(A)(ii) may not be grouped with any other activity of the taxpayer, including another trading activity. One commenter observed that such a rule would discourage trading funds from using multiple partnerships because it may result in partners never being able to demonstrate material participation in the trading activity under the 500 hour test or any other material participation test (i.e., §1.469-5T(a)) for any one partnership, even though the partner would materially participate in a

properly grouped activity. Another acknowledged the administrative burden associated with partnerships evaluating the activities of their passive partners but highlighted that partnerships were already required to collect details about partner's tax status in similar situations. A third suggested that the grouping rule could be modified to permit a partner to group activities provided the partner provides sufficient information to the partnership to enable it to identify the taxpayer as a materially participating partner.

The Treasury Department and the IRS do not adopt these recommendations because the rules under section 469 adequately address these concerns. Activity under section 469 is broadly defined to be a trade or business under section 162 and the rules further provide for grouping by a partnership or S corporation. As addressed previously, for the bifurcation method to be effective, modification of the section 469 grouping rules is necessary to avoid potential abuse and to allow the trading partnership to presume that an individual partner is a passive investor in the trading activity based solely on the partnership's understanding as to the lack of work performed in the trading activity. Additionally, if grouping were allowed, then passive partners could group their other trade or business activities, in which they materially participate, with their trading activity in order to become a material participant as to the trading activity, thus, avoiding the section 163(d) limit at the partner level. The final regulations clarify that this grouping rule applies only to individuals, estates, trusts, closely held C corporations, and personal service corporations that may directly or indirectly own interests in trading activities described in §1.469-1T(e)(6) and subject to section 163(d)(5)(ii).

One commenter observed that the proposed regulations do not discuss a tiered partnership structure with respect to the material participation rules. The Treasury Department and the IRS determined that such a rule is not needed. The bifurcation approach in proposed §1.163(j)-1(c) (1) and (2) applies where interest income or expense is allocable to one or more partners that do not materially participate (within the meaning of section 469), as described in section 163(d)(5)(A)(ii). Thus, in a tiered structure where interest is

not allocable to one or more partners that do not materially participate, the rules in §1.163(j)-6(c)(1) and (2) do not apply and the interest expense is subject to the rules under section 163(j)(4).

The same commenter recommended the final regulations provide that if a partner that has EBIE ceases to materially participate in a later taxable year, the EBIE would be allowed in a later year subject to any section 163(d) limitation; and conversely, if a passive investor partner has a section 163(d) investment carryover and then materially participates in a later taxable year, the 163(d) carryover would be allowed subject to any partner-level section 163(j) limitation. In light of concerns with partners shifting between participating and not participating in the trading activity in order to unsuspend EBIE, the Treasury Department and the IRS determined that such a rule is not warranted.

One commenter requested transition relief for trading partnerships that may have relied on the statement contained in the preamble to the 2018 Proposed Regulations that the BIE of the partnership allocable to trading activity will be subject to section 163(j) at the entity level, even if the interest expense is later subject to limitation under section 163(d) at the individual partner level. Partnerships that relied on the 2018 Proposed Regulations may have allocated EBIE to partners who do not materially participate in the trading activity of the partnership. Under the final regulations, partnerships carrying on trading activities do not allocate ETI or EBII from trading activities to their partners who do not materially participate in those activities. Rather, any interest expense and all other items from such activities allocable to these partners will be treated as items derived from an investment activity of the partnership. As a result, passive investors that were previously allocated EBIE from the trading partnership generally will not be allocated any ETI or EBII from that partnership in future years against which they can offset the EBIE.

The Treasury Department and the IRS agree that relief should be accorded to partners of trading partnerships that do not materially participate in the trading activity and that relied on the statement in the preamble to the 2018 Proposed Regulations. Accordingly, a transition rule is

provided in the final regulations to permit passive investors in a partnership engaged in a trading activity to deduct EBIE allocated to them from the partnership in any taxable year ending prior to the effective date of the final regulations without regard to the amount of ETI or EBII that may be allocated by the partnership to the partner in the first taxable year ending on or after the effective date of these final regulations.

For purposes of this transition rule, any EBIE that is no longer subject to disallowance under section 163(j) solely as a result of this transition rule will not be subject to limitation or disallowance under section 163(d). In such case, the partnership treated the interest expense as business interest expense for purposes of calculating its limitation under section 163(j). The treatment of interest expense by the partnership as BIE in prior years is not affected by this transition rule. Accordingly, the rule in section 163(j)(5) that interest expense cannot be treated as both BIE and investment interest expense would still apply, and the BIE of the partnership cannot be treated as investment interest expense of the partner in future years.

The commenter also observed that a corporate partner is never subject to section 163(d) regardless of material participation and requested clarification whether section 163(j) applies to a trading partnership's corporate partner at the partner or partnership level. The Treasury Department and the IRS have determined that the regulations as proposed adequately addressed this situation. Generally, a corporate partner is not a passive investor subject to section 163(d)(5)(A)(ii); therefore, the rules under proposed §1.163(j)-6(c) would not apply.

In the 2020 Proposed Regulations, the Treasury Department and the IRS requested comments regarding whether similar rules should be adopted with respect to S corporations that also may be involved in trading activities, and whether such rules would be compatible with subchapter S. One commenter recommended that the final regulations provide that an S corporation engaged in a trading activity be required to bifurcate its interest expense between shareholders who materially participate in the trading activity and shareholders who do not materially participate

and apply section 163(j) to the former and section 163(d) to the latter at the S corporation level.

The Treasury Department and the IRS appreciate this recommendation but, as acknowledged by the commenter, the implementation of such a rule would require different allocations of S corporation income and other items among shareholders of the S corporation. Unlike partnerships, S corporations must allocate items pro rata to the shareholders, in accordance with their respective percentages of stock ownership in the corporation. See generally section 1377(a)(1). Therefore, with regard to S corporations, the Treasury Department and the IRS have determined that (i) section 163(d) should continue to be applied at the shareholder level, and (ii) as provided by section 163(j)(4)(A) and (D), section 163(j) should continue to be applied at the S corporation level. Consequently, the final regulations do not incorporate the commenter's recommendation.

#### C. Treatment of Business Interest Income and Business Interest Expense with Respect to Lending Transactions Between a Partnership and a Partner (Self-Charged Lending Transactions)

The 2020 Proposed Regulations provide that, in the case of a self-charged lending transaction between a lending partner and a borrowing partnership in which the lending partner owns a direct interest, any BIE of the borrowing partnership attributable to a self-charged lending transaction is BIE of the borrowing partnership for purposes of proposed §1.163(j)-6(n). However, to the extent the lending partner receives interest income attributable to the self-charged lending transaction and also is allocated EBIE from the borrowing partnership in the same taxable year, the lending partner may treat such interest income as an allocation of EBII from the borrowing partnership in that taxable year, but only to the extent of the lending partner's allocation of EBIE from the borrowing partnership in the same taxable year. To prevent the potential double counting of BII, the lending partner includes interest income re-characterized as EBII only once when calculating the lending partner's own section 163(j) limitation. In cases where the lending partner is not a C

corporation, to the extent that any interest income exceeds the lending partner's allocation of EBIE from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner for purposes of section 163(d) for that year, such excess amount of interest income will continue to be treated as investment income of the lending partner for that year for purposes of section 163(d).

One commenter generally supported the approach for self-charged lending transactions provided in the 2020 Proposed Regulations and expected that many taxpayers may benefit from this rule. However, the commenter noted that the rule applies only to self-charged lending transactions where the lending partners directly own interests in the borrowing partnerships and stated that this rule is too narrow. The commenter recommended that the rule be broadened to include loans to a partnership by other members in the same consolidated group as a corporate partner. In addition, the commenter recommended that the rule for self-charged lending transactions should be expanded to include lending partners in upper-tier partnerships who make loans to lower-tier partnerships. The commenter stated that in both cases, the interest expense would ultimately flow up to the same taxpayer that recognizes the interest income.

The Treasury Department and the IRS have determined that the rule for self-charged lending transactions should be adopted in the final regulations without change. With respect to the recommendation that the self-charged lending rule should apply to indirect lenders in tiered-partnership situations, the Treasury Department and the IRS concluded that adopting a rule to allow interest income of a partner in an upper-tier partnership that lent money to a lower-tier partnership to offset EBIE that may be suspended in a lower-tier partnership would add undue complexity to these rules, and such rules would likely become more difficult to administer, particularly with respect to large and complex multi-tiered entity structures. With respect to the recommendation to extend the rule to apply to corporate partners where the lender is a member of the same consolidated group of corporations, the

Treasury Department and the IRS continue to consider whether this would be appropriate for inclusion in future guidance. The Treasury Department and the IRS are also considering additional guidance that would limit the application of the self-charged interest rule to a lender that is subject to tax under section 511, due to the special rules that apply to the calculation of unrelated business taxable income under section 512. See §1.512(a)-6.

The Treasury Department and the IRS solicited comments in the 2020 Proposed Regulations regarding whether the rule for self-charged lending transactions between partnerships and lending partners (or a similar rule) should apply to, lending transactions between S corporations and lending shareholders. No comments were received in response to this solicitation. The pro rata allocation requirements applicable to S corporations make adopting rules similar to those provided for partnership self-charged lending transactions difficult to apply and could potentially impact the eligibility requirements under subchapter S. Accordingly, the final regulations do not provide such a rule.

#### D. CARES Act Partnership Rules

The 2020 Proposed Regulations provide special rules for partners and partnerships for taxable years beginning in 2019 or 2020 under section 163(j)(10) as enacted by the CARES Act. Proposed §1.163(j)-6(g)(4) provides that 50 percent of any EBIE allocated to a partner for any taxable year beginning in 2019 is treated as BIE paid or accrued by the partner in the partner's first taxable year beginning in 2020 (referred to in the 2020 Proposed Regulations as §1.163(j)-6(g)(4) business interest expense). The amount that is treated as BIE paid or accrued by the partner in the partner's 2020 taxable year is not subject to a section 163(j) limitation at the partner level. The 2020 Proposed Regulations further provide that if a partner disposes of its interest in the partnership in the partnership's 2019 or 2020 taxable year, the amount treated as BIE paid or accrued by the partner under proposed §1.163(j)-6(g)(4) is deductible by the partner and thus does not result in a basis increase under §1.163(j)-6(h)(3). The 2020 Proposed Regulations state that a

taxpayer may elect to not have §1.163(j)-6(g)(4) apply, and provide two examples illustrating these rules in §§1.163(j)-6(o)(35) and (o)(36). The Treasury Department and the IRS specifically requested comments on these proposed rules and on whether further guidance was necessary.

One commenter agreed with the approach taken in the 2020 Proposed Regulations, but requested that the final regulations clarify that an election out of the 50 percent EBIE rule is made by a partner with respect to each partnership in which the partner holds an interest. The commenter stated that partners may have different reasons to elect out of the 50 percent EBIE rule and that by allowing partners to make the election out with respect to each partnership, partners will have greater flexibility in managing their tax consequences.

The Treasury Department and the IRS agree with this comment. Thus, the final regulations clarify that partners may elect out of the 50 percent EBIE rule on a partnership by partnership basis.

Another commenter requested confirmation with respect to an aspect of the example in §1.163(j)-6(o)(36). In the example, the partner is allocated EBIE in 2018 and 2019 and sells its partnership interest in 2019. The commenter requested confirmation that the partner would not deduct 50 percent of the EBIE since the sale of the partnership interest occurred in 2019, resulting in a gain/loss recognition event during the 2019 taxable year, and there would be no basis in the partnership for the partner to deduct 50 percent of the 2019 EBIE.

The Treasury Department and the IRS believe that the example, as drafted in the proposed regulations, represents a correct interpretation of the regulations and are therefore finalizing the example without change. However, these final regulations clarify that §1.163(j)-6(g)(4) business interest expense can be deducted by the disposing partner except to the extent that the business interest expense is negative section 163(j) expense as defined in §1.163(j)-6(h)(1) immediately before the disposition. Under the example in §1.163(j)-6(o)(36), the partner treats 50 percent of 2019 EBIE (\$10 x 50%) as §1.163(j)-6(g)(4) business interest expense. Section 1.163(j)-6(g)(4) provides that if a partner

disposes of a partnership interest in the partnership's 2019 or 2020 taxable year, the partner can deduct the §1.163(j)-6(g)(4) business interest expense and there is no basis increase under §1.163(j)-6(h)(3) for this amount. Thus, unless the partner elects out of the 50 percent EBIE rule, the partner would have a \$25 loss (instead of a \$30 loss) from the sale of its partnership interest in 2019 and \$5 of deductible BIE that is not subject to a section 163(j) limitation at the partner level.

The Treasury Department and the IRS received one comment on proposed §1.163(j)-6(d)(5). This commenter stated that the proposed regulations disregard the "11-step approach" in §1.163(j)-6(f)(2), and instead point to different mechanics of a tiered partnership allocation rule under proposed §1.163(j)-6(j)(9). The commenter recommended additional guidance and examples on the application of the proposed regulations to non-tiered partnerships and partnerships that historically allocate all items pro rata.

In light of this comment, and in light of the fact that the tiered partnership rules in the proposed regulations are not being finalized at this time, the Treasury Department and the IRS believe that a simpler method for a partnership to take into account 2019 ATI in 2020 is warranted. Therefore, these final regulations prescribe a simplified method that applies when a partnership uses its 2019 section 704 income, gain, loss, and deduction amounts in determining its 2020 allocable ATI and include an illustrative example.

#### V. Comments on and Changes to Proposed §1.163(j)-7: Application of the Section 163(j) Limitation to Foreign Corporations and United States Shareholders

##### A. Overview

Section 1.163(j)-7 provides rules for applying section 163(j) to relevant foreign corporations and their United States shareholders (U.S. shareholders).

As described in this part V of the Summary of Comments and Explanation of Revisions section, the Treasury Department and the IRS continue to study aspects of proposed §1.163(j)-7. Accordingly, the final regulations reserve

on §1.163(j)-7(c)(2)(iii) (treating a CFC group as single C corporation for purposes of allocations to an excepted trade or business) and (iv) (treating a CFC group as single taxpayer for purposes of treating amounts as interest), (f)(2) (ordering rule when a CFC group member has ECI), and (j) (computation of ATI of certain United States shareholders of applicable CFCs), and related definitions in §1.163(j)-7(k). These paragraphs of the 2020 Proposed Regulations are retained in proposed form and may be relied on to the extent provided in the Applicability Dates section.

## B. Negative Adjusted Taxable Income of CFC Group Members

Proposed §1.163(j)-7(c) provided rules for applying section 163(j) to CFC group members. Proposed §1.163(j)-7(c)(2)(i) provided that a single section 163(j) limitation is computed for a specified period of a CFC group based on the sum of the current-year business interest expense, disallowed BIE carryforwards, BII, floor plan financing interest expense, and ATI of each CFC group member. For this purpose, the ATI and other items of a CFC group member were generally computed on a separate-entity basis. Proposed §1.163(j)-7(c)(2)(i).

Under the general rule of §1.163(j)-1(b)(1)(vii), ATI of a taxpayer cannot be less than zero (no-negative ATI rule). Two comments were received regarding the application of the no-negative ATI rule with respect to CFC groups and CFC group members. One of the comments stated that it is unclear how the rule applies to CFC group members. Both comments asserted that the no-negative ATI rule should apply with respect to the CFC group, rather than each separate CFC group member. As a result, the ATI of a CFC group would generally be reduced by the negative ATI of CFC group members, if any. One comment noted that consolidated groups have a single ATI amount, which takes into account losses of consolidated group members. Another comment noted that, if negative ATI of CFC group members is not taken into account, CFC group members could be required to deduct BIE in a taxable year in which the sum of the CFC group members' tested losses exceed the sum of their tested income; the comment

questioned whether this result is appropriate, noting that it would often be more beneficial to carry forward the disallowed BIE to the subsequent taxable year in light of the fact that tested losses cannot be carried forward to subsequent taxable years.

The Treasury Department and the IRS agree that the ATI of CFC group members should take into account amounts less than zero for purposes of determining the ATI of a CFC group. Accordingly, the final regulations provide that the no-negative ATI rule applies with respect to the ATI of a CFC group, rather than a CFC group member.

## C. Transactions Between CFC Group Members

In general, intragroup transactions are taken into account for purposes of computing a CFC group's section 163(j) limitation. However, proposed §1.163(j)-7(c)(2)(ii) provided an anti-abuse rule that disregarded an intragroup transaction between CFC group members if a principal purpose of entering into the transaction was to affect the CFC group's or a CFC group member's section 163(j) limitation by increasing or decreasing the CFC group or a CFC group member's ATI. Some comments requested a broader rule that would permit taxpayers to elect annually to disregard BII and BIE between CFC group members for purposes of applying section 163(j). The comments asserted that this election would reduce the compliance burden on taxpayers.

The final regulations do not provide an election to disregard intragroup BII and BIE. The effect of the requested election would be to allow a deduction for all intragroup BIE and to cause the section 163(j) limitation applicable to other BIE (that is, BIE with respect to debt that is not between members of a CFC group) to be determined without regard to intragroup BII. Although the requested election would not affect the total amount of deductible BIE within the CFC group, it would change the location of the deduction within the CFC group (that is, the CFC group member for which a deduction is allowed). Moving a BIE deduction from one CFC group member to another may have significant Federal income tax consequences. For example, the location of a CFC group's interest de-

duction can affect the amount of a CFC group member's subpart F income and tested income (or tested loss) and, therefore, the amount of a U.S. shareholder's income inclusion under section 951(a) or 951A(a), respectively. Thus, the requested election could be used to inappropriately manipulate the impact of BIE deductions within a CFC group.

However, the final regulations expand the anti-abuse rule so that it may apply not only to certain intragroup transactions that affect ATI but also to intragroup transactions entered into with a principal purpose of affecting a CFC group or a CFC group member's section 163(j) limitation by increasing the CFC group or a CFC group member's BII. This rule is intended to prevent taxpayers from artificially increasing the total amount of BII and BIE within a CFC group for a specified period in order to shift disallowed BIE from one CFC group member to another or change the timing of deductions of BIE. For example, a payment of BIE by a payor CFC group member to a payee CFC group member will generally result in an equal increase in the CFC group's section 163(j) limitation (and therefore the amount of deductible BIE) as a result of the increase in the CFC group's BII. However, the increase in the CFC group's section 163(j) limitation is not necessarily allocated to the payor. Instead, under the ordering rules of §1.163(j)-7(c)(3), the additional section 163(j) limitation would be allocated first to the payee to the extent it has BIE, and then may be allocated to other CFC group members. This type of transaction would be subject to the anti-abuse rule if it was entered into with a principal purpose of increasing the amount of BIE deductible by other CFC group members.

## D. High-Tax Exceptions

### 1. Application of section 163(j) to Controlled Foreign Corporations with high-taxed income

One comment suggested that the Treasury Department and the IRS consider a special rule for the application of section 163(j) to CFC group members that are subject to the subpart F high-tax exception under §1.954-1(d) or the GILTI high-tax exclusion under §1.951A-2(c)(7) (togeth-

er, high-tax exceptions). For example, the comment suggested a multi-step approach under which section 163(j) would first be applied to CFC group members on a separate-entity basis for the purpose of applying the high-tax exceptions, and then ATI and BIE of CFC group members subject to the high-tax exceptions could be excluded in computing the CFC group's section 163(j) limitation.

The Treasury Department and the IRS have determined that applying section 163(j) first to each CFC group member on a separate-entity basis, then applying the high-tax exceptions, and then reapplying section 163(j) to a CFC group by excluding income eligible for the high-tax exceptions, would significantly increase the administrative and compliance burdens of section 163(j) and therefore reduce the benefits of making a CFC group election. Furthermore, such an approach would be inconsistent with the general concept and purpose of a consolidated approach to the CFC group election; for example, it would increase the relevance of the location of intragroup debt and ATI within a CFC group and could inappropriately enhance the effective foreign tax rate of such income. Accordingly, the final regulations do not adopt this recommendation.

## 2. Disallowed business interest expense carryforwards and the high-tax exceptions

Section 163(j) and the section 163(j) regulations generally apply to determine the deductibility of BIE of a relevant foreign corporation (which includes an applicable CFC) in the same manner as those provisions apply to determine the deductibility of BIE of a domestic C corporation. Section 1.163(j)-7(b). One comment requested that the Treasury Department and the IRS confirm that a CFC to which the high-tax exceptions apply can still have a disallowed BIE carryforward.

The high-tax exception does not modify the rules for determining the section 163(j) limitation or the amount of an applicable CFC's disallowed BIE carryforward. See part V.D.1 of this Summary of Comments and Explanation of Revisions section. Accordingly, an applicable CFC may have disallowed BIE carryforwards

if the applicable CFC is subject to a high-tax exception in the taxable year(s) in which the disallowed BIE carryforwards arose.

## E. Allocation of CFC Group Items to an Excepted Trade or Business

Proposed §1.163(j)-7(c)(2)(iii) provided that, for purposes of allocating items to an excepted trade or business under §1.163(j)-10, all CFC group members are treated as a single C corporation. Similarly, proposed §1.163(j)-7(c)(2)(iv) provided that, for purposes of determining whether certain amounts are treated as interest within the meaning of §1.163(j)-1(b)(22), all CFC group members are treated as a single taxpayer. Several comments addressed the method of allocating items of a CFC group member to an excepted trade or business under §1.163(j)-10. The Treasury Department and the IRS continue to study the proper method for allocating CFC group members' items to an excepted trade or business and when it is appropriate to treat a CFC group as a single entity. The Treasury Department and the IRS may address these issues in future guidance and will consider the comments at that time. Accordingly, the final regulations reserve on §1.163(j)-7(c)(2)(iii) and (iv).

## F. Limitation on Pre-group Disallowed Business Interest Expense Carryforwards

### 1. Pre-group disallowed business interest expense carryforwards attributable to specified group members

The 2020 Proposed Regulations provided special rules relating to disallowed BIE carryforwards of a CFC group member that arose in a taxable year before it joined the CFC group (pre-group disallowed BIE carryforwards). Under proposed §1.163(j)-7(c)(3)(iv)(A)(I), a CFC group member cannot deduct pre-group disallowed BIE carryforwards in excess of the cumulative section 163(j) pre-group carryforward limitation. This limitation is determined in a manner similar to the limitation on the use of carryovers of a member of a consolidated group arising in a separate return limitation year (SRLY). See §1.1502-21(c).

One comment requested that the limitation on pre-group disallowed BIE carryforwards be removed, because it increases the compliance burden on taxpayers and any potential for loss trafficking could adequately be addressed by an anti-abuse rule. Alternatively, if this request is not adopted, the comment requested that the limitation on pre-group disallowed BIE carryforwards not apply to disallowed BIE carryforwards that arose in a taxable year in which a CFC group election was available but prior to the first taxable year for which the CFC group election was in effect. The comment asserted that applying the limitation to such carryforwards is inappropriate because there is no loss trafficking concern unless a CFC is acquired from outside the group.

The Treasury Department and the IRS have determined that it would be inappropriate for the limitation on deduction of pre-group disallowed BIE carryforwards to be replaced with an anti-abuse rule focused on loss trafficking. Loss trafficking concerns may arise anytime the ATI or BII of one CFC group member is used to allow a deduction for BIE of another CFC group member attributable to a taxable year before the other CFC group member joined the CFC group. As a result, the final regulations retain the limitation on the deduction of pre-group disallowed BIE carryforwards.

### 2. Application of section 382 to CFCs joining or leaving a CFC group

As a general matter, the SRLY limitations described in §§1.1502-21(c) and 1.163(j)-5(d) do not apply to a member of a consolidated group if their application would result in an overlap with the application of section 382 (SRLY overlap rule). See §§1.1502-21(g)(1) and 1.163(j)-5(f). One comment requested clarification as to whether section 382 applies to a CFC that does not have ECI. The comment generally supported the limitation on pre-group disallowed BIE carryforwards but suggested that, if section 382 applies to CFCs, a rule similar to the SRLY overlap rule should be adopted to prevent the limitation on pre-group disallowed BIE carryforwards from applying to a CFC group member if its application would result in an overlap with the application of section 382.

Section 382, by its terms, applies to the disallowed BIE carryforwards of foreign corporations regardless of whether they have ECI. However, the Treasury Department and the IRS continue to study certain aspects of the application of sections 163(j) and 382 to foreign corporations, including the possible application of a SRLY overlap rule to applicable CFCs joining or leaving a CFC group, as well as the computation of any relevant section 382(a) limitation. The Treasury Department and the IRS may address these issues in future guidance and will consider the comments at that time.

## G. Specified Groups and Specified Group Members

### 1. The 80-percent ownership threshold

Proposed §1.163(j)-7(d) provided rules for determining a specified group and specified group members. A specified group includes one or more chains of applicable CFCs connected through stock ownership with a specified group parent, but only if the specified group parent owns stock meeting the requirements of section 1504(a)(2)(B) (which requires 80 percent ownership by value) in at least one applicable CFC, and stock meeting the requirements of section 1504(a)(2)(B) in each of the applicable CFCs (except the specified group parent) is owned by one or more of the other applicable CFCs or the specified group parent. Indirect ownership through a partnership or through a foreign estate or trust is taken into account for this purpose.

Some comments requested that the ownership threshold for applying this rule be reduced to 50 percent, or “more than 50 percent,” in order to make the rule consistent with the ownership rules in sections 957 and 954(d)(3). The comments asserted that a lower threshold would reduce the compliance burden of applying section 163(j) to CFCs on a separate-entity basis, would allow joint ventures to be included in the CFC group, and could prevent taxpayers from manipulating their ownership interests in order to break affiliation and exclude entities from the CFC group. One comment noted that local regulatory restrictions may prevent a U.S. shareholder from owning 80 percent of the stock in a CFC.

Another comment requested that the ownership threshold be reduced to 50 percent with respect to a CFC that has only one U.S. shareholder. The comment asserted that, if a CFC has only one U.S. shareholder, there is no concern of potentially inconsistent treatment by different shareholders and there would be no need for additional procedural requirements (for example, a requirement to provide notice to other shareholders). Alternatively, the comment suggested that a specified group parent that is a qualified U.S. person be permitted to elect to treat a CFC as a CFC group member if it meets the 50 percent (but not the 80 percent) ownership threshold, even if the specified group parent is not the sole U.S. shareholder.

The Treasury Department and the IRS have determined that it would be inappropriate to reduce the specified group ownership threshold below 80 percent. The application of section 163(j) to a CFC group is modeled on the rules for applying section 163(j) to a U.S. consolidated group under §1.163(j)-5. Accordingly, the definition of a specified group is generally consistent with the definition of an affiliated group under section 1504. In certain respects, the rules of §1.163(j)-7(c) have the effect of treating a CFC group as a single entity for purposes of section 163(j). Such treatment is not appropriate for CFCs that do not share at least 80 percent common ownership, that is, CFCs that are not highly related. Moreover, because one CFC group member’s ATI and BII can be used by other CFC group members to deduct BIE, reducing the specified ownership threshold would increase the potential for one CFC group member to disproportionately benefit, or suffer a detriment, from the attributes of another CFC group member even though those CFCs are not highly related.

As an alternative, one comment requested that a U.S. shareholder be permitted to take into account its pro rata share of CFC attributes in computing the CFC group section 163(j) limitation without regard to the percentage of the U.S. shareholder’s ownership interest. This approach is not adopted in the final regulations because it would require different U.S. shareholders to calculate the section 163(j) limitation differently and separate-

ly track disallowed BIE carryforwards with respect to the same CFC.

### 2. Clarifications to rules for determining a specified group and specified group members

The final regulations make several clarifying changes to the rules for determining a specified group and specified group members. First, the definition of specified group in §1.163(j)-7(d)(2)(i) is modified to clarify that a specified group may exist when a qualified U.S. person directly owns all of its applicable CFCs rather than owning one or more chains of applicable CFCs.

Second, the definition of specified group member in §1.163(j)-7(d)(3) is modified to clarify that there must be at least two applicable CFCs in a specified group in order for any applicable CFC to be a specified group member and for a CFC group election to be available.

Finally, the rule in §1.163(j)-7(d)(2)(vii) (concerning when a specified group ceases to exist) is modified to clarify that references to the common parent in §1.1502-75(d)(1), (d)(2)(i) through (d)(2)(ii), and (d)(3)(i) through (d)(3)(iv) are treated as references to the specified group parent. This is the case even if the specified group parent is a qualified U.S. person and therefore not included in the specified group.

## H. CFC Group Election

### 1. Timing and revocation of the CFC group election

Proposed §1.163(j)-7(e) provided rules and procedures for treating specified group members as CFC group members and for determining a CFC group. Proposed §1.163(j)-7(e)(5) provided rules for making and revoking a CFC group election. Under the 2020 Proposed Regulations, a CFC group election could not be revoked with respect to any specified period of the specified group that begins during the 60-month period following the last day of the first specified period for which the election was made. Similarly, once revoked, a CFC group election could not be made again with respect to any specified period of the specified

group that begins during the 60-month period following the last day of the first specified period for which the election was revoked. The preamble to the proposed regulations requested comments as to whether a specified group that does not make a CFC group election when it first comes into existence (or for the first specified period following 60 days after the date of publication of the Treasury decision adopting the 2020 Proposed Regulations as final in the **Federal Register**) should be precluded from making the CFC group election for the following 60-month period.

Some comments requested that taxpayers be permitted to make or revoke the CFC group election on an annual basis, due to the difficulty of predicting the effect of the election five years in advance (including the potential for changes in fact or law that could interact adversely with the CFC group election). The comments noted that, although the election is favorable in most cases, it could have unfavorable consequences in some circumstances.

Some comments recommended against imposing a 60-month waiting period on specified groups for which a CFC group election is not made for the first specified period in which a specified group exists (or the specified period beginning 60 days after the regulations are finalized), because taxpayers may lack the resources or information to determine whether to make the election for the first taxable year in which it is available. Furthermore, some comments asked for clarification concerning when the 60-month period begins if a CFC group election is made or revoked with respect to a prior specified period. Finally, one comment recommended that the Treasury Department and the IRS consider providing an exception to the 60-month rule that would allow a CFC group election to be revoked when there is a “change in control.” The comment did not suggest a definition of change in control.

The Treasury Department and the IRS have determined that taxpayers should not be permitted to revoke the CFC group election for a specified period beginning within 60 months after the specified period for which it is made or to make the CFC group election for a specified period beginning within 60 months after the specified period for which it is revoked.

The CFC group rules are based in part on the consolidated return rules, which do not allow affiliated groups that have elected to file a consolidated return to discontinue the filing of a consolidated return without the consent of the Commissioner (which generally requires a showing of good cause). See §1.1502-75(c). In addition, if a corporation ceases to be a member of a consolidated group, that corporation generally is not permitted to rejoin the consolidated group before the 61st month beginning after its first taxable year in which it ceased to be a member of the group. Section 1504(a)(3)(A).

Moreover, an annual election would enable taxpayers to use section 163(j) to inappropriately control the timing of BIE deductions. In general, the CFC group election is intended, in large part, to reduce taxpayer burden, including compliance costs and costs that might otherwise be incurred to restructure the location of debt within a CFC group solely for purposes of section 163(j), and to permit allocation of a CFC group’s section 163(j) limitation to CFC group members with BIE. The CFC group election is not intended to allow taxpayers to select the most favorable result in every taxable year.

The Treasury Department and the IRS agree that it is not necessary to impose the 60-month waiting period on specified groups that have neither made nor revoked a CFC group election. Accordingly, the final regulations do not impose a 60-month waiting period on a specified group for which a CFC group election is not made for the first specified period in which a specified group exists (or the specified period beginning 60 days after the regulations are finalized). The final regulations provide, consistent with the 2020 Proposed Regulations, that the 60-month period begins after the last day of the specified period for which the election was made or revoked. See §1.163(j)-7(e)(5). Therefore, if an election is made or revoked with respect to a specified period, the 60-month period begins to run on the day after the end of that specified period. Finally, the Treasury Department and the IRS continue to study whether an exemption to the 60-month rule for revoking a CFC group election is appropriate when the ownership of the CFC group changes but the specified group continues

and, therefore, the CFC group would also otherwise continue absent an exemption.

## 2. Disclosure required for taxable years in which a CFC group election is in effect

Under the 2020 Proposed Regulations, a designated U.S. person makes a CFC group election by attaching a statement to its relevant Federal income tax or information return. Proposed §1.163(j)-7(e)(5) (iv). However, the 2020 Proposed Regulations did not require a statement to be filed for taxable years following the taxable year for which an election is made. In order to facilitate ongoing disclosure of the computation of the CFC group 163(j) limitation in subsequent taxable years, the final regulations provide that (in accordance with publications, forms, instructions, or other guidance) each designated U.S. person must attach a statement to its relevant Federal income tax or information return for each of its taxable years that includes the last day of a specified period of a specified group for which a CFC group election is in effect. See §1.163(j)-7(e)(6). The CFC group election remains in effect even if the required statement is not filed.

### I. CFC Group Members with Effectively Connected Income

Proposed §1.163(j)-7(f) provided that if a CFC group member has income that is effectively connected with the conduct of a U.S. trade or business (ECI), then ECI items and related attributes of the CFC group member are not included in the calculation of the section 163(j) limitation of the CFC group or in the allocation of the limitation among CFC group members, but are treated as items of a separate CFC (ECI deemed corporation) that is not treated as a CFC group member. A comment requested clarification concerning the proper method for allocating assets between the CFC group member and the ECI deemed corporation, which is relevant to the allocation of BII and BIE to an excepted trade or business under §1.163(j)-10.

As discussed in part VI of this Summary of Comments and Explanation of Revisions section, the Treasury Department and the IRS continue to study the

application of section 163(j) to foreign corporations with ECI. The Treasury Department and the IRS may address these issues in future guidance and will consider the comment at that time. Before the issuance of such guidance, taxpayers should use a reasonable method for allocating assets between the CFC group member and the ECI deemed corporation. The method must be consistently applied to all CFC group members and each specified period of the CFC group after the first specified period in which it is applied.

In addition, because the Treasury Department and the IRS continue to study the application of section 163(j) to foreign corporations with ECI, the final regulations reserve on §1.163(j)-7(f)(2) (ordering rule with §1.163(j)-8 when a CFC group member has ECI).

## J. ATI Computation of an Applicable CFC

### 1. Foreign Income Taxes

The 2020 Proposed Regulations provided that, for purposes of computing the ATI of a relevant foreign corporation for a taxable year, tentative taxable income takes into account a deduction for foreign income taxes. Proposed §1.163(j)-7(g)(3). The preamble to the 2020 Proposed Regulations requested comments on whether, and the extent to which, the ATI of a relevant foreign corporation should be determined without regard to a deduction for foreign income taxes. Some comments asserted that all foreign income taxes, or foreign income taxes imposed by the country in which a CFC is organized or a tax resident, should not be taken into account as a deduction for purposes of computing a CFC's ATI. The comments asserted that not taking into account a deduction for such foreign income taxes would provide parity between CFCs and domestic corporations, which do not deduct Federal income taxes (but may deduct state and foreign taxes) in determining their ATI.

Other comments noted that, if a domestic corporation elects to claim a foreign tax credit, the deduction for foreign income taxes is disallowed under section 275(a)(4) and is not taken into account in determin-

ing the domestic corporation's ATI. Therefore, disregarding a CFC's deduction for foreign income taxes would conform the ATI of a CFC with that of a domestic corporation doing business through a foreign branch that elects to credit foreign income taxes. Another comment asserted that foreign income taxes should not be deducted to the extent a CFC's U.S. shareholders elect to credit foreign income taxes. Finally, several comments suggested that the proposed rule penalizes CFCs operating in high-tax jurisdictions.

The Treasury Department and the IRS agree that it is appropriate to determine the ATI of a relevant foreign corporation without regard to a deduction for foreign income taxes that are eligible to be claimed as a foreign tax credit. Accordingly, the final regulations provide that no deduction for foreign income taxes (within the meaning of §1.960-1(b)) is taken into account for purposes of determining the ATI of a relevant foreign corporation. Thus, regardless of whether an election is made to claim a credit for these foreign income taxes, the foreign income taxes do not reduce ATI.

### 2. Anti-abuse rule

Proposed §1.163(j)-7(g)(4) provided that, if certain conditions are met, when one specified group member or applicable partnership (specified borrower) pays interest to another specified group member or applicable partnership (specified lender), and the payment is BIE to the specified borrower and income to the specified lender, then the ATI of the specified borrower is increased by the amount necessary for the BIE of the specified borrower not to be limited under section 163(j). A partnership is an applicable partnership if at least 80 percent of the interests in capital or profits is owned, in the aggregate, directly or indirectly through one or more other partnerships, by specified group members of the same specified group.

The final regulations provide that, for purposes of determining whether a partnership is an applicable partnership, a partner's interests in the profits and capital of the partnership are determined in accordance with the rules and principles of §1.706-1(b)(4)(ii) through (iii).

## K. Safe Harbor

Proposed §1.163(j)-7(h) provided a safe-harbor election for stand-alone

applicable CFCs and CFC groups. If the safe-harbor election is in effect for a taxable year of a stand-alone applicable CFC or specified taxable year of a CFC group member, no portion of the BIE of the stand-alone applicable CFC or of each CFC group member, as applicable, is disallowed under section 163(j). The safe-harbor election is intended to reduce the compliance burden with respect to applicable CFCs that would not have disallowed BIE if they applied section 163(j) by allowing taxpayers in general to use subpart F income and GILTI items in lieu of ATI. In general, the safe-harbor election measures whether BIE is less than or equal to the sum of 30 percent of the applicable CFC's subpart F income and GILTI (not to exceed the applicable CFC's taxable income), taking into account only amounts attributable to a non-excepted trade or business.

The preamble to the 2020 Proposed Regulations requested comments on appropriate modifications, if any, to the safe-harbor election that would further the goal of reducing the compliance burden on stand-alone applicable CFCs and CFC groups that would not have disallowed BIE if they applied the section 163(j) limitation. In this regard, comments requested that the safe harbor be expanded to cover applicable CFCs and CFC groups that have BII that is greater than or equal to BIE. The comments noted that an application of section 163(j) would not disallow any BIE of an applicable CFC or CFC group that has net BII.

The Treasury Department and the IRS agree that it is appropriate for the safe-harbor to be expanded as requested because an application of section 163(j) in this case would not disallow any BIE. Accordingly, the final regulations provide that a safe-harbor election may be made with respect to a stand-alone applicable CFC or CFC group if its BIE does not exceed either (i) its BII, or (ii) 30 percent of the lesser of its eligible amount (in general, the sum of the applicable CFC's subpart F income and GILTI, taking into account only items properly allocable to a non-excepted trade or business) or its qualified

tentative taxable income (that is, the applicable CFC's tentative taxable income determined by taking into account only items properly allocable to a non-excepted trade or business). Thus, under the final regulations, if either a stand-alone applicable CFC or a CFC group has BII that is greater than or equal to its BIE, it is not necessary to determine its qualified tentative taxable income or eligible amount in order to make the safe-harbor election. However, consistent with the 2020 Proposed Regulations, the election may not be made for a CFC group that has pre-group disallowed BIE carryforwards.

In addition, consistent with the changes described in part V.B of the Summary of Comments and Explanation of Revisions section (providing that negative ATI of a CFC group member is taken into account for purposes of computing the CFC group's section 163(j) limitation), the determination of the eligible amount of a stand-alone applicable CFC or a CFC group has been modified to account for tested losses, if any, of an applicable CFC. See §1.163(j)-7(h)(3). Rather than providing a formula for calculating each component of the eligible amount, the final regulations rely on existing rules under sections 951, 951A, 245A (to the extent provided in section 964(e)(4)), and 250 to determine the taxable income a domestic corporation would have had if it wholly owned the stand-alone applicable CFC or CFC group members and had no other assets or income. See §1.163(j)-7(h)(3).

#### L. Increase in Adjusted Taxable Income of United States Shareholders

Proposed §1.163(j)-7(j) provided rules that increase a U.S. shareholder's ATI by a portion of its specified deemed inclusions (as defined in §1.163(j)-1(b)(1)(ii)(G)). Several comments were received on these rules. The Treasury Department and the IRS continue to study the method for determining the portion of the specified deemed inclusions of a U.S. shareholder that should increase its ATI. The Treasury Department and the IRS may address this issue in future guidance and will consider the comments at that time. Accordingly, the final regulations reserve on §1.163(j)-7(j).

#### VI. *Comments on and Changes to Proposed §1.163(j)-8: Application of the Business Interest Deduction Limitation to Foreign Persons with Effectively Connected Income*

Proposed §1.163(j)-8 provides rules for applying section 163(j) to a nonresident alien individual or foreign corporation with ECI. The Treasury Department and the IRS continue to study methods of determining the amount of deductible BIE and disallowed business interest expense carryforwards that are allocable to ECI, such as the ATI ratio defined in proposed §1.163(j)-8(c)(1)(ii) and the interaction of proposed §1.163(j)-8 with the tiered partnership rules in proposed §1.163(j)-6(j). The Treasury Department and the IRS anticipate addressing these issues in future guidance and will consider the comments at that time. Accordingly, the final regulations continue to reserve on §1.163(j)-8.

#### VII. *Comments on and Changes to Proposed §1.469-9: Definition of Real Property Trade or Business*

Section 469(c)(7)(C) defines real property trade or business by reference to eleven types of trades or businesses that are not defined in the statute. The 2020 Proposed Regulations, in response to questions about the application of section 469(c)(7)(C) to timberlands, provided definitions for two terms – real property development and real property redevelopment – to further clarify what constitutes a real property trade or business.

One commenter questioned why the preamble to the 2020 Proposed Regulations references the definition of “farming” in section 464(e), when the term “farming business” in section 163(j)(7)(C) is defined by reference to section 263A(e)(4) rather than to section 464(e). The commenter further noted that a section 263A(e)(4) “farming business” excludes not only timber but also any evergreen tree which is more than 6 years old at the time severed from the roots. The commenter posited that there is no reason why such trees should be treated differently from timber for section 163(j) purposes.

The Treasury Department and the IRS have concluded that no change is required to the definition of real property trade or

business and that the definitions of “real property development” and “real property redevelopment” in proposed §1.469-9(b)(2)(ii)(C) and (D) should be adopted in the final regulations without change. However, it should be noted that §1.469-9(b)(2)(i)(B) references section 464(e) to exclude farming activities from the definition of real property trade or business for purposes of section 469(c)(7)(C). In promulgating §1.469-9(b)(2)(i)(B), the Treasury Department and the IRS determined that the term “farming” as provided in section 464(e) is the most appropriate definition for purposes of section 469(c)(7). Section 464(e) generally excludes the cultivation and harvesting of trees (except those bearing fruit or nuts) from the definition of “farming.” Accordingly, the Treasury Department and the IRS note that the term “timberland” as used in §1.469-9(b)(2)(ii)(C) and (D) includes evergreen trees (including those described in section 263A(e)(4)). Therefore, to the extent the evergreen trees may be located on parcels of land covered by forest, the Treasury Department and the IRS have concluded that the business activities of cultivating and harvesting such evergreen trees may be properly considered as a component of a “real property development” or “real property redevelopment” trade or business under the final regulations, and no additional clarification is needed in this regard. To the extent that any business activities of cultivating or harvesting evergreen trees do not explicitly fall within these two definitions, then such business activities may otherwise qualify under one or more of the other terms provided in section 469(c)(7)(C). Providing a definition for any of the remaining undefined terms in section 469(c)(7)(C) is beyond the scope of the final regulations.

#### VIII. *Comments on and Changes to Proposed §1.163(j)-10*

##### A. Proposed Limitation on Corporate Look-Through Rules

For purposes of determining the extent to which a shareholder's basis in the stock of a domestic non-consolidated C corporation or CFC is allocable to an excepted or non-excepted trade or business under §1.163(j)-10, §1.163(j)-10(c)(5)(ii)

(B) provides several look-through rules whereby the shareholder “looks through” to the corporation’s basis in its assets.

The application of these look-through rules may produce distortive results in certain situations. For example, assume Corporation X’s basis in its assets is split equally between X’s excepted and non-excepted trades or businesses, and that (as a result) X has a 50 percent exempt percentage applied to its interest expense. However, rather than operate its excepted trade or business directly, X operates its excepted trade or business through a wholly owned, non-consolidated subsidiary (Corporation Y), and each of X and Y borrows funds from external lenders. Assuming for purposes of this example that neither the anti-avoidance rule in §1.163(j)-2(h) nor the anti-abuse rule in §1.163(j)-10(c)(8) applies, Y’s interest expense would not be subject to the section 163(j) limitation because Y is engaged solely in an excepted trade or business. Moreover, a portion of X’s interest expense also would be allocable to an excepted trade or business by virtue of the application of the look-through rule in §1.163(j)-10(c)(5)(ii)(B)(2) to X’s basis in Y’s stock.

The anti-avoidance rule in §1.163(j)-2(h) and the anti-abuse rule in §1.163(j)-10(c)(8) would preclude the foregoing result in certain circumstances. However, proposed §1.163(j)-10(c)(5)(ii)(D)(2) would modify the look-through rule for domestic non-consolidated C corporations and CFCs to limit the potentially distortive effect of this look-through rule on tiered structures in situations to which the anti-avoidance and anti-abuse rules do not apply. More specifically, proposed §1.163(j)-10(c)(5)(ii)(D)(2) would modify the look-through rule for non-consolidated C corporations to provide that, for purposes of determining a taxpayer’s basis in its assets used in excepted and non-excepted trades or businesses, any such corporation whose stock is being looked through may not itself apply the look-through rule (Limited Look-Through Rule).

For example, P wholly and directly owns S1, which wholly and directly owns S2. Each of these entities is a non-consolidated C corporation to which the small business exemption does not apply. In determining the extent to which its interest

expense is subject to the section 163(j) limitation, S1 may look through the stock of S2 for purposes of allocating S1’s basis in its S2 stock between excepted and non-excepted trades or businesses. However, in determining the extent to which P’s interest expense is subject to the section 163(j) limitation, S1 may not look through the stock of S2 for purposes of allocating P’s basis in its S1 stock between excepted and non-excepted trades or businesses.

Several commenters objected to the Limited Look-Through Rule. One commenter stated that the Limited Look-Through Rule should not be finalized because it would penalize taxpayers that incur debt at the holding company level but hold excepted trade or business assets through tiers of non-consolidated subsidiaries (such as CFCs) for non-tax reasons. The commenter contended that this result is especially distortive in regulated industries, such as utilities, in which debt financing at the operating-entity level may be limited or prohibited by regulators. Another commenter noted that the Limited Look-Through Rule potentially conflicts with the single C corporation approach for CFCs under proposed §1.163(j)-7(c)(2)(iii).

The Treasury Department and the IRS remain concerned that application of the look-through rules in §1.163(j)-10 to non-consolidated C corporations may produce distortive results in certain situations. However, as stated in the preamble to the 2020 Proposed Regulations, the Treasury Department and the IRS are aware that taxpayers are organized into multi-tiered structures for legitimate, non-tax reasons and that it may be commercially difficult or impossible for taxpayers to limit or reduce the number of tiers in many cases. The Treasury Department and the IRS have therefore determined that such multi-tiered structures should be able to apply the look through rules in §1.163(j)-10. However, the Treasury Department and the IRS have also determined that the application of the look through rules in §1.163(j)-10 is inappropriate in cases where a principal purpose of a multi-tiered structure is to benefit from distortion under those rules.

Thus, the final regulations replace the Limited Look-Through Rule with an anti-abuse rule providing that, for pur-

poses of applying the look-through rules in §1.163(j)-10(c)(5)(ii)(B) and (C) to a non-consolidated C corporation (upper-tier entity), that upper-tier entity may not apply those look-through rules to a lower-tier non-consolidated C corporation if a principal purpose for borrowing funds at the upper-tier entity level or adding an upper-tier or lower-tier entity to the ownership structure is increasing the amount of the taxpayer’s basis allocable to excepted trades or businesses.

For example, P wholly and directly owns S1 (the upper-tier entity), which wholly and directly owns S2. Each of S1 and S2 is a non-consolidated C corporation to which the small business exemption does not apply, and S2 is engaged in an excepted trade or business. With a principal purpose of increasing the amount of its basis allocable to excepted trades or businesses, P has S1 (rather than S2) borrow funds from a third party. S1 may not look through the stock of S2 (and may not apply the asset basis look-through rule described in §1.163(j)-10(c)(5)(ii)(B)(2)(iv)) for purposes of P’s allocation of its basis in its S1 stock between excepted and non-excepted trades or businesses; instead, S1 must treat its stock in S2 as an asset used in a non-excepted trade or business for that purpose. However, S1 may look through the stock of S2 for purposes of S1’s allocation of its basis in its S2 stock between excepted and non-excepted trades or businesses.

#### B. 80-Percent Ownership Threshold in §1.163(j)-10(c)(7)(i)

A commenter recommended eliminating the 80-percent ownership threshold in §1.163(j)-10(c)(7)(i) for applying the look-through rules in §1.163(j)-10(c)(5)(ii) to non-consolidated C corporations. More specifically, the commenter recommended providing that interest expense allocable to an equity interest in an entity engaged in an electing real property trade or business (RPTOB) be treated as allocated to an electing RPTOB to the extent the assets of that entity are attributable to an electing RPTOB, regardless of the level of the equity interest. The commenter stated that, because a less-than-80-percent interest in a subsidiary corporation is treated as allocable to a “trade or business” for pur-

poses of the section 163(j) limitation, it is appropriate to treat the stock of that corporation as allocable to an electing RPTOB if the subsidiary corporation is an electing RPTOB, without regard to an ownership threshold.

As stated in the preamble to the 2018 Proposed Regulations, the Treasury Department and the IRS have determined that non-consolidated entities generally should not be aggregated for purposes of applying the section 163(j) limitation. Moreover, as stated in the preamble to T.D. 9905, the Treasury Department and the IRS have determined that an 80-percent ownership threshold is appropriate for domestic non-consolidated C corporations because, unlike a partnership, a corporation generally is respected as an entity separate from its owner(s) for tax purposes and, unlike a partnership or an S corporation, a C corporation is not taxed as a flow-through entity. Thus, the final regulations do not accept the commenter's recommendation.

### C. Application of Look-Through Rules to Small Businesses

Section 1.163(j)-10(c)(5)(ii)(D) provides that a taxpayer may not apply the look-through rules in §1.163(j)-10(c)(5)(ii) to a partnership, S corporation, or non-consolidated C corporation that is eligible for the small business exemption under section 163(j)(3) and §1.163(j)-2(d)(1), unless that entity elects under §1.163(j)-9 for a trade or business to be an electing RPTOB or an electing farming business. Under §1.163(j)-9(b)(2)(i), an exempt small business entity that conducts a RPTOB may make a “protective election” for its RPTOB to be an excepted trade or business.

A commenter noted that, if a taxpayer indirectly holds an interest in an electing RPTOB through an exempt upper-tier partnership that does not conduct an excepted trade or business, the taxpayer would be ineligible to allocate the taxpayer's interest expense to the electing RPTOB under T.D. 9905. To ensure that the owners of

an exempt small business entity are treated consistently regardless of the entity's overall capital structure, the commenter recommended either (i) allowing the owners of an exempt small business entity to apply the look-through rules without the need for a “protective election” to be an excepted trade or business, or (ii) allowing the small business entity to elect to opt into the look-through rules.

The Treasury Department and the IRS appreciate the comments received on the application of the look-through rules to small businesses. These comments concern provisions in T.D. 9905 that were not revised in the 2020 Proposed Regulations, and the Treasury Department and the IRS have determined that addressing these comments would exceed the scope of the final regulations. However, the Treasury Department and the IRS will continue to consider these comments for purposes of potential future guidance.

### D. Alternative to Asset Basis Allocation

A commenter recommended amending §1.163(j)-10 to permit taxpayers to use a fair market value allocation method when determining allocations of BIE for purposes of section 163(j). To discourage taxpayers from shifting allocation methods, the commenter recommended that a fair market value allocation election be irrevocable absent consent from the IRS.

As explained in the preamble to T.D. 9905, disputes between taxpayers and the IRS over the fair market value of an asset are a common and costly occurrence. Moreover, in the TCJA, Congress repealed the use of fair market value in the apportionment of interest expense under section 864 of the Code (see section 14502(a) of the TCJA). As noted in the preamble to T.D. 9905, Congress stated that the ability to elect to allocate interest expense under section 864 on the basis of fair market value of assets has led to inappropriate results and needless complexity. For these and other reasons, the Treasury Department and the IRS continue to believe that allocating interest expense based on relative

amounts of asset basis is more appropriate than a regime based on the relative fair market value of assets. Thus, the final regulations do not accept this comment.

### Applicability Dates

These final regulations apply to taxable years beginning on or after March 22, 2021. See additional discussion in part VI of the Special Analyses addressing the Congressional Review Act.

Some provisions regarding the choice to apply the final regulations to taxable years beginning before the applicability date have changed from the 2020 Proposed Regulations. Commenters noted that these provisions in the 2020 Proposed Regulations were complicated. More specifically, in the 2020 Proposed Regulations, retroactive application of certain provisions requires application of all of the section 163(j) regulations contained in T.D. 9905, some or all of the provisions in these final regulations, and other specified provisions. Additionally, most provisions had to be applied to subsequent taxable years once applied for a taxable year (subsequent year application). As provided in this section, to simplify the applicability date provisions and provide certainty to taxpayers, these final regulations, except as otherwise described later in this **Applicability Dates** section, require taxpayers choosing to apply the final regulations to a taxable year beginning before the applicability date to apply the section 163(j) regulations contained in T.D. 9905 as modified by these final regulations, along with other specified provisions, and require subsequent year application.

Except for §§1.163-15 and 1.1256(e)-2, pursuant to section 7805(b)(7), taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules of these final regulations to a taxable year beginning after December 31, 2017,<sup>1</sup> and before March 22, 2021, provided that they consistently apply the section 163(j) regulations contained in T.D. 9905 as modified

<sup>1</sup>Under the 2020 Proposed Regulations, for purposes of determining applicability dates, the term “related party” has the meaning provided in sections 267(b) and 707(b)(1). Section 267(c)(3) broadens the scope of related parties under section 267(b) by potentially treating individual partners in a partnership as related to a corporation owned by the partnership, even if the individual partners own only a small interest in the partnership. The Treasury Department and the IRS have determined that this broad scope is unnecessary in this context and may impede the ability of certain taxpayers to choose to apply the regulations to pre-applicability taxable years. Accordingly, under these final regulations, for purposes of determining applicability dates, the term “related party” is determined without regard to section 267(c)(3).

by these final regulations and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.382-7, 1.383-0, 1.383-1, 1.469-9, 1.469-11, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-36, 1.1502-79, 1.1502-90, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4 contained in T.D. 9905 as modified by these final regulations to that taxable year and each subsequent taxable year.

Pursuant to section 7805(b)(7), taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may apply the provisions of §1.163-15 or 1.1256(e)-2 of the final regulations for a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that they consistently apply the rules in §1.163-15 or 1.1256(e)-2, as applicable, to that taxable year and each subsequent taxable year.

Alternatively, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may rely on the rules in the 2020 Proposed Regulations to the extent provided in the 2020 Proposed Regulations.

To the extent that a rule in the 2020 Proposed Regulations is not finalized in these final regulations, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may rely on that rule for a taxable year beginning on or after March 22, 2021, provided that they consistently follow all of the rules in the 2020 Proposed Regulations that are not being finalized to that taxable year and each subsequent taxable year beginning on or before the date the Treasury decision adopting that rule as final is applicable or other guidance regarding continued reliance is issued.

#### **Statement of Availability of IRS Documents**

The IRS Notices, Revenue Rulings, and Revenue Procedures cited in this document are published in the Internal Revenue Bulletin (or Cumulative Bulletin) and are available from the Superintendent of

Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

#### **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. For purposes of E.O. 13771 this rule is regulatory.

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

##### **A. Need for the final regulations**

The Tax Cuts and Jobs Act (TCJA) substantially modified the statutory rules of section 163(j) to limit the amount of net business interest expense that can be deducted in the current taxable year. Because this limitation on deduction for business interest expense is relatively new, taxpayers would benefit from regulations that explain key terms and calculations. The Treasury Department and the IRS published proposed regulations in December 2018 (2018 Proposed Regulations) and published final regulations in September 2020 (T.D. 9905) to finalize most sections of the 2018 Proposed Regulations. Concurrently with the publication of T.D. 9905, the Treasury Department and the IRS published proposed regulations (2020

Proposed Regulations) to provide additional section 163(j) limitation guidance to T.D. 9905 in response to certain comments to the 2018 Proposed Regulations. The final regulations are needed to bring clarity to instances where the meaning of the statute was unclear and to respond to comments received on the 2020 Proposed Regulations.

##### **B. Background and Overview**

Section 163(j), substantially revised by the TCJA, provides a set of statutory rules that impose a limitation on the amount of business interest expense that a taxpayer may deduct for Federal tax purposes. This limitation does not apply to businesses with gross receipts of \$25 million or less (inflation adjusted). This provision has the general effect of putting debt-financed investment by businesses on a more equal footing with equity-financed investment, a treatment that Congress believed would lead to a more efficient capital structure for firms. See Senate Budget Explanation of the Bill as Passed by SFC (2017-11-20) at pp. 163-4. Subsequently, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) amended section 163(j) to provide special rules relating to the ATI limitation for taxable years beginning in 2019 or 2020.

##### **C. Economic Analysis**

###### **1. Baseline**

In this analysis, the Treasury Department and the IRS assess the economic effects of the final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of the final regulations.

###### **2. Summary of Economic Effects**

The final regulations provide certainty and clarity to taxpayers regarding terms and calculations that are contained in section 163(j), which was substantially modified by TCJA. In the absence of this clarity, the likelihood that different taxpayers would interpret the rules regarding the deductibility of business interest expense (BIE) differently would be exacerbated. In general, overall economic performance

is enhanced when businesses face more uniform signals about tax treatment. Certainty and clarity over tax treatment also reduce compliance costs for taxpayers.

For those situations where taxpayers would generally adopt similar interpretations of the statute even in the absence of guidance, the final regulations provide value by helping to ensure that those interpretations are consistent with the purpose of the statute. For example, the final regulations may specify a tax treatment that few or no taxpayers would adopt in the absence of specific guidance.

The Treasury Department and the IRS project that the final regulations will have an annual economic effect greater than \$100 million (\$2020) relative to the no-action baseline. This determination is based on the substantial volume of business interest payments in the economy<sup>2</sup> and the general responsiveness of business investment to effective tax rates,<sup>3</sup> one component of which is the deductibility of interest expense. Based on these two factors, even modest changes in the deductibility of interest payments (and in the certainty of that deductibility) provided by the final regulations, relative to the no-action baseline, can be expected to have annual effects greater than \$100 million. This claim is particularly likely to hold for the first set of general section 163(j) guidance that is promulgated following major legislation, such as TCJA, and for other major guidance, which the Treasury Department and the IRS have determined includes the final regulations.

Regarding the nature of the economic effects, the Treasury Department and the IRS project that the final regulations will increase investment in the United States and increase the proportion that is debt-financed, relative to the no-action baseline. They have further determined that these effects are consistent with the intent and purpose of the statute. Because the final regulations are projected to lead to a decrease in Federal tax revenue relative to the no-action baseline, there may be an increase in the Federal deficit relative to the no-action baseline. This may lead to a decrease in investment by taxpayers not directly affected by these final regulations, relative to the

no-action baseline. This effect should be weighed against the enhanced efficiency arising from the clarity and enhanced consistency with the intent and purpose of the statute provided by these regulations. The Treasury Department and the IRS have determined that the final regulations provide a net benefit to the U.S. economy relative to the no-action baseline.

The Treasury Department and the IRS have not undertaken more precise quantitative estimates of these effects because many of the definitions and calculations under section 163(j) are new and many of the economic decisions that are implicated by these final regulations involve highly specific taxpayer circumstances. The Treasury Department and the IRS do not have readily available data or models to estimate with reasonable precision the types and volume of different financing arrangements that taxpayers might undertake under the final regulations versus the no-action baseline.

In the absence of such quantitative estimates, the Treasury Department and the IRS have undertaken a qualitative analysis of the economic effects of the final regulations relative to the no-action baseline and relative to alternative regulatory approaches. This analysis is presented in Part I.C.3 of this Special Analyses.

No comments on the economic analysis of the 2020 Proposed Regulations were received.

### 3. Economic Effects of Specific Provisions

#### a. Definition of Interest

T.D. 9905 set forth several categories of amounts and transactions that generate interest for purposes of section 163(j). The final regulations provide further guidance on the definition of interest relevant to the calculation of interest expense and interest income. In particular, the final regulations provide rules under which the dividends paid by a regulated investment company (RIC) that earns net business interest income (BII) (referred to as section 163(j) interest dividends) are to be treated as interest income by the RIC's shareholders.

That is, under the final regulations, certain interest income earned by the RIC and paid to a shareholder as a dividend is treated as if the shareholder earned the interest income directly for purposes of section 163(j).

These final regulations clarify that reported dividends paid by RICs can include designations of BII for the purposes of the section 163(j) limitation. This clarification makes clear that investment through RICs is treated, for purposes of the section 163(j) limitation, similarly to investment through other possible debt instruments. To the extent that taxpayers believed, in the absence of the final regulations, that dividends paid by RICs are not treated as BII for the purposes of the section 163(j) limitation, then taxpayers may respond to the final regulations by increasing investment in RICs. The Treasury Department and the IRS have determined that this treatment is consistent with the intent and purpose of the statute.

*Affected Taxpayers.* The Treasury Department and the IRS have determined that the rules regarding section 163(j) interest dividends will potentially affect approximately 10,000 RICs. The Treasury Department and the IRS do not have readily available data on the number of RIC shareholders that would receive section 163(j) interest dividends that the shareholder could treat as BII for purposes of the shareholder's section 163(j) limitation. They further do not have data on the volume of dividends that would be eligible for this treatment.

#### b. Provisions related to Partnerships

##### i. Trading Partnerships

Section 163(j) limits the deductibility of interest expense at the partnership level. The final regulations address commenter concerns about the interaction between this section 163(j) limitation and the section 163(d) partner level limitation on interest expense that existed prior to TJCA. Under logic described in the preamble to the 2018 Proposed Regulations, section 163(j) limitations would apply at the partnership level while section 163(d) limita-

<sup>2</sup> Interest deductions in tax year 2013 for corporations, partnerships, and sole proprietorships were approximately \$800 billion.

<sup>3</sup> See E. Zwick and J. Mahon, "Tax Policy and Heterogeneous Investment Behavior," at *American Economic Review* 2017, 107(1): 217-48 and articles cited therein.

tions would apply at the partner level and these tests would be applied independently. Commenters suggested and the Treasury Department and the IRS have agreed that the correct interpretation of the statute is to exempt interest expense that is limited at the partner level by section 163(d) from the partnership-level section 163(j) limitation in accordance with the language of section 163(j)(5).

The final regulations provide that interest expense at the partnership level that is allocated to non-materially participating partners subject to section 163(d) is not included in the section 163(j) limitation calculation of the partnership. Generally, the section 163(d) limitation is more generous than the section 163(j) limitation. Relative to the 2018 Proposed Regulations, this change may encourage these partners to incur additional interest expense because they will be less likely to be limited in their ability to use it to offset other income. Commenters argued that exempting from section 163(j) any interest expense allocated to non-materially participating partners subject to section 163(d) will treat this interest expense in the same way as the interest expense generated through separately managed accounts, which are not subject to section 163(j) limitations.

The Treasury Department and the IRS project that the final regulations will result in additional investment in trading partnerships and generally higher levels of debt in any given trading partnership relative to the 2018 Proposed Regulations. Because investments in trading partnerships may be viewed as economically similar to investments in separately managed accounts arrangements, they further project that the final regulations, by making the tax treatments of these two arrangements generally similar, will improve U.S. economic performance relative to the no-action baseline.

*Number of Affected Taxpayers.* The Treasury Department and the IRS have determined that the rules regarding trading partnerships will potentially affect approximately 275,000 partnerships, not including their partners. This number was reached by determining, using data for the 2017 taxable year, the number of Form 1065 and Form 1065-B filers that (1) completed Schedule B to Form 1065 and marked box b, c, or d in question 1 to

denote limited partnership, limited liability company, or limited liability partnership status; and (2) have a North American Industry Classification System (NAICS) code starting with 5231 (securities and commodity contracts intermediation and brokerage), 5232 (securities and commodity exchanges), 5239 (other financial investment activities), or 5259 (other investment pools and funds).

Additionally, the Treasury Department and the IRS have determined that the rules regarding publicly traded partnerships will potentially affect approximately 80 partnerships, not including their partners. This number was reached by determining, using data for the 2017 taxable year, the number of Form 1065 and 1065-B filers with gross receipts exceeding \$25 million that answered “yes” to question 5 on Schedule B to Form 1065 denoting that the entity is a publicly traded partnership. The Treasury Department and the IRS do not have readily available data on the number of filers that are tax shelters that are potentially affected by these provisions.

#### ii. Self-charged Lending

The 2018 Proposed Regulations requested comments on the treatment of lending transactions between a partnership and a partner (self-charged lending transactions). Suppose that a partnership receives a loan from a partner and allocates the resulting interest expense to that partner. Prior to TCJA, the interest income and interest expense from this loan would net precisely to zero on the lending partner’s tax return. Under section 163(j) as revised by TCJA, however, the partnership’s interest expense deduction may now be limited. Therefore, in absence of specific regulatory guidance, the lending partner may receive interest income from the partnership accompanied by less-than-fully-offsetting interest expense. Instead, the lending partner would receive excess business interest expense (EBIE), which would not be available to offset his personal interest income. This outcome has the effect of increasing the cost of lending transactions between partners and their partnerships relative to otherwise similar financing arrangements.

To avoid this outcome, the final regulations treat the lending partner’s interest

income from the loan as excess business interest income (EBII) from the partnership, but only to the extent of the partner’s share of any EBIE from the partnership for the taxable year. This allows the interest income from the loan to be offset by the EBIE. The business interest expense (that is, BIE) of the partnership attributable to the lending transaction will thus be treated as BIE of the partnership for purposes of applying section 163(j) to the partnership.

The Treasury Department and the IRS expect that the final regulations will lead a higher proportion of self-charged lending transactions in partnership financing, relative to the no-action baseline. In a self-charged lending transaction, the lending partner is on both sides of the transaction. It is the lender and, through the partnership, the borrower. Because of this, debt from self-charged lending transactions is generally viewed as less risky than traditional debt, as both the lender and the borrower are incentivized to repay the loan without default. Therefore, the Treasury Department and the IRS believe that the better policy choice is to not subject self-charged lending transactions to section 163(j). The Treasury Department and the IRS further project that the final regulations will increase the proportion of partnership financing that is debt-financed relative to the no-action baseline. The Treasury Department and the IRS have determined that these effects are consistent with the intent and purpose of the statute.

*Number of Affected Taxpayers.* The Treasury Department and the IRS do not have readily available data to determine the number of taxpayers affected by rules regarding self-charged interest because no reporting modules currently connect these payments by and from partnerships.

#### c. Provisions related to Controlled Foreign Corporations (CFCs)

##### i. How to Apply Section 163(j) when CFCs have shared ownership

T.D. 9905 clarified that section 163(j) and the section 163(j) regulations generally apply to determine the deductibility of a CFC’s BIE for tax purposes in the same manner as these provisions apply to a domestic corporation. The final regulations

provide additional rules and guidance as to how section 163(j) applies to CFCs, including when CFCs have shared ownership and are eligible to be members of CFC groups.

The Treasury Department and the IRS considered three options with respect to the application of section 163(j) to CFC groups. The first option was to apply the 163(j) limitation to CFCs on a stand-alone basis, regardless of whether CFCs have shared ownership. However, if section 163(j) were applied on a stand-alone basis, business interest deductions of individual CFCs might be limited by section 163(j) even when, if calculated on a group basis, business interest deductions would not be limited. Taxpayers could restructure or “self-help” to mitigate the effects of the section 163(j) limitation. Such an option would lead to restructuring costs for the taxpayer (relative to the third option, described later) with no corresponding economically productive activity.

The second option, which was proposed in the 2018 Proposed Regulations, was to allow an election to treat related CFCs in a similar manner as partnerships with respect to their U.S. shareholders. Under this option, while the section 163(j) rules would still be computed at the individual CFC level, the business interest expense of each CFC group member that was subject to section 163(j) was limited to its share of the net business interest expense of the CFC group, and the “excess taxable income” of a CFC could be passed up from lower-tier CFCs to upper-tier CFCs and U.S. shareholders in the same group. Excess taxable income is the amount of income by which a CFC’s ATI exceeds the threshold amount of ATI below which there would be disallowed BIE.

Comments to the 2018 Proposed Regulations suggested that computing a section 163(j) limitation for each CFC and rolling up CFC excess taxable income would be burdensome for taxpayers, especially since some multinational organizations have hundreds of CFCs. In addition, comments noted that the ability to pass up excess taxable income would encourage multinational organizations to restructure such that CFCs with low interest payments and high ATI are lower down the ownership chain and CFCs

with high interest payments and low ATI are higher up in the chain of ownership. Similar to the first option, this restructuring would impose costs on taxpayers without any corresponding productive economic activity.

The third option, which is adopted by the Treasury Department and the IRS in the final regulations, was to allow taxpayers to elect to apply the section 163(j) rules to CFC groups on an aggregate basis, similar to the rules applicable to U.S. consolidated groups. This option was suggested by many comments and is the approach taken in the final regulations. Under this option, a single section 163(j) limitation is computed for a CFC group by summing the items necessary for this computation (for example, current-year BIE and ATI) across all CFC group members. The CFC group’s limitation is then allocated to each CFC member using allocation rules similar to those that apply to U.S. consolidated groups.

The choice to use the consolidated approach versus the stand-alone entity approach may affect the amount of interest that can be deducted. The amount of interest that can be deducted may affect the amount of subpart F income and tested income for purposes of determining the amount of inclusions under sections 951 and 951A. However, the consolidated approach applies only for purposes of computing the section 163(j) limitation and not for purposes of applying any other Code provision, such as section 951 or 951A.

This option reduces the compliance burden on taxpayers in comparison to applying the section 163(j) rules on an individual CFC basis and calculating the excess taxable income to be passed up from lower-tier CFCs to higher-tier CFCs. In comparison to the first and second options, this option also removes the incentive for taxpayers to undertake costly restructuring, since the location of interest payments and ATI among CFC group members will not affect the interest disallowance for the group. The Treasury Department and the IRS have not estimated this difference in compliance costs because they do not have readily available data or models to do so.

The final regulations also set out a number of rules to govern membership in

a CFC group. These rules specify which CFCs can be members of the same CFC group, how CFCs with U.S. effectively connected income (ECI) should be treated, and the timing for making or revoking a CFC group election. These rules provide clarity and certainty to taxpayers regarding the CFC group election for section 163(j). In the absence of these regulations, taxpayers may make financing decisions or undertake restructuring based on differential interpretations of the appropriate tax treatment, an outcome that is generally inefficient relative to decisions based on the more uniform interpretation provided by the final regulations.

*Number of Affected Taxpayers.* The set of taxpayers affected by this rule includes any taxpayer with ownership in a CFC that is a member of a CFC group that has average gross receipts over a three-year period in excess of \$25 million. The Treasury Department and the IRS estimate that there are approximately 7,500 taxpayers with two or more CFCs based on counts of e-filed tax returns for tax years 2015-2017. This estimate includes C corporations, S corporations, partnerships, and individuals with CFC ownership.

#### ii. Foreign income taxes and ATI of a CFC

The 2020 Proposed Regulations provided that the ATI of a CFC is determined by taking into account a deduction for foreign income taxes. The preamble to the 2020 Proposed Regulations requested comments on whether, and the extent to which, the ATI of a CFC should be determined without regard to a deduction for foreign income taxes. The final regulations provide that the ATI of a CFC is determined without regard to a deduction for foreign income taxes that are eligible to be claimed as a foreign tax credit. Thus, regardless of whether an election is made to claim a credit for these foreign income taxes, the foreign income taxes do not reduce ATI.

The Treasury Department and the IRS considered three options, based on comments received, in determining the extent to which foreign income taxes paid by a CFC should be taken into account in determining its ATI. The first option would

not take into account a deduction for foreign income taxes imposed by the national government of the country in which a CFC is organized or a tax resident, but would take into account a deduction for taxes imposed by sub-national levels of government. This would result in treating a CFC in an analogous manner to a domestic corporation, which does not deduct Federal income taxes (but may deduct state and foreign taxes) in determining its ATI. However, this option would result in the ATI of a CFC being determined in a different manner than the ATI of a domestic corporation doing business through a foreign branch that elects to credit foreign income taxes (as discussed in the next option). Furthermore, this option would increase (relative to the next option) the administrative and compliance burdens of taxpayers required to determine which foreign income taxes paid by a CFC are imposed by a national government and which are imposed by sub-national levels of government.

The second option considered would not take into account foreign income taxes for which an election is made to claim a foreign tax credit. This option would conform the ATI of a CFC with that of a domestic corporation doing business through a foreign branch. If a domestic corporation doing business through a foreign branch elects to claim a foreign tax credit, the deduction for foreign income taxes is disallowed under section 275(a)(4) and is not taken into account in determining the domestic corporation's ATI. However, unlike a foreign branch that has a single owner, a CFC may have multiple shareholders. Because the election to credit foreign income taxes is made at the shareholder-level, this option would require a CFC to determine which of its shareholders elects to credit foreign income taxes, thereby increasing the administrative and compliance burdens. Furthermore, some shareholders of a CFC may elect to credit foreign income taxes, while other shareholders of the CFC may not elect or may not be eligible to elect a credit (for example, because the shareholder is a foreign corporation). Since the section 163(j) limitation is determined at the CFC-level, rather than on a shareholder-by-shareholder basis, this option could result in one shareholder being affected by the election of an unrelated

shareholder of the same CFC, an outcome that would generally lead to economically inefficient decision-making.

The third option, which is adopted by the Treasury Department and the IRS in the final regulations, does not take into account a deduction for foreign income taxes that are eligible to be claimed as a foreign tax credit for purposes of calculating a CFC's ATI, regardless of whether the CFC's U.S. shareholders have made an election to claim a foreign tax credit. Relative to the first and second options, this option minimizes the administrative and compliance burden of determining ATI of a CFC, and also results in the greatest amount of ATI and section 163(j) limitation. In addition, this option does not treat CFCs located in high-tax countries differently than CFCs located in low-tax countries. Otherwise similar CFCs will have similar ATIs regardless of their foreign income taxes. In this way, the rule does not penalize U.S. shareholders of CFCs with high foreign taxes.

*Number of Affected Taxpayers.* The population of affected taxpayers includes any taxpayer that is a U.S. shareholder of a CFC. The Treasury Department and the IRS estimate that there are approximately 10,000 to 11,000 affected taxpayers based on a count of e-filed tax returns for tax years 2015-2017. These counts include C corporations, S corporations, partnerships, and individuals with CFC ownership that meet a \$25 million three-year average gross receipts threshold. The Treasury Department and the IRS do not have readily available data on the number of filers that are tax shelters that are potentially affected by these provisions.

d. Election to use 2019 ATI to determine 2020 section 163(j) limitation for consolidated groups

The final regulations provide that if a taxpayer filing as a consolidated group elects to substitute its 2019 ATI for its 2020 ATI, that group can use the consolidated group ATI for the 2019 taxable year, even if membership of the consolidated group changed in the 2020 taxable year. For example, suppose consolidated group C has three members in the 2019 taxable year, P, the common parent of the consolidated group, and S1 and S2,

which are both wholly owned by P. In the 2019 taxable year, each member of consolidated group C had \$100 of ATI on a stand-alone basis, and that consolidated group C had \$300 of ATI. In the 2020 taxable year, consolidated group C sells all of the stock of S2 and acquires all of the stock of a new member, S3. In the 2019 taxable year, S3 had \$50 in ATI on a stand-alone basis. Under the final regulations, consolidated group C may elect to use \$300 in ATI from 2019 as a substitute for its ATI in the 2020 taxable year.

The Treasury Department and the IRS considered as an alternative basing the 2019 ATI on the membership of the consolidated group in the 2020 taxable year. In the example in the previous paragraph, this approach would subtract out the \$100 in ATI from S2 and add the \$50 in ATI from S3, for a total of \$250 in 2019 ATI that could potentially be substituted for 2020 ATI for consolidated group C. This approach would add burden to taxpayers relative to the final regulations by requiring additional calculations and tracking of ATI on a member-by-member basis to determine the amount of 2019 ATI that can be used in the 2020 taxable year without providing any general economic benefit.

In addition, the 2019 tax year will have closed for most taxpayers by the time the final regulations will be published. This implies that a final rule based on the consolidated group composition in the 2019 taxable year to calculate the amount of 2019 ATI that can be used in the 2020 taxable year will, relative to the alternative approach of using the composition in the 2020 taxable year, reduce the incentive for taxpayers to engage in costly mergers, acquisitions, or divestitures to achieve a favorable tax result for those taxpayers for whom the 2020 taxable year has not closed by the time the final regulations are published.

*Number of Affected Taxpayers.* The Treasury Department and the IRS estimate that approximately 34,000 corporate taxpayers filed a consolidated group tax return for tax year 2017. This represents an upper-bound of the number of taxpayers affected by the final rule as not all consolidated groups would need to calculate the amount of section 163(j) interest limitation in tax years 2019 and 2020.

## II. Paperwork Reduction Act

The collection of information in the final regulations has been submitted to the OMB for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) (PRA). 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 OMB control number.

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 return information are confidential, as required by section 6103 of the Code.

### iv. Collections of Information

The collections of information subject to the PRA in the final regulations are in §§1.163(j)-6(d)(5), 1.163(j)-6(g)(4), 1.163(j)-7(e)(5)(iv), 1.163(j)-7(e)(6), and 1.163(j)-7(h)(5).

The collections of information in §§1.163(j)-6(d)(5) and 1.163(j)-6(g)(4) are required to make two elections relating to changes made to section 163(j) by the CARES Act. The election under §1.163(j)-6(d)(5) is for a passthrough taxpayer to use the taxpayer's ATI for the last taxable year beginning in 2019 as its ATI for any taxable year beginning in 2020, in accordance with section 163(j)(10)(B). The election under §1.163(j)-6(g)(4) relates to EBIE of a partnership for any taxable year beginning in 2019 that is allocated to a partner. Section 163(j)(10)(A)(ii)(II) provides that, unless the partner elects out, in 2020, the partner treats 50 percent of the EBIE as not subject to the section 163(j) limitation. If the partner elects out, the partner treats all EBIE as subject to the same limitations as other EBIE allocated to the partner.

Revenue Procedure 2020-22 describes the time and manner for making these elections. For both elections, taxpayers make the election by timely filing a Federal income tax return or Form 1065, including extensions, an amended Federal income tax return, amended Form 1065, or administrative adjustment request, as applicable. More specifically, taxpayers complete the Form 8990, "Limitation on Business Interest Expense under Section 163(j)," using the taxpayer's 2019 ATI and/or not applying the rule in section 163(j)(10)(ii)(II), as applicable. No formal statements are required to make these elections. Accordingly, the reporting burden associated with the collections of information in §§1.163(j)-6(d)(5) and 1.163(j)-6(g)(4) will be reflected in the IRS Form 8990 PRA Submissions (OMB control number 1545-0123).

The collections of information in §1.163(j)-7 are required for taxpayers (1) to make or revoke an election under §1.163(j)-7(e)(5)(iv) to apply section 163(j) to a CFC group (CFC group election) and to file an annual information statement to demonstrate how the CFC group calculated its section 163(j) limitation under §1.163(j)-7(e)(6) (annual information statement), or (2) to make an annual election to exempt a CFC or CFC group from the section 163(j) limitation under §1.163(j)-7(h)(5) (safe-harbor election). The CFC group election or revocation of the CFC group election are made by attaching a statement to the US shareholder's annual return. Similarly, the annual information statement must be attached to the US shareholder's annual return. The CFC group election remains in place until revoked and may not be revoked for any period beginning before 60 months following the period for which it is initially made. The safe-harbor election is made on an annual basis.

Under §1.964-1(c)(3)(i), to make an election on behalf of a foreign corporation, the controlling domestic shareholder provides a statement with its return and notice of the election to the minority shareholders under §1.964-1(c)(3)(ii) and (iii). See also §1.952-2(b)-(c). These collections are necessary to ensure that the election is properly effectuated, and that taxpayers properly report the amount of interest that is potentially subject to the limitation.

### B. Future Modifications to Forms to Collect Information

At this time, the Treasury Department and the IRS are considering modifications to the Form 8990, "Limitation on Business Interest Expense IRC 163(j)," with regard to the elections under section 163(j)(10) regarding the election under §§1.163(j)-6(d)(5) and 1.163(j)-6(g)(4), the CFC group election, annual information statement, and safe-harbor election. Any modifications to Form 8990 would not be effective until the form cycle for the 2021 taxable year. For the PRA, the reporting burden of Form 8990 is associated with OMB control number 1545-0123. In the 2018 Proposed Regulations, Form 8990 was estimated to be required by fewer than 92,500 taxpayers.

If an additional information collection requirement is imposed through these regulations in the future, for purposes of the PRA, any reporting burden associated with these regulations will be reflected in the aggregated burden estimates and the OMB control numbers for general income tax forms or the Form 8990, "Limitation on Business Interest Expense Under Section 163(j)".

The forms are available on the IRS website at:

| Form  | OMB Number | IRS Website Link  | Status  |
|---|------------|---|---|
| Form 1040   | 1545-0074  | <a href="https://www.irs.gov/pub/irs-pdf/f1040.pdf">https://www.irs.gov/pub/irs-pdf/f1040.pdf</a><br>(Instructions: <a href="https://www.irs.gov/pub/irs-pdf/i1040gi.pdf">https://www.irs.gov/pub/irs-pdf/i1040gi.pdf</a> ) | Published in the Federal Register on 10/30/2020. Public comment period ends 12/29/2020. |
| Link: <a href="https://www.federalregister.gov/documents/2020/10/30/2020-24139/proposed-extension-of-information-collection-request-submitted-for-public-comment-comment-request">https://www.federalregister.gov/documents/2020/10/30/2020-24139/proposed-extension-of-information-collection-request-submitted-for-public-comment-comment-request</a> |            |   |   |

| Form           | OMB Number  | IRS Website Link   | Status  |
|----------------|---|--|---|
| Form 1120      | 1545-0123   | <a href="https://www.irs.gov/pub/irs-pdf/f1120.pdf">https://www.irs.gov/pub/irs-pdf/f1120.pdf</a><br>(Instructions: <a href="https://www.irs.gov/pub/irs-pdf/i1120.pdf">https://www.irs.gov/pub/irs-pdf/i1120.pdf</a> )                    | Published in the Federal Register on 11/3/2020. Public comment period ends January 4, 2021. |
| Form 1120S     |   | <a href="https://www.irs.gov/pub/irs-pdf/f1120s.pdf">https://www.irs.gov/pub/irs-pdf/f1120s.pdf</a><br>(Instructions: <a href="https://www.irs.gov/pub/irs-pdf/i1120s.pdf">https://www.irs.gov/pub/irs-pdf/i1120s.pdf</a> )                |   |
| Form 1065      |   | <a href="https://www.irs.gov/pub/irs-pdf/f1065.pdf">https://www.irs.gov/pub/irs-pdf/f1065.pdf</a><br>(Instructions: <a href="https://www.irs.gov/pub/irs-pdf/i1065.pdf">https://www.irs.gov/pub/irs-pdf/i1065.pdf</a> )                    |   |
| Form 1120-REIT |   | <a href="https://www.irs.gov/pub/irs-pdf/f1120rei-2018.pdf">https://www.irs.gov/pub/irs-pdf/f1120rei-2018.pdf</a> (Instructions: <a href="https://www.irs.gov/pub/irs-pdf/i1120rei.pdf">https://www.irs.gov/pub/irs-pdf/i1120rei.pdf</a> ) |   |
| Form 8990      |   | <a href="https://www.irs.gov/pub/irs-pdf/f8990_accessible.pdf">https://www.irs.gov/pub/irs-pdf/f8990_accessible.pdf</a> (Instructions: <a href="https://www.irs.gov/pub/irs-pdf/i8990.pdf">https://www.irs.gov/pub/irs-pdf/i8990.pdf</a> ) |   |
|                | Link: <a href="https://www.federalregister.org/documents/2020/11/03/2020-24251/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s">https://www.federalregister.org/documents/2020/11/03/2020-24251/proposed-collection-comment-request-for-forms-1065-1066-1120-1120-c-1120-f-1120-h-1120-nd-1120-s</a> |  |   |

In addition, when available, drafts of IRS forms are posted for comment at <https://apps.irs.gov/app/picklist/list/draft-TaxForms.htm>. IRS forms are available at <https://www.irs.gov/forms-instructions>. Forms will not be finalized until after they have been approved by OMB under the PRA.

### C. Burden Estimates

The following estimates for the collections of information in the final regulations are based on the most recently available Statistics of Income (SOI) tax data.

For the collection of income in §1.163(j)-6(d)(5), where a passthrough taxpayer elects to use the taxpayer's ATI for the last taxable beginning in 2019 as the taxpayer's ATI for any taxable year beginning in 2020, the most recently available 2017 SOI tax data indicates that, on the high end, the estimated number of respondents is 49,202. This number was determined by examining, for the 2017 tax year, Form 1065 and Form 1120-S filers with greater than \$26 million in gross receipts that have reported interest expense, and do not have an NAICS code that is associated with a trade or business that normally would be exempted from the section 163(j) limitation.

For the collection of information under §1.163(j)-6(g)(4), in which a partner elects out of treating 50 percent of any EBIE allocated to the partner in 2019 as not subject to a limitation in 2020, the Treasury Department and the IRS estimate that only taxpayers that actively want to reduce their deductions will make this election. The application of the base erosion minimum tax under section 59A depends, in part, on the amount of a taxpayer's deductions. Accordingly, the Treasury Department and the IRS estimate that taxpayers that are subject to both the base erosion minimum tax under section 59A and section 163(j) are the potential filers of this election. Using the 2017 SOI tax data, the Treasury Department estimates that 1,182 firms will make the election. This estimate was determined by examining three criteria: first, the number of taxpayers subject to section 59A, namely, C corporations with at least \$500,000,000 in gross receipts, second, the portion of those taxpayers that do not have an NAICS code associated with a trade or business that is generally not subject to the section 163(j) limitation (2211 (electric power generation, transmission and distribution), 2212 (natural gas distribution), 2213 (water, sewage and other systems), 111 or 112 (farm-

ing), 531 (real property)), and, third, the portion of taxpayers satisfying the first two criteria that received a Form K-1, "Partner's Share of Income, Deductions, Credits, etc."

The reporting burdens associated with the information collections in §§1.163(j)-6(d)(5) and 1.163(j)-6(g)(4) are included in the aggregated burden estimates for OMB control numbers 1545-0074 in the case of individual filers and 1545-0123 in the case of business filers. The overall burden estimates associated with those OMB control numbers are aggregate amounts that relate to the entire package of forms associated with the applicable OMB control number and will in the future include, but not isolate, the estimated burden of the tax forms that will be created or revised as a result of the information collections in these regulations. No burden estimates specific to §§1.163(j)-6(d)(5) and 1.163(j)-6(g)(4) of the final regulations are currently available.

The Treasury Department and the IRS request comments on all aspects of the forms that reflect the information collection burdens related to the final regulations, including estimates for how much time it would take to comply with the paperwork burdens related to the forms described and ways for the IRS to minimize the paperwork burden.

For the collections of information in §1.163(j)-7, namely the CFC group election and annual statement, and the safe-harbor election, and the corresponding notice under §1.964-1(c)(3)(iii), the most recently available 2017 SOI tax data indicates that, on the high end, the estimated number of respondents is 4,980 firms. This number was determined by examining, for the 2017 tax year, Form 1040, Form 1120, Form 1120-S, and Form 1065 filers with greater than \$26 million in gross receipts that filed a Form 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, where an interest expense amount was reported on Schedule C of the Form 5471.

The estimated number of respondents that could be subject to the collection of information for the CFC group or safe-harbor election is 4,980. The estimated annual burden per respondent/recordkeeper varies from 0 to 30 minutes, depending on individual circumstances, with an estimated average of 15 minutes. The estimated total annual reporting and/or recordkeeping burden is 1,245 hours (4,980 respondents \* 15 minutes). The estimated annual cost burden to respondents is \$95 per hour. Accordingly, we expect the total annual cost burden for the CFC group election and safe-harbor election statements to be \$118,275 (4,980 \* .25 \* \$95).

### III. Regulatory Flexibility Act

It is hereby certified that the final regulations will not have a significant economic impact on a substantial number of small entities.

This certification can be made because the Treasury Department and the IRS have determined that the number of small entities that are affected as a result of the regulations is not significant. These rules do not disincentivize taxpayers from their operations, and any burden imposed is not significant because the cost of implementing the rules, if any, is low.

As discussed in the 2018 Proposed Regulations, section 163(j) provides exceptions for which many small entities will qualify. First, under section 163(j)(3), the

limitation does not apply to any taxpayer, other than a tax shelter under section 448(a)(3), which meets the gross receipts test under section 448(c) for any taxable year. A taxpayer meets the gross receipts test under section 448(c) if the taxpayer has average annual gross receipts for the 3-taxable year period ending with the taxable year that precedes the current taxable year that do not exceed \$26,000,000. The gross receipts threshold is indexed annually for inflation. Because of this threshold, the Treasury Department and the IRS project that entities with 3-year average gross receipts below \$26 million will not be affected by these regulations except in rare cases.

Section 163(j) provides that certain trades or businesses are not subject to the limitation, including the trade or business of performing services as an employee, electing real property trades or businesses, electing farming businesses, and certain utilities as defined in section 163(j)(7)(A)(iv). Under the 2018 Proposed Regulations, taxpayers that otherwise qualified as real property trades or businesses or farming businesses that satisfied the small business exemption in section 448(c) were not eligible to make an election to be an electing real property trade or business or electing farming business. Under T.D. 9905, however, those taxpayers are eligible to make an election to be an electing real property trade or business or electing farming business. Additionally, T.D. 9905 provides that certain utilities not otherwise excepted from the limitation can elect for a portion of their non-excepted utility trade or business to be excepted from the limitation. Any economic impact on any small entities as a result of the requirements in the final regulations, not just the requirements that impose a PRA burden, is not expected to be significant because the cost of implementing the rules, if any, is low.

The Treasury Department and the IRS do not have readily available data on the number of filers that are tax shelters, as defined in section 448(a)(3), that are potentially affected by these provisions. As described in more detail earlier in this preamble, the final regulations cover

several topics, including, but not limited to, self-charged interest, the treatment of section 163(j) in relation to trader funds, the impact of section 163(j) on publicly traded partnerships, and the application of section 163(j) to United States shareholders of controlled foreign corporations.

The Treasury Department and the IRS do not have readily available data to determine the number of taxpayers affected by rules regarding self-charged interest because no reporting modules currently connect these payments by and from partnerships. Additionally, the Treasury Department and the IRS do not have readily available data to determine the number of taxpayers affected by rules regarding debt proceeds distributed from a taxpayer account or from cash. However, the rules do not impose a significant paperwork or implementation cost burden on taxpayers. Under Notice 89-35, taxpayers have been required to maintain books and records to properly report the tax treatment of interest. The rules in §1.163-15 are a finalization of the rules in section VI of Notice 89-35, which extends the period in §1.163-8T(c)(4)(iii)(B) from 15 to 30 days to determine whether debt proceeds have been distributed from a particular account.

As shown in the following table, the Treasury Department and the IRS estimate that approximately 276 trading partnerships will be affected by these rules. The table was calculated using data for the 2018 taxable year, the number of Form 1065 and Form 1065-B filers, with more than \$26 million in gross receipts but less than the amount considered to be a small entity for purposes of this Regulatory Flexibility Act analysis, that (1) completed Schedule B to Form 1065 and marked box b, c, or d in question 1 to denote limited partnership, limited liability company or limited liability partnership status; and (2) have a North American Industry Classification System (NAICS) code starting with 5231 (securities and commodity contracts intermediation and brokerage), 5232 (securities and commodity exchanges), 5239 (other financial investment activities) or 5259 (other investment pools and funds).

| Form 1065 and 1065-B Filers + NAICS Codes + Gross Receipts Range + Schedule B, Question 1 Box b, c, or d Marked |                                  |                                      |
|---|----------------------------------|--------------------------------------|
| NAICS Code (description)  | Gross Receipts Range             | Schedule B, Question 1 Box b, c or d |
| 5231 (securities and commodity contracts intermediation and brokerage)  | >\$26M but not more than \$41.5M | 22                                   |
| 5232 (securities and commodity exchanges)   | >\$26M but not more than \$41.5M | 0                                    |
| 6239 (other financial investment activities)  | >\$26M but not more than \$41.5M | 242                                  |
| 5259 (other investment pools and funds)   | >\$26M but not more than \$35M   | 12                                   |
|   | <b>TOTAL</b>                     | <b>276</b>                           |

Additionally, the Treasury Department and the IRS have determined that the rules regarding publicly traded partnerships might affect approximately 71 taxpayers. This number was reached by determining, using data for the 2018 taxable year, the number of Form 1065 and 1065-B filers with gross receipts exceeding \$25 million that answered “yes” to question 5 on Schedule B to Form 1065 denoting that the entity is a publicly traded partnership.

As noted earlier, the final regulations do not impose any new collection of information on these entities. These final regulations actually assist small entities in meeting their filing obligations by providing definitive advice on which they can rely.

For the section 163(j)(10) elections for passthrough taxpayers under final §§1.163(j)-6(d)(5) and 1.163(j)-6(g)(4), most small taxpayers do not need to make the elections because, as discussed above, they are not subject to the section 163(j) limitation. For small taxpayers that are subject to the limitation, the cost to implement the election is low. Pursuant to Revenue Procedure 2020-22, these passthrough taxpayers simply complete the Form 8990 as if the election has been made. Accordingly, the burden of complying with the elections, if needed, is no different than for taxpayers who do not make the elections.

The persons potentially subject to final §1.163(j)-7 are U.S. shareholders of one or more CFCs for which BIE is reported, and that (1) have average annual gross receipts for the 3-taxable year period ending with the taxable year that precedes the current taxable year exceeding \$26,000,000, and (2) want to make the

CFC group election or safe-harbor election. Section 1.163(j)-7 of the final regulations requires such taxpayers to attach a statement to their return providing basic information regarding the CFC group or standalone CFC.

As discussed in the PRA section of this preamble, the reporting burden for both statements is estimated at 0 to 30 minutes, depending on individual circumstances, with an estimated average of 15 minutes for all affected entities, regardless of size. The estimated monetized burden for compliance is \$95 per hour.

Accordingly, the Secretary certifies that the rule will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking preceding this final rule was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small business. No comments on the notice were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

#### IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 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. These final regulations do 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. These final regulations do not have federalism implications and do not impose substantial direct compliance costs on state and local governments or preempt state law within the meaning of the Executive Order.

#### VI. *Congressional Review Act*

The Administrator of OIRA has determined that this is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 et seq.) (CRA). Under section 801(3) of the CRA, a major rule takes effect 60 days after the rule is published in the **Federal Register**.

Notwithstanding this requirement, section 808(2) of the CRA allows agencies to dispense with the requirements of section 801 when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public interest and the rule shall take effect at such time as the agency promulgating the rule determines. Pursuant to section 808(2) of the CRA, the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective date

is unnecessary and contrary to the public interest.

These final regulations resolve ambiguity with respect to the statute and certain aspects of the 2020 Proposed Regulations, prevent abuse through the application of several anti-abuse rules, and grant taxpayer relief that would not be available based solely on the statute. Following the amendments to section 163(j) by the TCJA, the Treasury Department and the IRS published the proposed regulations to provide certainty to taxpayers. In particular, as demonstrated by the wide variety of public comments in response to the proposed regulations received after the publication of the final regulations, taxpayers continue to express uncertainty regarding the proper application of the statutory rules and the final regulations under section 163(j). This uncertainty extends to the application of a number of important temporary provisions in section 163(j) enacted as part of the CARES Act that were intended to provide relief for taxpayers impacted by COVID-19. The final regulations provide rules that are relevant to the application of these taxpayer-favorable provisions. Certainty with respect to these temporary provisions is essential so that taxpayers can accurately model the impact of these provisions on their liquidity in order to make timely informed business decisions during the limited periods in which these provisions are in place. Furthermore, in order to make informed business decisions, taxpayers will need to consider the potentially complex interaction of these temporary provisions, and section 163(j) more generally, with other Code provisions (for example, sections 59A, 172, and 250), which further heightens the need for prompt guidance. Consistent with Executive Order 13924 (May 19, 2020), the Treasury Department and the IRS have therefore determined that an expedited effective date of the final regulations would “give businesses... the confidence they need to re-open by providing guidance on what the law requires.” 85 FR 31353-4. Accordingly, the Treasury Department and the IRS have determined that the rules in this Treasury decision will take effect on the date it is filed with the Office of the **Federal Register** for public inspection.

## Drafting Information

The principal authors of these regulations are Susie Bird, Charlie Gorham, Nathaniel Kupferman, Jaime Park, Sophia Wang, and James Williford (Income Tax & Accounting), Vishal Amin, Brian Choi, Jacob Moore, Adrienne M. Mikolashek, and William Kostak (Passthroughs and Special Industries), Azeka J. Abramoff and Raphael J. Cohen (International), Russell G. Jones and John B. Lovelace (Corporate), and William Blanchard, Michael Chin, Steven Harrison, and Pamela Lew (Financial Institutions & Products). Other personnel from the Treasury Department and the IRS participated in their development.

## Statement of Availability of IRS Documents

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

## List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

## Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

### PART 1 – INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.163-15 is added to read as follows:

*§1.163-15 Debt Proceeds Distributed from Any Taxpayer Account or from Cash.*

(a) *In general.* Regardless of paragraphs (c)(4) and (5) of §1.163-8T, in the case of debt proceeds deposited in

an account, a taxpayer that is applying §1.163-8T or §1.163-14 may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are deposited in any account of the taxpayer as made from such proceeds to the extent thereof. Similarly, in the case of debt proceeds received in cash, a taxpayer that is applying §1.163-8T or §1.163-14 may treat any expenditure made from any account of the taxpayer, or from cash, within 30 days before or 30 days after debt proceeds are received in cash as made from such proceeds to the extent thereof. For purposes of this section, terms used have the same meaning as in §1.163-8T(c)(4) and (5).

(b) *Applicability date.* This section applies to taxable years beginning on or after March 22, 2021. However, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in this section to a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules in this section to that taxable year and each subsequent taxable year.

Par. 3. Section 1.163(j)-0 is amended by:

1. Adding entries for §§ 1.163(j)-1(b)(1)(iv)(A)(4) and 1.163(j)-1(b)(1)(iv)(B)(I) and (2).
2. Revising the entry for §1.163(j)-1(b)(1)(iv)(C).
3. Adding entries for §1.163(j)-1(b)(1)(iv)(E) through (G).
4. Revising the entries for §1.163(j)-1(b)(22)(iii)(F) and (b)(35).
5. Adding entries for §§1.163(j)-1(c)(4), 1.163(j)-2(b)(3)(i) through (iv), and 1.163(j)-2(d)(3).
6. Revising the entries for §§1.163(j)-2(k) and 1.163(j)-6(c)(1) through (3).
7. Adding entries for §§1.163(j)-6(c)(4), 1.163(j)-6(d)(3) through (5), 1.163(j)-6(e)(5) and (6), 1.163(j)-6(f)(1)(iii), 1.163(j)-6(g)(4), and 1.163(j)-6(l)(4)(iv).
8. Revising the entries for §§1.163(j)-6(n) and (p), 1.163(j)-7(c) through (f) and (h) through (m).
9. Adding entries for §1.163(j)-7(g)(3) and (4).

10. Revising the entries for §§1.163(j)-10(c)(5)(ii)(D) and 1.163(j)-10(f).

The revisions and additions read as follows:

*§1.163(j)-0 Table of Contents.*

\* \* \* \* \*

*§1.163(j)-1 Definitions.*

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(iv) \* \* \*

(A) \* \* \*

(4) Nonrecognition transactions.

(B) \* \* \*

(1) In general.

(2) Application of the alternative computation method.

(C) Successor rules.

(1) Successor assets.

(2) Successor entities.

\* \* \* \* \*

(E) Alternative computation method.

(1) Alternative computation method for property dispositions.

(2) Alternative computation method for dispositions of member stock.

(3) Alternative computation method for dispositions of partnership interests.

(F) Cap on negative adjustments.

(1) In general.

(2) Example.

(G) Treatment of depreciation, amortization, or depletion capitalized under section 263A.

\* \* \* \* \*

(22) \* \* \*

(iii) \* \* \*

(F) Section 163(j) interest dividends.

(1) In general.

(2) Limitation on amount treated as interest income.

(3) Conduit amounts.

(4) Holding period.

(5) Exception to holding period requirement for money market funds and certain regularly declared dividends.

\* \* \* \* \*

(35) Section 163(j) interest dividend.

(i) In general.

(ii) Reduction in the case of excess reported amounts.

(iii) Allocation of excess reported amount.

(A) In general.

(B) Special rule for noncalendar year RICs.

(iv) Definitions.

(A) Reported section 163(j) interest dividend amount.

(B) Excess reported amount.

(C) Aggregate reported amount.

(D) Post-December reported amount.

(E) Excess section 163(j) interest income.

(v) Example.

\* \* \* \* \*

(c) \* \* \*

\* \* \* \* \*

(4) Paragraphs (b)(1)(iv)(A)(2) through (4), (B) through (G), (b)(22)(iii)(F), and (b)(35).

*§1.163(j)-2 Deduction for business interest expense limited.*

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(i) In general.

(ii) Short taxable years.

(iii) Transactions to which section 381 applies.

(iv) Consolidated groups.

\* \* \* \* \*

(d) \* \* \*

(3) Determining a syndicate's loss amount.

\* \* \* \* \*

(k) Applicability dates.

(1) In general.

(2) Paragraphs (b)(3)(iii), (b)(3)(iv), and (d)(3).

\* \* \* \* \*

*§1.163(j)-6 Application of the business interest deduction limitation to partnerships and subchapter S Corporations*

\* \* \* \* \*

(c) \* \* \*

(1) Modification of business interest income for partnerships.

(2) Modification of business interest expense for partnerships.

(3) Transition rule.

(4) Character of business interest expense.

(d) \* \* \*

(3) Section 743(b) adjustments and publicly traded partnerships.

(4) Modification of adjusted taxable income for partnerships.

(5) Election to use 2019 adjusted taxable income for taxable years beginning in 2020.

(e) \* \* \*

(5) Partner basis items, remedial items, and publicly traded partnerships.

(6) [Reserved].

(f) \* \* \*

(1) \* \* \*

(iii) Exception applicable to publicly traded partnerships.

\* \* \* \* \*

(g) \* \* \*

(4) Special rule for taxable years beginning in 2019 and 2020.

\* \* \* \* \*

(l) \* \* \*

(4) \* \* \*

(iv) [Reserved].

\* \* \* \* \*

(n) Treatment of self-charged lending transactions between partnerships and partners.

(o) \* \* \*

(p) Applicability dates.

(1) In general.

(2) Paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5), (f)(1)(iii), (g)(4), (n), and (o)(24) through (29), and (34) through (36).

*§1.163(j)-7 Application of the section 163(j) limitation to foreign corporations and United States shareholders.*

\* \* \* \* \*

(c) Application of section 163(j) to CFC group members of a CFC group.

(1) Scope.

(2) Calculation of section 163(j) limitation for a CFC group for a specified period.

(i) In general.

(ii) Certain transactions between CFC group members disregarded.

(iii) [Reserved]

(iv) [Reserved]

(3) Deduction of business interest expense.

(i) CFC group business interest expense.

(A) In general.

(B) Modifications to relevant terms.



1. In paragraph (b)(1)(iv)(A)(I), adding the text “and paragraphs (b)(1)(iv)(B) and (E)” after the text “paragraphs (b)(1)(ii)(C), (D), and (E)”.

2. Revising paragraphs (b)(1)(iv)(A)(2) and (3).

3. Adding paragraph (b)(1)(iv)(A)(4).

4. Revising paragraphs (b)(1)(iv)(B), (C), and (D).

5. Adding paragraphs (b)(1)(iv)(E), (F), and (G).

6. Revising paragraphs (b)(1)(viii)(A) through (D).

7. Adding paragraph (b)(1)(viii)(E).

8. Adding paragraphs (b)(22)(iii)(F) and (b)(35).

9. In paragraph (c)(1), removing “paragraphs (c)(2) and (3)” from the first sentence and adding “paragraphs (c)(2), (3), and (4)” in its place.

10. Adding paragraph (c)(4).

The revisions and additions read as follows:

*§1.163(j)-1 Definitions.*

\* \* \* \* \*

(b) \* \* \*

(1) \* \* \*

(iv) \* \* \*

(A) \* \* \*

(2) *Intercompany transactions.* For purposes of paragraphs (b)(1)(ii)(C) and (D) and paragraphs (b)(1)(iv)(B) and (b)(1)(iv)(E)(I) and (2) of this section, the term *sale or other disposition* excludes all intercompany transactions, within the meaning of §1.1502-13(b)(1)(i), to the extent necessary to achieve single-entity taxation of the consolidated group.

(3) *Deconsolidations.* Notwithstanding any other rule in this paragraph (b)(1)(iv)(A), any transaction in which a member (S) leaves a consolidated group (selling group), including a section 381(a) transaction described in paragraph (b)(1)(iv)(A)(I) of this section, is treated as a taxable disposition of all S stock held by any member of the selling group for purposes of paragraphs (b)(1)(ii)(C) and (D) and paragraphs (b)(1)(iv)(B) and (b)(1)(iv)(E)(I) and (2) of this section, unless the transaction is described in §1.1502-13(j)(5)(i). Following S’s deconsolidation, any subsequent sales or dispositions of S stock by the selling group do not trigger further adjustments under paragraphs (b)

(1)(ii)(C) and (D) and paragraphs (b)(1)(iv)(B) and (b)(1)(iv)(E)(I) and (2) of this section. If a transaction is described in §1.1502-13(j)(5)(i), the transaction is not treated as a sale or other disposition for purposes of paragraphs (b)(1)(ii)(C) and (D) and paragraphs (b)(1)(iv)(B) and (b)(1)(iv)(E)(I) and (2) of this section. See also the successor rules in paragraph (b)(1)(iv)(C) of this section.

(4) *Nonrecognition transactions.* The disposition of property, member stock (other than in a deconsolidation described in paragraph (b)(1)(iv)(A)(3) of this section), or partnership interests in a nonrecognition transaction, other than a section 381(a) transaction described in paragraph (b)(1)(iv)(A)(I) of this section, is treated as a taxable disposition of the property, member stock, or partnership interest disposed of for purposes of paragraph (b)(1)(iv)(E)(I)(i), (b)(1)(iv)(E)(2)(i), and (b)(1)(iv)(E)(3)(i) of this section, respectively. For example, if a taxpayer transfers property to a wholly owned, non-consolidated subsidiary, the transfer of the property is treated as a taxable disposition for purposes of paragraph (b)(1)(iv)(E)(I)(i) of this section notwithstanding the application of section 351.

(B) *Deductions by members of a consolidated group—(1) In general.* If paragraph (b)(1)(ii)(C), (D), or (E) of this section applies to adjust the tentative taxable income of a consolidated group, and if the consolidated group does not use the alternative computation method in paragraph (b)(1)(iv)(E) of this section, the amount of the adjustment under paragraph (b)(1)(ii)(C) of this section equals the greater of the allowed or allowable depreciation, amortization, or depletion of the property, as provided under section 1016(a)(2), for the consolidated group for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property.

(2) *Application of the alternative computation method.* If paragraph (b)(1)(ii)(C), paragraph (b)(1)(ii)(D), or paragraph (b)(1)(ii)(E) of this section applies to adjust the tentative taxable income of a consolidated group, and if the consolidated group uses the alternative computation method in paragraph (b)(1)(iv)(E) of this section, the amount of the adjustment computed under paragraph

(b)(1)(iv)(E)(I)(i), paragraph (b)(1)(iv)(E)(2)(i), or paragraph (b)(1)(iv)(E)(3)(i) of this section must take into account the net gain that would be taken into account by the consolidated group, including from intercompany transactions, determined by treating the sale or other disposition as a taxable transaction (see paragraphs (b)(1)(iv)(A)(3) and (4) of this section regarding deconsolidations and certain nonrecognition transactions, respectively).

(C) *Successor rules—(1) Successor assets.* This paragraph (b)(1)(iv)(C)(I) applies if deductions described in paragraph (b)(1)(ii)(C) of this section are allowed or allowable to a consolidated group member (S) and either the depreciable property or S’s stock is subsequently transferred to another member (S1) in an intercompany transaction in which the transferor receives S1 stock. If this paragraph (b)(1)(iv)(C)(I) applies, and if the transferor’s basis in the S1 stock received in the intercompany transaction is determined, in whole or in part, by reference to its basis in the depreciable property or the S stock, the S1 stock received in the intercompany transaction is treated as a successor asset for purposes of paragraph (b)(1)(ii)(D) and (b)(1)(iv)(E)(2) of this section. Thus, except as otherwise provided in paragraph (b)(1)(iv)(D) of this section, the subsequent disposition of either the S1 stock or the S stock (or both) may require the application of the adjustment rules of paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section.

(2) *Successor entities.* The acquiring corporation in a section 381(a) transaction to which the exception in paragraph (b)(1)(iv)(A)(I) of this section applies is treated as a successor to the distributor or transferor corporation for purposes of paragraphs (b)(1)(ii)(C) through (E) and (b)(1)(iv)(B) and (E) of this section. Therefore, for example, in applying paragraphs (b)(1)(ii)(C) through (E) and (b)(1)(iv)(B) and (E) of this section, the acquiring corporation is treated as succeeding to the allowed or allowable items of the distributor or transferor corporation. Similarly, the surviving group in a transaction described in §1.1502-13(j)(5)(i) to which the exception in paragraph (b)(1)(iv)(A)(3) of this section applies is treated as a successor to the terminating group for purposes of para-

graphs (b)(1)(ii)(C) through (E) and (b)(1)(iv)(B) and (E) of this section.

(D) *Anti-duplication rule—(1) In general.* The aggregate of the subtractions from tentative taxable income of a consolidated group under paragraphs (b)(1)(ii)(C) through (E) or paragraphs (b)(1)(iv)(E)(1) through (3) of this section with respect to an item of property (including with regard to dispositions of successor assets described in paragraph (b)(1)(iv)(C)(1) of this section) cannot exceed the aggregate amount of the consolidated group members' deductions described in paragraph (b)(1)(ii)(C) of this section with respect to such item of property. In addition, once an item of property is no longer held by any member of a consolidated group (whether or not an adjustment to the tentative taxable income of the group is made under paragraph (b)(1)(ii)(C) of this section with respect to the direct or indirect disposition of that property), no further adjustment to the group's tentative taxable income is made under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section in relation to the same property with respect to any subsequent stock disposition.

(2) *Adjustments following deconsolidation.* If a corporation (S) leaves a consolidated group (Group 1) in a transaction that requires an adjustment under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section, no further adjustment is required under paragraph (b)(1)(ii)(C) or (E) or paragraph (b)(1)(iv)(E) of this section in a separate return year (as defined in §1.1502-1(e)) of S with respect to depreciation, amortization, or depletion deductions allowed or allowable to Group 1. See paragraph (b)(1)(iv)(A) of this section for special rules regarding the meaning of the term "sale or other disposition" for purposes of the adjustments required under paragraphs (b)(1)(ii)(C) through (E) and paragraphs (b)(1)(iv)(B) and (E) of this section. For example, assume that S deconsolidates from Group 1 in a transaction not described in §1.1502-13(j)(5)(i) after holding property for which depreciation, amortization, or depletion deductions were allowed or allowable in Group 1. On the deconsolidation, S and Group 1 would adjust tentative taxable income with regard to that property. See paragraphs (b)(1)(iv)(A)(3), (b)(1)(ii)(D), and (b)(1)(iv)

(E)(2) of this section. If, following the deconsolidation, S sells the property referred to in the previous sentence, no subtraction from tentative taxable income is made under paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(1) of this section during S's separate return year with regard to the amounts included in Group 1. See paragraphs (b)(1)(iv)(A)(3), (b)(1)(ii)(D), and (b)(1)(iv)(E)(2) of this section.

(E) *Alternative computation method.* If paragraph (b)(1)(ii)(C), (D), or (E) of this section applies to adjust the tentative taxable income of a taxpayer, the taxpayer may compute the amount of the adjustments required by such paragraph using the formulas in paragraph (b)(1)(iv)(E)(1), (2), and (3) of this section, respectively, provided that the taxpayer applies such formulas to all dispositions for which an adjustment is required under paragraph (b)(1)(ii)(C), (D), or (E) of this section. For special rules regarding the treatment of deconsolidating transactions and nonrecognition transactions, see paragraph (b)(1)(iv)(A)(3) and (4) of this section, respectively. For special rules regarding the application of the formulas in paragraph (b)(1)(iv)(E)(1), (2), and (3) of this section by consolidated groups, see paragraph (b)(1)(iv)(B)(2) of this section.

(1) *Alternative computation method for property dispositions.* With respect to the sale or other disposition of property, the lesser of:

(i) Any gain recognized on the sale or other disposition of such property by the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group); and

(ii) The greater of the allowed or allowable depreciation, amortization, or depletion of the property, as provided under section 1016(a)(2), for the taxpayer (or, if the taxpayer is a member of a consolidated group, the consolidated group) for the taxable years beginning after December 31, 2017, and before January 1, 2022, with respect to such property.

(2) *Alternative computation method for dispositions of member stock.* With respect to the sale or other disposition by a member of a consolidated group of stock of another member for whom depreciation, amortization, or depletion was allowed or allowable with regard to an item

of property (or stock of any successor to that member), the lesser of:

(i) Any gain recognized on the sale or other disposition of such stock; and

(ii) The investment adjustments under §1.1502-32 with respect to such stock that are attributable to deductions described in paragraph (b)(1)(ii)(C) of this section. The investment adjustments referred to in this paragraph (b)(1)(iv)(E)(2)(ii) include investment adjustments replicated in stock of members that are successor entities.

(3) *Alternative computation method for dispositions of partnership interests.* With respect to the sale or other disposition of an interest in a partnership, the lesser of:

(i) Any gain recognized on the sale or other disposition of such interest; and

(ii) The taxpayer's (or, if the taxpayer is a consolidated group, the consolidated group's) distributive share of deductions described in paragraph (b)(1)(ii)(C) of this section with respect to property held by the partnership at the time of such sale or other disposition to the extent such deductions were allowable under section 704(d).

(F) *Cap on negative adjustments—(1) In general.* A subtraction from (or negative adjustment to) tentative taxable income that is required under paragraph (b)(1)(ii)(C), (D), or (E) or paragraph (b)(1)(iv)(B) or (E) of this section is reduced to the extent the taxpayer establishes that the positive adjustments to tentative taxable income under paragraphs (b)(1)(i)(D) through (F) of this section in a prior taxable year did not result in an increase in the amount allowed as a deduction for business interest expense for such year. The extent to which the positive adjustments under paragraphs (b)(1)(i)(D) through (F) of this section resulted in an increase in the amount allowed as a deduction for business interest expense in a prior taxable year (such amount of positive adjustments, the *negative adjustment cap*) is determined after taking into account all other adjustments to tentative taxable income under paragraph (b)(1)(i) and (ii) of this section for that year, as established through books and records. The amount of the negative adjustment cap for a prior taxable year is reduced in future taxable years to the extent of negative adjustments under paragraphs (b)(1)(ii)(C) through (E) and paragraphs (b)(1)(iv)(B)

and (E) of this section with respect to the prior taxable year.

(2) *Example.* A is a calendar-year individual taxpayer engaged in a trade or business that is neither an excepted trade or business nor eligible for the small business exemption. A has no disallowed business interest expense carryforwards. In 2021, A has \$100x of business interest expense, no business interest income or floor plan financing interest expense, and \$400x of tentative taxable income. After taking into account the adjustments to tentative taxable income under paragraph (b)(1)(i) and (ii) of this section other than positive adjustments under paragraphs (b)(1)(i)(D) through (F) of this section, A has tentative taxable income of \$450x. A increases its tentative taxable income by \$30x (from \$450x to \$480x) under paragraph (b)(1)(i)(D) of this section to reflect \$30x of depreciation deductions with respect to Asset Y in 2021. Thus, for 2021, A would have a section 163(j) limitation of \$135x (\$450x x 30 percent) without regard to adjustments under paragraphs (b)(1)(i)(D) through (F) of this section. After the application of paragraph (b)(1)(i)(D) of this section, A has a section 163(j) limitation of \$144x (\$480x x 30 percent). In 2022, A sells Asset Y at a gain of \$50x. Under paragraph (b)(1)(iv)(F)(I) of this section, A is not required to reduce its tentative taxable income in 2022 under paragraph (b)(1)(ii)(C) through (E) or paragraph (b)(1)(iv)(E) of this section. As established by A, the \$30x addition to tentative taxable income under paragraph (b)(1)(i)(D) of this section resulted in no increase in the amount allowed as a deduction for business interest expense in 2021.

(G) *Treatment of depreciation, amortization, or depletion capitalized under section 263A.* Paragraphs (b)(1)(ii)(C) through (E) of this section and this paragraph (b)(1)(iv) apply with respect to the sale or other disposition of property to which paragraph (b)(1)(iii) of this section applies. For example, if a taxpayer with depreciable machinery capitalizes the depreciation into inventory under section 263A, paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E) of this section (and, if the taxpayer is a consolidated group, paragraph (b)(1)(iv)(B) of this section) applies upon the disposition of the machinery, subject to the cap in paragraph (b)(1)(iv)

(F) of this section. Similarly, the successor asset rules in paragraph (b)(1)(iv)(C)(I) of this section would apply if the depreciable machinery subsequently were transferred to another member (S1) in an intercompany transaction in which the transferor received S1 stock.

\* \* \* \* \*

(viii) \* \* \*

(A) *Example 1—(I) Facts.* In 2021, A purchases a depreciable asset (Asset X) for \$30x and fully depreciates Asset X under section 168(k). For the 2021 taxable year, A establishes that its ATI before adding back depreciation deductions with respect to Asset X under paragraph (b)(1)(i)(D) of this section is \$130x, and that its ATI after adding back depreciation deductions with respect to Asset X under paragraph (b)(1)(i)(D) of this section is \$160x. A incurs \$45x of business interest expense in 2021. In 2024, A sells Asset X to an unrelated third party for \$25x.

(2) *Analysis.* A's section 163(j) limitation for 2021 is \$48x (\$160x x 30 percent). Thus, all \$45x of A's business interest expense incurred in 2021 is deductible in that year. Under paragraph (b)(1)(ii)(C) of this section, A must subtract \$30x from its tentative taxable income in computing its ATI for its 2024 taxable year. Alternatively, under paragraph (b)(1)(iv)(E)(I) of this section, A must subtract \$25x (the lesser of \$30x or \$25x (\$25x - \$0x)) from its tentative taxable income in computing its ATI for its 2024 taxable year. However, the negative adjustments under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(I) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Under that paragraph, A's negative adjustment under either paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(I) of this section is capped at \$20x, or \$150x (the amount of ATI that A needed in order to deduct all \$45x of business interest expense in 2021) minus \$130x (the amount of A's tentative taxable income in 2021 before adding back any amounts under paragraph (b)(1)(i)(D) through (F) of this section). As established by A, the additional \$10x (\$30x - \$20x) of depreciation deductions that were added back to tentative taxable income in 2021 under paragraph (b)(1)(i)(D) of this section did not increase A's business interest expense deduction for that year.

(3) *Transfer of assets in a nonrecognition transaction to which section 381 applies.* The facts are the same as in paragraph (b)(1)(viii)(A)(I) of this section, except that, rather than sell Asset X to an unrelated third party in 2024, A merges with and into an unrelated third party in 2024 in a transaction described in section 368(a)(1)(A) in which no gain is recognized. As provided in paragraph (b)(1)(iv)(A)(I) of this section, the merger transaction is not treated as a "sale or other disposition" for purposes of paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(I) of this section. Thus, no adjustment to tentative taxable income is required in 2024 under paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(I) of this section.

(4) *Transfer of assets in a nonrecognition transaction to which section 351 applies.* The facts are the same as in paragraph (b)(1)(viii)(A)(I) of this section, except that, rather than sell Asset X to an unrelated third party in 2024, A transfers Asset X to

B (A's wholly owned subsidiary) in 2024 in a transaction to which section 351 applies. The section 351 transaction is treated as a "sale or other disposition" for purposes of paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(I) of this section, and it is treated as a taxable disposition for purposes of paragraph (b)(1)(iv)(E)(I) of this section. See paragraph (b)(1)(iv)(A)(I) and (4) of this section. However, the negative adjustments under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(I) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Thus, A must subtract \$20x from its tentative taxable income in computing its ATI for its 2024 taxable year.

(B) *Example 2—(I) Facts.* In 2021, S purchases a depreciable asset (Asset Y) for \$30x and fully depreciates Asset Y under section 168(k). P reduces its basis in its S stock by \$30x under § 1.1502-32 to reflect S's depreciation deductions with respect to Asset Y. For the 2021 taxable year, the P group establishes that its ATI before adding back S's depreciation deductions with respect to Asset Y under paragraph (b)(1)(i)(D) of this section is \$130x, and that its ATI after adding back S's depreciation deductions with respect to Asset Y under paragraph (b)(1)(i)(D) of this section is \$160x. The P group incurs \$45x of business interest expense in 2021. In 2024, P sells all of its S stock to an unrelated third party at a gain of \$25x.

(2) *Analysis.* The P group's section 163(j) limitation for 2021 is \$48x (\$160x x 30 percent). Thus, all \$45x of the P group's business interest expense incurred in 2021 is deductible in that year. Under paragraph (b)(1)(ii)(D) of this section, the P group must subtract \$30x from its tentative taxable income in computing its ATI for its 2024 taxable year. Alternatively, under paragraph (b)(1)(iv)(E)(2) of this section, the P group must subtract \$25x (the lesser of \$30x or \$25x) from its tentative taxable income in computing its ATI for its 2024 taxable year. However, the negative adjustments under paragraphs (b)(1)(ii)(D) and (b)(1)(iv)(E)(2) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Under that paragraph, the P group's negative adjustment under either paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section is capped at \$20x, or \$150x (the amount of ATI the P group needed in order to deduct all \$45x of business interest expense in 2021) minus \$130x (the amount of the P group's tentative taxable income in 2021 before adding back any amounts under paragraph (b)(1)(i)(D) through (F) of this section). As established by the P group, the additional \$10x (\$30x - \$20x) of depreciation deductions that were added back to tentative taxable income in 2021 under paragraph (b)(1)(i)(D) of this section did not increase the P group's business interest expense deduction for that year.

(3) *Disposition of less than all member stock.* The facts are the same as in paragraph (b)(1)(viii)(B)(I) of this section, except that, in 2024, P sells half of its S stock to an unrelated third party. The results are the same as in paragraph (b)(1)(viii)(B)(2) of this section. See paragraph (b)(1)(iv)(A)(3) of this section. Thus, the P group must subtract \$20x from its tentative taxable income in computing its ATI for its 2024 taxable year. No further adjustment under paragraphs (b)(1)(ii)(C) and (D) or paragraphs (b)

(1)(iv)(E)(I) and (2) of this section is required if P subsequently sells its remaining S stock or if S subsequently disposes of Asset Y. See paragraphs (b)(1)(iv)(A)(3) and (b)(1)(iv)(D) of this section.

(4) *Intercompany transfer; disposition of successor assets—(i) Adjustments in 2024.* The facts are the same as in paragraph (b)(1)(viii)(B)(I) of this section, except that, rather than sell all of its S stock to an unrelated third party in 2024, P transfers all of its S stock to T in 2024 in a transaction to which section 351 applies and, in 2025, P sells all of its T stock to an unrelated third party at a gain of \$40x. As provided in paragraph (b)(1)(iv)(A)(2) of this section, P's intercompany transfer of its S stock to T is not a "sale or other disposition" for purposes of paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section. Thus, no adjustment to tentative taxable income is required in 2024 under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section.

(ii) *Adjustments in 2025.* Pursuant to paragraph (b)(1)(iv)(C)(I) of this section, P's stock in T is treated as a successor asset for purposes of paragraph (b)(1)(ii)(D) and (b)(1)(iv)(E)(2) of this section. Moreover, P's sale of its T stock causes both T and S to deconsolidate. Thus, under paragraph (b)(1)(iv)(A)(3) of this section, the transaction is treated as a taxable disposition of all of the T stock and all of the S stock held by all members of the P group. Under the anti-duplication rule in paragraph (b)(1)(iv)(D) of this section, the total amount of gain recognized for purposes of paragraph (b)(1)(iv)(E)(2)(i) of this section is \$40x, the greater of the gain on the disposition of the T stock (\$40x) or on the disposition of the S stock (\$25x). However, the negative adjustments under paragraph (b)(1)(iv)(E)(2) of this section are subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Thus, the P group must subtract \$20x from its tentative taxable income in computing its ATI for its 2025 taxable year.

(5) *Alternative computation and non-deconsolidating disposition of member stock.* The facts are the same as in paragraph (b)(1)(viii)(B)(I) of this section, except that, in 2024, P sells just ten percent of its S stock to an unrelated third party at a gain of \$2.5x. Under paragraph (b)(1)(iv)(E)(2) of this section, the lesser of P's gain recognized on the sale of the S stock (\$2.5x) and the investment adjustments under §1.1502-32 with respect to the S stock P sold (\$3x) is \$2.5x, an amount less than the \$20x limitation under paragraph (b)(1)(iv)(F) of this section. Thus, the P group must subtract \$2.5x from its tentative taxable income in computing its ATI for its 2024 taxable year.

(6) *Non-deconsolidating disposition of member stock followed by asset disposition.* The facts are the same as in paragraph (b)(1)(viii)(B)(5) of this section, except that, in 2025, S sells Asset Y to an unrelated third party for a gain of \$20x. Under paragraph (b)(1)(iv)(E)(I) of this section, the amount of the adjustment in 2025 is the lesser of two amounts. The first amount is the amount of S's gain recognized on the sale of Asset Y (\$20x). See paragraph (b)(1)(iv)(E)(I)(i) of this section. The second amount is the amount of depreciation with respect to Asset Y (see paragraph (b)(1)(iv)(E)(I)(ii) of this section), reduced by the amount of depreciation previously taken into account in the computation under paragraph (b)(1)(iv)(E)(2)(ii) of this section (\$30x - \$3x,

or \$27x). See paragraph (b)(1)(iv)(D)(I) of this section. Thus, the amount of the adjustment under paragraphs (b)(1)(iv)(D) and (b)(1)(iv)(E)(I) of this section is \$20x. In turn, this amount is subject to the negative adjustment cap under paragraph (b)(1)(iv)(F), which, after accounting for the negative adjustment on the earlier sale of S stock in 2024, is \$17.5x (\$20x - \$2.5x). Accordingly, the P group must subtract \$17.5x from its tentative taxable income in computing its ATI for its 2025 taxable year.

(C) *Example 3—(I) Facts.* The facts are the same as in paragraph (b)(1)(viii)(B)(I) of this section, except that, in 2024, S sells Asset Y to an unrelated third party for \$25x and, in 2025, P sells all of its S stock to an unrelated third party at a gain of \$25x.

(2) *Analysis.* The results are the same as in paragraph (b)(1)(viii)(B)(2) of this section. Thus, the P group must subtract \$20x from its tentative taxable income in computing its ATI for its 2024 taxable year. P's sale of all of its S stock in 2025 is a "sale or other disposition" for purposes of paragraph (b)(1)(ii)(D) and (b)(1)(iv)(E)(2) of this section. However, pursuant to paragraph (b)(1)(iv)(D)(I) of this section, no further adjustment to the P group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section.

(3) *Disposition of S stock prior to S's asset disposition.* The facts are the same as in paragraph (b)(1)(viii)(C)(I) of this section, except that, in 2024, P sells all of its S stock to an unrelated third party at a gain of \$25x and, in 2025, S sells Asset Y to an unrelated third party for \$25x. The results are the same as in paragraph (b)(1)(viii)(B)(2) of this section. Thus, the P group must subtract \$20x from its tentative taxable income in computing its ATI for its 2024 taxable year. Pursuant to paragraph (b)(1)(iv)(D)(2) of this section, no adjustment to the acquiring group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(I) of this section.

(4) *Deconsolidation of S in nonrecognition transaction.* The facts are the same as in paragraph (b)(1)(viii)(C)(3) of this section, except that, rather than sell all of its S stock to an unrelated third party, P causes S to merge with and into an unrelated third party in a transaction described in section 368(a)(1)(A). As provided in paragraph (b)(1)(iv)(A)(3) of this section, the merger transaction is treated as a taxable disposition of all of P's stock in S for purposes of paragraphs (b)(1)(ii)(D) and (b)(1)(iv)(E)(2) of this section because S leaves the P group. Thus, the results are the same as in paragraph (b)(1)(viii)(C)(3) of this section.

(D) *Example 4—(I) Facts.* P wholly owns T, which wholly owns S. In 2021, S purchases a depreciable asset (Asset Z) for \$30x and fully depreciates Asset Z under section 168(k). T reduces its basis in its S stock, and P reduces its basis in its T stock, by \$30x under §1.1502-32 to reflect S's depreciation deductions with respect to Asset Z. For the 2021 taxable year, the P group establishes that its ATI before adding back S's depreciation deductions with respect to Asset Z under paragraph (b)(1)(i)(D) of this section is \$130x, and that its ATI after adding back S's depreciation deductions with respect to Asset Z under paragraph (b)(1)(i)(D) of this section is \$160x. The P group incurs \$45x of business interest

expense in 2021. In 2024, T sells all of its S stock to an unrelated third party at a gain of \$25x. In 2025, P sells all of its T stock to an unrelated third party at a gain of \$40x.

(2) *Analysis.* The results are the same as in paragraph (b)(1)(viii)(B)(2) of this section. Thus, the P group must subtract \$20x from its tentative taxable income in computing its ATI for its 2024 taxable year. Pursuant to paragraph (b)(1)(iv)(D)(I) of this section, no negative adjustment to the P group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section.

(3) *Disposition of T stock in 2024.* The facts are the same as in paragraph (b)(1)(viii)(D)(I) of this section, except that, in 2024, P sells all of its T stock to another consolidated group at a gain of \$40x and, in 2025, T sells all of its S stock to an unrelated party at a gain of \$25x. Whereas the transaction described in paragraph (b)(1)(viii)(B)(4) of this section is treated as a taxable disposition of both the T stock and the S stock, only the actual disposition of the T stock in the transaction described in this paragraph (b)(1)(viii)(D)(3) is treated as a taxable disposition for purposes of paragraphs (b)(1)(ii)(D) and (b)(1)(iv)(E)(2) of this section. See paragraph (b)(1)(iv)(A)(3) of this section. However, the results are the same as in paragraph (b)(1)(viii)(B)(2) and (b)(1)(viii)(B)(4) of this section because of the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Thus, the P group must subtract \$20x from its tentative taxable income in computing its ATI for its 2024 taxable year. Pursuant to paragraph (b)(1)(iv)(D) of this section, no negative adjustment to the acquiring group's tentative taxable income is required in 2025 under paragraph (b)(1)(ii)(D) or paragraph (b)(1)(iv)(E)(2) of this section.

(E) *Example 5—(I) Facts.* In 2021, A purchases Assets X and Y for \$30x and \$80x, respectively, and fully depreciates each asset under section 168(k). For the 2021 taxable year, A establishes that its ATI before adding back depreciation deductions with respect to Assets X and Y under paragraph (b)(1)(i)(D) of this section is \$150x, and that its ATI after adding back depreciation deductions with respect to Assets X and Y under paragraph (b)(1)(i)(D) of this section is \$260x. A incurs \$75x of business interest expense in 2021. In 2024, A sells Assets X and Y to an unrelated third party for \$40x and \$90x, respectively.

(2) *Analysis.* A's section 163(j) limitation for 2021 is \$78x (\$260x × 30 percent). Thus, all \$75x of A's business interest expense incurred in 2021 is deductible in that year. Under paragraph (b)(1)(ii)(C) of this section, A must subtract \$110x (\$30x + \$80x) from its tentative taxable income in computing its ATI for its 2024 taxable year. Alternatively, under paragraph (b)(1)(iv)(E)(I) of this section, A must subtract \$30x with respect to Asset X (the lesser of \$30x or \$40x (\$40x - \$0x)), and \$80x with respect to Asset Y (the lesser of \$80x or \$90x (\$90x - \$0x)), from its tentative taxable income in computing its ATI for its 2024 taxable year. However, the negative adjustments under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(I) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Under that paragraph, A's negative adjustment in 2024 under either paragraph (b)(1)(ii)(C) (\$110x) or paragraph (b)(1)(iv)(E)(I) (also \$110x) of

this section is limited to \$100x. This amount equals \$250x (the amount of ATI that A needed in order to deduct all \$75x of business interest expense in 2021) minus \$150x (the amount of A's tentative taxable income in 2021 before adding back any amounts under paragraph (b)(1)(i)(D) through (F) of this section). As established by A, the additional \$10x (\$110x - \$100x) of depreciation deductions that were added back to tentative taxable income in 2021 under paragraph (b)(1)(i)(D) of this section did not increase A's business interest expense deduction for that year.

(3) *Sale of assets in different taxable years.* The facts are the same as in paragraph (b)(1)(viii)(E)(I) of this section, except that A sells Asset Y to an unrelated third party for \$90x in 2025. Under paragraph (b)(1)(ii)(C) of this section, A must subtract \$30x from its tentative taxable income in computing its ATI for its 2024 taxable year. Alternatively, under paragraph (b)(1)(iv)(E)(I) of this section, A must subtract \$30x (the lesser of \$30x or \$40x (\$40x - \$0x)) from its tentative taxable income in computing its ATI for its 2024 taxable year. Because A's negative adjustment cap for its 2021 taxable year is \$100x (see paragraph (b)(1)(viii)(E)(2) of this section), A's negative adjustment in 2024 of \$30x is not reduced under paragraph (b)(1)(iv)(F) of this section. In 2025, A must subtract \$80x from its tentative taxable income under paragraph (b)(1)(ii)(C) of this section in computing its ATI. Alternatively, under paragraph (b)(1)(iv)(E)(I) of this section, A must subtract \$80x (the lesser of \$80x or \$90x (\$90x - \$0x)) from its tentative taxable income in computing its ATI for its 2025 taxable year. However, the negative adjustments under paragraphs (b)(1)(ii)(C) and (b)(1)(iv)(E)(I) of this section are both subject to the negative adjustment cap in paragraph (b)(1)(iv)(F) of this section. Moreover, A's negative adjustment cap for its 2021 taxable year is reduced from \$100x to \$70x to reflect A's \$30x negative adjustment in 2024. See paragraph (b)(1)(iv)(F) of this section. Thus, A's negative adjustment for 2025 under either paragraph (b)(1)(ii)(C) or paragraph (b)(1)(iv)(E)(I) of this section is reduced from \$80x to \$70x. As established by A, the additional \$10x (\$110x - \$100x) of depreciation deductions that were added back to tentative taxable income in 2021 under paragraph (b)(1)(i)(D) of this section did not increase A's business interest expense deduction for that year.

\* \* \* \* \*

(22) \* \* \*

(iii) \* \* \*

(F) *Section 163(j) interest dividends—(I) In general.* Except as otherwise provided in this paragraph (b)(22)(iii)(F), a section 163(j) interest dividend is treated as interest income.

(2) *Limitation on amount treated as interest income.* A shareholder may not treat any part of a section 163(j) interest dividend as interest income to the extent the amount of the section 163(j) interest dividend exceeds the excess of the amount of the entire dividend that includes the section 163(j) interest dividend over the sum of the conduit amounts other than

interest-related dividends under section 871(k)(1)(C) and section 163(j) interest dividends that affect the shareholder's treatment of that dividend.

(3) *Conduit amounts.* For purposes of paragraph (b)(22)(iii)(F)(2) of this section, the term *conduit amounts* means, with respect to any category of income (including tax-exempt interest) earned by a RIC for a taxable year, the amounts identified by the RIC (generally in a designation or written report) in connection with dividends of the RIC for that taxable year that are subject to a limit determined by reference to that category of income. For example, a RIC's conduit amount with respect to its net capital gain is the amount of the RIC's capital gain dividends under section 852(b)(3)(C).

(4) *Holding period.* Except as provided in paragraph (b)(22)(iii)(F)(5) of this section, no dividend is treated as interest income under paragraph (b)(22)(iii)(F)(I) of this section if the dividend is received with respect to a share of RIC stock—

(i) That is held by the shareholder for 180 days or less (taking into account the principles of section 246(c)(3) and (4)) during the 361-day period beginning on the date which is 180 days before the date on which the share becomes ex-dividend with respect to such dividend; or

(ii) To the extent that the shareholder is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(5) *Exception to holding period requirement for money market funds and certain regularly declared dividends.* Paragraph (b)(22)(iii)(F)(4)(i) of this section does not apply to dividends distributed by any RIC regulated as a money market fund under 17 CFR 270.2a-7 (Rule 2a-7 under the 1940 Act) or to regular dividends paid by a RIC that declares section 163(j) interest dividends on a daily basis in an amount equal to at least 90 percent of its excess section 163(j) interest income, as defined in paragraph (b)(35)(iv)(E) of this section, and distributes such dividends on a monthly or more frequent basis.

\* \* \* \* \*

(35) *Section 163(j) interest dividend.* The term *section 163(j) interest dividend* means a dividend paid by a RIC for a taxable year for which section 852(b) applies

to the RIC, to the extent described in paragraph (b)(35)(i) or (ii) of this section, as applicable.

(i) *In general.* Except as provided in paragraph (b)(35)(ii) of this section, a section 163(j) interest dividend is any dividend, or part of a dividend, that is reported by the RIC as a section 163(j) interest dividend in written statements furnished to its shareholders.

(ii) *Reduction in the case of excess reported amounts.* If the aggregate reported amount with respect to the RIC for the taxable year exceeds the excess section 163(j) interest income of the RIC for such taxable year, the section 163(j) interest dividend is—

(A) The reported section 163(j) interest dividend amount; reduced by

(B) The excess reported amount that is allocable to that reported section 163(j) interest dividend amount.

(iii) *Allocation of excess reported amount—(A) In general.* Except as provided in paragraph (b)(35)(iii)(B) of this section, the excess reported amount, if any, that is allocable to the reported section 163(j) interest dividend amount is that portion of the excess reported amount that bears the same ratio to the excess reported amount as the reported section 163(j) interest dividend amount bears to the aggregate reported amount.

(B) *Special rule for noncalendar year RICs.* In the case of any taxable year that does not begin and end in the same calendar year, if the post-December reported amount equals or exceeds the excess reported amount for that taxable year, paragraph (b)(35)(iii)(A) of this section is applied by substituting "post-December reported amount" for "aggregate reported amount," and no excess reported amount is allocated to any dividend paid on or before December 31 of such taxable year.

(iv) *Definitions.* The following definitions apply for purposes of this paragraph (b)(35):

(A) *Reported section 163(j) interest dividend amount.* The term *reported section 163(j) interest dividend amount* means the amount of a dividend distribution reported to the RIC's shareholders under paragraph (b)(35)(i) of this section as a section 163(j) interest dividend.

(B) *Excess reported amount.* The term *excess reported amount* means the excess

of the aggregate reported amount over the RIC's excess section 163(j) interest income for the taxable year.

(C) *Aggregate reported amount.* The term *aggregate reported amount* means the aggregate amount of dividends reported by the RIC under paragraph (b)(35)(i) of this section as section 163(j) interest dividends for the taxable year (including section 163(j) interest dividends paid after the close of the taxable year described in section 855).

(D) *Post-December reported amount.* The term *post-December reported amount* means the aggregate reported amount determined by taking into account only dividends paid after December 31 of the taxable year.

(E) *Excess section 163(j) interest income.* The term *excess section 163(j) interest income* means, with respect to a taxable year of a RIC, the excess of the RIC's business interest income for the taxable year over the sum of the RIC's business interest expense for the taxable year and the RIC's other deductions for the taxable year that are properly allocable to the RIC's business interest income.

(v) *Example—(A) Facts.* X is a domestic C corporation that has elected to be a RIC. For its taxable year ending December 31, 2021, X has \$100x of business interest income (all of which is qualified interest income for purposes of section 871(k)(1)(E)) and \$10x of dividend income (all of which is qualified dividend income within the meaning of section 1(h)(11) and would be eligible for the dividends received deduction under section 243, determined as described in section 854(b)(3)). X has \$10x of business interest expense and \$20x of other deductions. X has no other items for the taxable year. On December 31, 2021, X pays a dividend of \$80x to its shareholders, and reports, in written statements to its shareholders, \$71.82x as a section 163(j) interest dividend; \$10x as dividends that may be treated as qualified dividend income or as dividends eligible for the dividends received deduction; and \$72.73x as interest-related dividends under section 871(k)(1)(C). Shareholder A, a domestic C corporation, meets the holding period requirements in paragraph (b)(22)(iii)(F)(4) of this section with respect to the stock of X, and receives a dividend of \$8x from X on December 31, 2021.

(B) *Analysis.* X determines that \$18.18x of other deductions are properly allocable to X's business interest income. X's excess section 163(j) interest income under paragraph (b)(35)(iv)(E) of this section is \$71.82x (\$100x business interest income - (\$10x business interest expense + \$18.18x other deductions allocated) = \$71.82x). Thus, X may report up to \$71.82x of its dividends paid on December 31, 2021, as section 163(j) interest dividends to its shareholders. X may also report up to \$10x of its dividends paid on December 31, 2021, as dividends that

may be treated as qualified dividend income or as dividends that are eligible for the dividends received deduction. X determines that \$9.09x of interest expense and \$18.18x of other deductions are properly allocable to X's qualified interest income. Therefore, X may report up to \$72.73x of its dividends paid on December 31, 2021, as interest-related dividends under section 871(k)(1)(C) (\$100x qualified interest income - \$27.27x deductions allocated = \$72.73x). A treats \$1x of its \$8x dividend as a dividend eligible for the dividends received deduction and no part of the dividend as an interest-related dividend under section 871(k)(1)(C). Therefore, under paragraph (b)(22)(iii)(F)(2) of this section, A may treat \$7x of the section 163(j) interest dividend as interest income for purposes of section 163(j) (\$8x dividend - \$1x conduit amount = \$7x limitation).

\* \* \* \* \*

(c) \* \* \*

(4) *Paragraphs (b)(1)(iv)(A)(2) through (4), (B) through (G), (b)(22)(iii)(F), and (b)(35).* Paragraphs (b)(1)(iv)(A)(2) through (4), (b)(1)(iv)(B) through (G), (b)(22)(iii)(F), and (b)(35) of this section apply to taxable years beginning on or after March 22, 2021. Taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in paragraphs (b)(1)(iv)(A)(2) through (4), (b)(1)(iv)(B) through (G), (b)(22)(iii)(F), and (b)(35) of this section to a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules in the section 163(j) regulations contained in T.D. 9905 (§§1.163(j)-0 through 1.163(j)-11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.382-7, 1.383-0, 1.383-1, 1.469-9, 1.469-11, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-36, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4 contained in T.D. 9905, as modified by T.D. 9943, to that taxable year and all subsequent taxable years.

Par. 5. Section 1.163(j)-2 is amended by:

1. Adding paragraphs (b)(3)(iii) and (iv) and (d)(3).

2. Redesignating paragraph (k) as paragraph (k)(1).

3. Adding a new subject heading for paragraph (k).

4. Revising the subject heading of newly redesignated paragraph (k)(1).

5. Adding paragraph (k)(2).

The revisions and additions read as follows:

*§1.163(j)-2 Deduction for business interest expense limited.*

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(iii) *Transactions to which section 381 applies.* For purposes of the election described in paragraph (b)(3)(i) of this section, and subject to the limitation in paragraph (b)(3)(ii) of this section, the 2019 ATI of the acquiring corporation in a transaction to which section 381 applies equals the amount of the acquiring corporation's ATI for its last taxable year beginning in 2019.

(iv) *Consolidated groups.* For purposes of the election described in paragraph (b)(3)(i) of this section, and subject to the limitation in paragraph (b)(3)(ii) of this section, the 2019 ATI of a consolidated group equals the amount of the consolidated group's ATI for its last taxable year beginning in 2019.

\* \* \* \* \*

(d) \* \* \*

(3) *Determining a syndicate's loss amount.* For purposes of section 163(j), losses allocated under section 1256(e)(3)(B) and §1.448-1T(b)(3) are determined without regard to section 163(j). See also §1.1256(e)-2(b).

\* \* \* \* \*

(k) *Applicability dates.*

(1) *In general.* \* \* \*

(2) *Paragraphs (b)(3)(iii), (b)(3)(iv), and (d)(3).* Paragraphs (b)(3)(iii) and (iv) and (d)(3) of this section apply to taxable years beginning on or after March 22, 2021. However, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in paragraphs (b)(3)(iii), (b)(3)(iv), and (d)(3) of this section to a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules in paragraphs (b)(3)(iii) and (iv) of this section and the rules in the sec-

tion 163(j) regulations contained in T.D. 9905 (§§1.163(j)-0 through 1.163(j)-11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.382-7, 1.383-0, 1.383-1, 1.469-9, 1.469-11, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-36, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4 contained in T.D. 9905 as modified by T.D. 9943, for that taxable year and for each subsequent taxable year.

Par. 6. Section 1.163(j)-6 is amended by:

1. Adding paragraphs (c)(1) and (2).
2. Redesignating paragraph (c)(3) as paragraph (c)(4).
3. Adding new paragraph (c)(3) and paragraphs (d)(3) through (5) and (e)(5).
4. Adding paragraphs (f)(1)(iii) and (g)(4).
5. Adding paragraph (n).
6. Adding paragraphs (o)(24) through (26), reserved paragraphs (o)(27) through (33), and paragraphs (o)(34) through (36).
7. Redesignating paragraph (p) as paragraph (p)(1), revising the subject heading of paragraph (p), and adding a subject heading for newly designated paragraph (p)(1).
8. Adding paragraph (p)(2).

The revisions and additions read as follows:

*§1.163(j)-6 Application of the section 163(j) limitation to partnerships and subchapter S corporations.*

\* \* \* \* \*

(c) \* \* \*

(1) *Modification of business interest income for partnerships.* The business interest income of a partnership generally is determined in accordance with §1.163(j)-1(b)(4). However, to the extent that interest income of a partnership that is properly allocable to trades or businesses that are per se non-passive activities is allocated to partners that do not materially participate (within the meaning of section 469), as described in §1.469-1T(e)(6) and subject to section 163(d)(5)(A)(ii), such interest income shall not be considered business

interest income for purposes of determining the section 163(j) limitation of a partnership pursuant to §1.163(j)-2(b). A per se non-passive activity is an activity that is not treated as a passive activity for purposes of section 469 regardless of whether the owners of the activity materially participate in the activity.

(2) *Modification of business interest expense for partnerships.* The business interest expense of a partnership generally is determined in accordance with §1.163(j)-1(b)(3). However, to the extent that interest expense of a partnership that is properly allocable to trades or businesses that are per se non-passive activities is allocated to partners that do not materially participate (within the meaning of section 469), as described in §1.469-1T(e)(6) and subject to section 163(d)(5)(A)(ii), such interest expense shall not be considered business interest expense for purposes of determining the section 163(j) limitation of a partnership pursuant to §1.163(j)-2(b).

(3) *Transition rule.* With respect to a partner in a partnership engaged in a trade or business described in §1.469-1T(e)(6) and subject to section 163(d)(5)(A)(ii), if such partner had been allocated EBIE from the partnership with respect to the trade or business described in §1.469-1T(e)(6) and subject to section 163(d)(5)(A)(ii) in any prior taxable year in which the partner did not materially participate, such partner may treat such excess business interest expense not previously treated as paid or accrued under §1.163(j)-6(g)(2) as paid or accrued by the partner in the first taxable year ending on or after the effective date of the final regulations and not subject to further limitation under section 163(j) or 163(d).

\* \* \* \* \*

(d) \* \* \*

(3) *Section 743(b) adjustments and publicly traded partnerships.* Solely for purposes of §1.163(j)-6, a publicly traded partnership, as defined in §1.7704-1, shall treat the amount of any section 743(b) adjustment of a purchaser of a partnership unit that relates to a remedial item that the purchaser inherits from the seller as an offset to the related section 704(c) remedial item. For this purpose, §1.163(j)-6(e)(2)(ii) applies. See *Example 25* in paragraph (o)(25) of this section.

(4) *Modification of adjusted taxable income for partnerships.* The adjusted taxable income of a partnership generally is determined in accordance with §1.163(j)-1(b)(1). However, to the extent that the items comprising the adjusted taxable income of a partnership that are properly allocable to trades or businesses that are per se non-passive activities are allocated to partners that do not materially participate (within the meaning of section 469), as described in section 163(d)(5)(A)(ii), such partnership items shall not be considered adjusted taxable income for purposes of determining the section 163(j) limitation of a partnership pursuant to §1.163(j)-2(b).

(5) *Election to use 2019 adjusted taxable income for taxable years beginning in 2020.* In the case of any taxable year beginning in 2020, a partnership may elect to apply this section by substituting its adjusted taxable income for the last taxable year beginning in 2019 for the adjusted taxable income for such taxable year (post-election ATI or 2019 ATI). See §1.163(j)-2(b)(4) for the time and manner of making or revoking this election. An electing partnership determines each partner's allocable ATI (as defined in paragraph (f)(2)(ii) of this section) by using the partnership's 2019 section 704 income, gain, loss, and deduction as though such amounts were recognized by the partnership in 2020. See *Example 34* in paragraph (o)(34) of this section.

(e) \* \* \*

(5) *Partner basis items, remedial items, and publicly traded partnerships.* Solely for purposes of §1.163(j)-6, a publicly traded partnership, as defined in §1.7704-1, shall either allocate gain that would otherwise be allocated under section 704(c) based on a partner's section 704(b) sharing ratios, or, for purposes of allocating cost recovery deductions under section 704(c), determine a partner's remedial items, as defined in §1.163(j)-6(b)(3), based on an allocation of the partnership's asset basis (inside basis) items among its partners in proportion to their share of corresponding section 704(b) items (rather than applying the traditional method, described in §1.704-3(b)). See *Example 24* in paragraph (o)(24) of this section.

(f) \* \* \*

(1) \* \* \*

(iii) *Exception applicable to publicly traded partnerships.* Publicly traded partnerships, as defined in §1.7704-1, do not apply the rules in paragraph (f)(2) of this section to determine a partner's share of section 163(j) excess items. Rather, publicly traded partnerships determine a partner's share of section 163(j) excess items by applying the same percentage used to determine the partner's share of the corresponding section 704(b) items that comprise ATI.

\* \* \* \* \*

(g) \* \* \*

(4) *Special rule for taxable years beginning in 2019 and 2020.* In the case of any excess business interest expense of a partnership for any taxable year beginning in 2019 that is allocated to a partner under paragraph (f)(2) of this section, 50 percent of such excess business interest expense (§1.163(j)-6(g)(4) business interest expense) is treated as business interest expense that, notwithstanding paragraph (g)(2) of this section, is paid or accrued by the partner in the partner's first taxable year beginning in 2020. Additionally, §1.163(j)-6(g)(4) business interest expense is not subject to the section 163(j) limitation at the level of the partner. For purposes of paragraph (h)(1) of this section, any §1.163(j)-6(g)(4) business interest expense is, similar to deductible business interest expense, taken into account before any excess business interest expense. This paragraph applies after paragraph (n) of this section. If a partner disposes of a partnership interest in the partnership's 2019 or 2020 taxable year, §1.163(j)-6(g)(4) business interest expense is deductible by the partner (except to the extent that the business interest expense is negative section 163(j) expense as defined in §1.163(j)-6(h)(1) immediately prior to the disposition) and thus does not result in a basis increase under paragraph (h)(3) of this section. See *Example 35* and *Example 36* in paragraphs (o)(35) and (o)(36), respectively, of this section. A partner may elect to not have this provision apply with respect to each partnership interest held by the partner on an interest by interest basis. The rules and procedures regarding the time and manner of making, or revoking, such an election are provided in Revenue Procedure 2020-22, 2020-18 I.R.B. 745, and may be further modified

through other guidance (see §§601.601(d) and 601.602 of this chapter).

\* \* \* \* \*

(n) *Treatment of self-charged lending transactions between partnerships and partners.* In the case of a lending transaction between a partner (lending partner) and partnership (borrowing partnership) in which the lending partner owns a direct interest (self-charged lending transaction), any business interest expense of the borrowing partnership attributable to the self-charged lending transaction is business interest expense of the borrowing partnership for purposes of this section. If in a given taxable year the lending partner is allocated excess business interest expense from the borrowing partnership and has interest income attributable to the self-charged lending transaction (interest income), the lending partner is deemed to receive an allocation of excess business interest income from the borrowing partnership in such taxable year. The amount of the lending partner's deemed allocation of excess business interest income is the lesser of such lending partner's allocation of excess business interest expense from the borrowing partnership in such taxable year or the interest income attributable to the self-charged lending transaction in such taxable year. To prevent the double counting of business interest income, the lending partner includes interest income that was treated as excess business interest income pursuant to this paragraph (n) only once when calculating its own section 163(j) limitation. To the extent an amount of interest income received by a lending partner is attributable to a self-charged lending transaction, and is deemed to be an allocation of excess business interest income from the borrowing partnership pursuant to this paragraph (n), such an amount of interest income will not be treated as investment income for purposes of section 163(d). In cases where the lending partner is not a C corporation, to the extent that any interest income exceeds the lending partner's allocation of excess business interest expense from the borrowing partnership for the taxable year, and such interest income otherwise would be properly treated as investment income of the lending partner for purposes of section 163(d) for that year, such excess amount of interest income will continue

to be treated as investment income of the lending partner for that year for purposes of section 163(d). See *Example 26* in paragraph (o)(26) of this section.

(o) \* \* \*

(24) *Example 24—(i) Facts.* On January 1, 2020, L and M form LM, a publicly traded partnership (as defined in §1.7704-1), and agree that each will be allocated a 50 percent share of all LM items. The partnership agreement provides that LM will make allocations under section 704(c) using the remedial allocation method under §1.704-3(d). L contributes depreciable property with an adjusted tax basis of \$4,000 and a fair market value of \$10,000. The property is depreciated using the straight-line method with a 10-year recovery period and has 4 years remaining on its recovery period. M contributes \$10,000 in cash, which LM uses to purchase land. Except for the depreciation deductions, LM's expenses equal its income in each year of the 10 years commencing with the year LM is formed. LM has a valid section 754 election in effect.

(ii) *Section 163(j) remedial items and partner basis items.* LM sells the asset contributed by L in a fully taxable transaction at a time when the adjusted basis of the property is \$4,000. Under §1.163(j)-6(e)(2)(ii), solely for purposes of §1.163(j)-6, the tax gain of \$6,000 is allocated equally between L and M (\$3,000 each). To avoid shifting built-in gain to the non-contributing partner (M) in a manner consistent with the rule in section 704(c), a remedial deduction of \$3,000 is allocated to M (leaving M with no net tax gain), and remedial income of \$3,000 is allocated to L (leaving L with total tax gain of \$6,000).

(25) *Example 25—(i) Facts.* The facts are the same as *Example 24* in paragraph (o)(24) of this section except the property contributed by L had an adjusted tax basis of zero. For each of the 10 years following the contribution, there would be \$500 of section 704(c) remedial income allocated to L and \$500 of remedial deductions allocated to M with respect to the contributed asset. A buyer of M's units would step into M's shoes with respect to the \$500 of annual remedial deductions. A buyer of L's units would step into L's shoes with respect to the \$500 of annual remedial income and would have an annual section 743(b) deduction of \$1,000 (net \$500 of deductions).

(ii) *Analysis.* Pursuant to §1.163(j)-6(d)(2)(ii), solely for purposes of §1.163(j)-6, a buyer of L's units immediately after formation of LM would offset its \$500 annual section 704(c) remedial income allocation with \$500 of annual section 743(b) adjustment (leaving the buyer with net \$500 of section 743(b) deduction). As a result, such buyer would be in the same position as a buyer of M's units. Each buyer would have net deductions of \$500 per year, which would not affect ATI before 2022.

(26) *Example 26—(i) Facts.* X and Y are partners in partnership PRS. In Year 1, PRS had \$200 of excess business interest expense. Pursuant to §1.163(j)-6(f)(2), PRS allocated \$100 of such excess business interest expense to each of its partners. In Year 2, X lends \$10,000 to PRS and receives \$1,000 of interest income for the taxable year (self-charged lending transaction). X is not in the trade or business of lending money. The \$1,000 of interest expense resulting

from this loan is allocable to PRS's trade or business assets. As a result, such \$1,000 of interest expense is business interest expense of PRS. X and Y are each allocated \$500 of such business interest expense as their distributive share of PRS's business interest expense for the taxable year. Additionally, in Year 2, PRS has \$3,000 of ATI. PRS allocates the items comprising its \$3,000 of ATI \$0 to X and \$3,000 to Y.

(ii) *Partnership-level.* In Year 2, PRS's section 163(j) limit is 30 percent of its ATI plus its business interest income, or \$900 (\$3,000 x 30 percent). Thus, PRS has \$900 of deductible business interest expense, \$100 of excess business interest expense, \$0 of excess taxable income, and \$0 of excess business interest income. Pursuant to §1.163(j)-6(f)(2), \$400 of X's allocation of business interest expense is treated as deductible business interest expense, \$100 of X's allocation of business interest expense is treated as excess business interest expense, and \$500 of Y's allocation of business interest expense is treated as deductible business interest expense.

(iii) *Lending partner.* Pursuant to §1.163(j)-6(n), X treats \$100 of its \$1,000 of interest income as excess business interest income allocated from PRS in Year 2. Because X is deemed to have been allocated \$100 of excess business interest income from PRS, and excess business interest expense from a partnership is treated as paid or accrued by a partner to the extent excess business interest income is allocated from such partnership to a partner, X treats its \$100 allocation of excess business interest expense from PRS in Year 2 as business interest expense paid or accrued in Year 2. X, in computing its limit under section 163(j), has \$100 of business interest income (\$100 deemed allocation of excess business interest income from PRS in Year 2) and \$100 of business interest expense (\$100 allocation of excess business interest expense treated as paid or accrued in Year 2). Thus, X's \$100 of business interest expense is deductible business interest expense. At the end of Year 2, X has \$100 of excess business interest expense from PRS (\$100 from Year 1). X treats \$900 of its \$1,000 of interest income as investment income for purposes of section 163(d).

(27) – (33) [Reserved]

(34) *Example 34—(i) Facts.* X and Y are equal partners in partnership PRS. Further, X and Y share the profits of PRS equally. In 2019, PRS had ATI of \$100. Additionally, in 2019, PRS had \$100 of section 704(b) income which was allocated \$50 to X and \$50 to Y (PRS did not have any section 704(c) income in 2019). In 2020, PRS's only items of income, gain, loss or deduction was \$1 of trade or business income, which it allocated to X pursuant to section 704(c).

(ii) *Partnership-level.* In 2020, PRS makes the election described in §1.163(j)-6(d)(5) to use its 2019 ATI in 2020. As a result, PRS has \$100 of ATI in 2020. PRS does not have any business interest expense. Therefore, PRS has \$100 of excess taxable income in 2020.

(iii) *Partner-level allocations.* PRS allocates its \$100 of excess taxable income to X and Y pursuant to §1.163(j)-6(f)(2). To determine each partner's share of the \$100 of excess taxable income, PRS must determine each partner's allocable ATI (as defined in §1.163(j)-6(f)(2)(ii)). Because PRS made the election described in §1.163(j)-6(d)(5), PRS must determine the allocable ATI of each of its partners

pursuant to paragraph (d)(5). Specifically, PRS determines each partner's share of allocable ATI based on PRS's 2019 section 704 income, gain, loss, and deduction. PRS had \$100 of section 704(b) income in 2019 which was allocated \$50 to X and \$50 to Y. Therefore, in 2020, X and Y are both allocated \$50 of excess taxable income (50% x \$100).

(35) *Example 35—(i) Facts.* X, a partner in partnership PRS, was allocated \$20 of excess business interest expense from PRS in 2018 and \$10 of excess business interest expense from PRS in 2019. In 2020, PRS allocated \$16 of excess taxable income to X.

(ii) *Analysis.* X treats 50 percent of its \$10 of excess business interest expense allocated from PRS in 2019 as §1.163(j)-6(g)(4) business interest expense. Thus, \$5 of §1.163(j)-6(g)(4) business interest expense is treated as paid or accrued by X in 2020 and is not subject to the section 163(j) limitation at X's level. Because X was allocated \$16 of excess taxable income from PRS in 2020, X treats \$16 of its \$25 of excess business interest expense as business interest expense paid or accrued pursuant to §1.163(j)-6(g)(2). X, in computing its limit under section 163(j) in 2020, has \$16 of ATI (as a result of its allocation of \$16 of excess taxable income from PRS), \$0 of business interest income, and \$16 of business interest expense (\$16 of excess business interest expense treated as paid or accrued in 2020). Pursuant to §1.163(j)-2(b)(2)(i), X's section 163(j) limit in 2020 is \$8 (\$16 x 50 percent). Thus, X has \$8 of business interest expense that is deductible under section 163(j). The \$8 of X's business interest expense not allowed as a deduction (\$16 business interest expense subject to section 163(j), less \$8 section 163(j) limit) is treated as business interest expense paid or accrued by X in 2021. At the end of 2020, X has \$9 of excess business interest expense from PRS (\$20 from 2018, plus \$10 from 2019, less \$5 treated as paid or accrued pursuant to §1.163(j)-6(g)(4), less \$16 treated as paid or accrued pursuant to §1.163(j)-6(g)(2)).

(36) *Example 36—(i) Facts.* X is a partner in partnership PRS. At the beginning of 2018, X's outside basis in PRS was \$100. X was allocated \$20 of excess business interest expense from PRS in 2018 and \$10 of excess business interest expense from PRS in 2019. X sold its PRS interest in 2019 for \$70.

(ii) *Analysis.* X treats 50 percent of its \$10 of excess business interest expense allocated from PRS in 2019 as §1.163(j)-6(g)(4) business interest expense. Thus, \$5 of §1.163(j)-6(g)(4) business interest expense is treated as paid or accrued by X in 2020 and is not subject to the section 163(j) limitation at X's level. Pursuant to paragraph (h)(3) of this section, immediately before the disposition, X increases the basis of its PRS interest from \$70 to \$95 (add back of \$20 of EBIE from 2018 and \$5 of remaining EBIE from 2019). Thus, X has a \$25 section 741 loss recognized on the sale (\$70 - \$95).

(p) *Applicability dates.*

(1) *In general.* \* \* \*

(2) *Paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5), (f)(1)(iii), (g)(4), (n), and (o)(24) through (29), and (34) through (36).* Paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5), (f)(1)(iii), (g)(4), (n), and (o)(24) through (29), and

(34) through (36) of this section apply to taxable years beginning on or after March 22, 2021. However, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in paragraphs (c)(1) and (2), (d)(3) through (5), (e)(5), (f)(1)(iii), (g)(4), (n), and (o)(24) through (29), and (34) through (36) to a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules in T.D. 9905 (§§1.163(j)-0 through 1.163(j)-11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.382-7, 1.383-0, 1.383-1, 1.469-9, 1.469-11, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-36, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4 contained in T.D. 9905 as modified by T.D. 9943, for that taxable year and for each subsequent taxable year.

Par. 7. Section 1.163(j)-7 is amended by revising paragraph (a), adding paragraphs (c) through (f), (g)(3) and (4), (h), (k), and (l), and revising paragraph (m) to read as follows:

*§1.163(j)-7 Application of the section 163(j) limitation to foreign corporations and United States shareholders.*

(a) *Overview.* This section provides rules for the application of section 163(j) to relevant foreign corporations and United States shareholders of relevant foreign corporations. Paragraph (b) of this section provides the general rule regarding the application of section 163(j) to a relevant foreign corporation. Paragraph (c) of this section provides rules for applying section 163(j) to CFC group members of a CFC group. Paragraph (d) of this section provides rules for determining a specified group and specified group members. Paragraph (e) of this section provides rules and procedures for treating a specified group member as a CFC group member and for determining a CFC group. Paragraph (f) of this section provides rules regarding

the treatment of a CFC group member that has ECI. Paragraph (g) of this section provides rules concerning the computation of ATI of an applicable CFC. Paragraph (h) of this section provides a safe harbor that exempts certain stand-alone applicable CFCs and CFC groups from the application of section 163(j) for a taxable year. Paragraphs (i) and (j) of this section are reserved. Paragraph (k) of this section provides definitions that apply for purposes of this section (see also §1.163(j)-1 for additional definitions). Paragraph (l) of this section provides examples illustrating the application of this section.

\*\*\*\*\*

(c) *Application of section 163(j) to CFC group members of a CFC group—*

(1) *Scope.* This paragraph (c) provides rules for applying section 163(j) to a CFC group and a CFC group member. Paragraph (c)(2) of this section provides rules for computing a single section 163(j) limitation for a specified period of a CFC group. Paragraph (c)(3) of this section provides rules for allocating a CFC group's section 163(j) limitation to CFC group members for specified taxable years. Paragraph (c)(4) of this section provides currency translation rules. Paragraph (c)(5) of this section provides special rules for specified periods beginning in 2019 or 2020.

(2) *Calculation of section 163(j) limitation for a CFC group for a specified period—*(i) *In general.* A single section 163(j) limitation is computed for a specified period of a CFC group. For purposes of applying section 163(j) and the section 163(j) regulations, the current-year business interest expense, disallowed business interest expense carryforwards, business interest income, floor plan financing interest expense, and ATI of a CFC group for a specified period equal the sums of each CFC group member's respective amounts for its specified taxable year with respect to the specified period. A CFC group member's current-year business interest expense, business interest income, floor plan financing interest expense, and ATI for a specified taxable year are generally determined on a separate-company basis. For purposes of determining the ATI of a CFC group, §1.163(j)-1(b)(1)(vii) (providing that ATI cannot be less than zero) applies with respect to the ATI of the CFC

group but not the ATI of any CFC group member.

(ii) *Certain transactions between CFC group members disregarded.* Any transaction between CFC group members of a CFC group that is entered into with a principal purpose of affecting a CFC group or a CFC group member's section 163(j) limitation by increasing or decreasing a CFC group or a CFC group member's ATI or business interest income for a specified taxable year is disregarded for purposes of applying section 163(j) and the section 163(j) regulations.

(3) *Deduction of business interest expense—*(i) *CFC group business interest expense—*(A) *In general.* The extent to which a CFC group member's current-year business interest expense and disallowed business interest expense carryforwards for a specified taxable year that ends with or within a specified period may be deducted under section 163(j) is determined under the rules and principles of §1.163(j)-5(a)(2) and (b)(3)(ii), subject to the modifications described in paragraph (c)(3)(i)(B) of this section.

(B) *Modifications to relevant terms.* For purposes of paragraph (c)(3)(i)(A) of this section, the rules and principles of §1.163(j)-5(b)(3)(ii) are applied by—

(1) Replacing “§1.163(j)-4(d)(2)” in §1.163(j)-5(a)(2)(ii) with “§1.163(j)-7(c)(2)(i)”;

(2) Replacing the term “allocable share of the consolidated group's remaining section 163(j) limitation” with “allocable share of the CFC group's remaining section 163(j) limitation”;

(3) Replacing the terms “consolidated group” and “group” with “CFC group”;

(4) Replacing the term “consolidated group's remaining section 163(j) limitation” with “CFC group's remaining section 163(j) limitation”;

(5) Replacing the term “consolidated return year” with “specified period”;

(6) Replacing the term “current year” or “current-year” with “current specified period” or “specified taxable year with respect to the current specified period,” as the context requires;

(7) Replacing the term “member” with “CFC group member”; and

(8) Replacing the term “taxable year” with “specified taxable year with respect to a specified period.”

(ii) *Carryforwards treated as attributable to the same taxable year.* For purposes of applying the principles of §1.163(j)-5(b)(3)(ii), as required under paragraph (c)(3)(i) of this section, CFC group members' disallowed business interest expense carryforwards that arose in specified taxable years with respect to the same specified period are treated as disallowed business interest expense carryforwards from taxable years ending on the same date and are deducted on a pro rata basis, under the principles of §1.163(j)-5(b)(3)(ii)(C)(3), pursuant to paragraph (c)(3)(i) of this section.

(iii) *Multiple specified taxable years of a CFC group member with respect to a specified period.* If a CFC group member has more than one specified taxable year (each year, an *applicable specified taxable year*) with respect to a single specified period of a CFC group, then all the applicable specified taxable years are taken into account for purposes of applying the principles of §1.163(j)-5(b)(3)(ii), as required under paragraph (c)(3)(i) of this section, with respect to the specified period. The portion of the section 163(j) limitation allocable to disallowed business interest expense carryforwards of the CFC group member that arose in taxable years before the first applicable specified taxable year is prorated among the applicable specified taxable years in proportion to the number of days in each applicable specified taxable year.

(iv) *Limitation on pre-group disallowed business interest expense carryforward—*

(A) *General rule—*(1) *CFC group member pre-group disallowed business interest expense carryforward.* This paragraph (c)(3)(iv) applies to pre-group disallowed business interest expense carryforwards of a CFC group member. The amount of the pre-group disallowed business interest expense carryforwards described in the preceding sentence that may be included in any CFC group member's business interest expense deduction for any specified taxable year under this paragraph (c)(3) may not exceed the aggregate section 163(j) limitation for all specified periods of the CFC group, determined by reference only to the CFC group member's items of income, gain, deduction, and loss, and reduced (including below zero) by the CFC group member's business interest

expense (including disallowed business interest expense carryforwards) taken into account as a deduction by the CFC group member in all specified taxable years in which the CFC group member has continuously been a CFC group member of the CFC group (*cumulative section 163(j) pre-group carryforward limitation*).

(2) *Subgrouping*. In the case of a pre-group disallowed business interest expense carryforward, a pre-group subgroup is composed of the CFC group member with the pre-group disallowed business interest expense carryforward (the *loss member*) and each other CFC group member of the loss member's CFC group (the *current group*) that was a member of the CFC group in which the pre-group disallowed business interest expense carryforward arose and joined the specified group of the current group at the same time as the loss member. A CFC group member that is a member of a pre-group subgroup remains a member of the pre-group subgroup until its first taxable year during which it ceases to be a member of the same specified group as the loss member. For purposes of this paragraph (c), the rules and principles of §1.163(j)-5(d)(1)(B) apply to a pre-group subgroup as if the pre-group subgroup were a SRLY subgroup.

(3) *Transition rule*. Solely for purposes of paragraph (c)(3)(iv)(A)(2) of this section, a CFC group includes a group of applicable CFCs for which a CFC group election was made under guidance under section 163(j) published on December 28, 2018. Therefore, if the requirements of paragraph (c)(3)(iv)(A)(2) of this section are satisfied, a group of applicable CFCs described in the preceding sentence may be treated as a pre-group subgroup.

(B) *Deduction of pre-group disallowed business interest expense carryforwards*. Notwithstanding paragraph (c)(3)(iv)(A)(1) of this section, pre-group disallowed business interest expense carryforwards are available for deduction by a CFC group member in its specified taxable year only to the extent the CFC group has remaining section 163(j) limitation for the specified period after the deduction of current-year business interest expense and disallowed business interest expense carryforwards from earlier taxable years that are permitted to be deducted in specified taxable

years of CFC group members with respect to the specified period. See paragraph (c)(3)(i) of this section and §1.163(j)-5(b)(3)(ii)(A). Pre-group disallowed business interest expense carryforwards are deducted on a pro rata basis (under the principles of paragraph (c)(3)(i) of this section and §1.163(j)-5(b)(3)(ii)(C)(4)) with other disallowed business interest expense carryforwards from taxable years ending on the same date.

(4) *Currency translation*. For purposes of applying this paragraph (c), items of a CFC group member are translated into a single currency for the CFC group and back to the functional currency of the CFC group member using the average exchange rate for the CFC group member's specified taxable year. The single currency for the CFC group may be the U.S. dollar or the functional currency of a plurality of the CFC group members.

(5) *Special rule for specified periods beginning in 2019 or 2020*—(i) *50 percent ATI limitation applies to a specified period of a CFC group*. In the case of a CFC group, §1.163(j)-2(b)(2) (including the election under §1.163(j)-2(b)(2)(ii)) applies to a specified period of the CFC group beginning in 2019 or 2020, rather than to a specified taxable year of a CFC group member. An election under §1.163(j)-2(b)(2)(ii) for a specified period of a CFC group is not effective unless made by each designated U.S. person. Except as otherwise provided in this paragraph (c)(5)(i), the election is made in accordance with Revenue Procedure 2020-22, 2020-18 I.R.B. 745. For purposes of applying §1.964-1(c), the election is treated as if made for each CFC group member.

(ii) *Election to use 2019 ATI applies to a specified period of a CFC group*—(A) *In general*. In the case of a CFC group, for purposes of applying paragraph (c)(2) of this section, an election under §1.163(j)-2(b)(3)(i) is made for a specified period of a CFC group beginning in 2020 and applies to the specified taxable years of each CFC group member with respect to such specified period, taking into account the application of paragraph (c)(5)(ii)(B) of this section. The election under §1.163(j)-2(b)(3)(i) does not apply to any specified taxable year of a CFC group member other than those described in the preceding

sentence. An election under §1.163(j)-2(b)(3)(i) for a specified period of a CFC group is not effective unless made by each designated U.S. person. Except as otherwise provided in this paragraph (c)(5)(ii)(A), the election is made in accordance with Revenue Procedure 2020-22, 2020-18 I.R.B. 745. For purposes of applying §1.964-1(c), the election is treated as if made for each CFC group member.

(B) *Specified taxable years that do not begin in 2020*. If a specified taxable year of a CFC group member with respect to the specified period described in paragraph (c)(5)(ii)(A) of this section begins in 2019, then, for purposes of applying paragraph (c)(2) of this section, §1.163(j)-2(b)(3) is applied to such specified taxable year by substituting “2018” for “2019” and “2019” for “2020.” If a specified taxable year of a CFC group member with respect to the specified period described in paragraph (c)(5)(ii)(A) of this section begins in 2021, then, for purposes of applying paragraph (c)(2) of this section, §1.163(j)-2(b)(3) is applied to such specified taxable year by substituting “2020” for “2019” and “2021” for “2020.”

(d) *Determination of a specified group and specified group members*—(1) *Scope*. This paragraph (d) provides rules for determining a specified group and specified group members. Paragraph (d)(2) of this section provides rules for determining a specified group. Paragraph (d)(3) of this section provides rules for determining specified group members.

(2) *Rules for determining a specified group*—(i) *Definition of a specified group*. Subject to paragraph (d)(2)(ii) of this section, the term *specified group* means one or more applicable CFCs or chains of applicable CFCs connected through stock ownership with a specified group parent (which is included in the specified group only if it is an applicable CFC), but only if—

(A) The specified group parent owns directly or indirectly stock meeting the requirements of section 1504(a)(2)(B) in at least one applicable CFC; and

(B) Stock meeting the requirements of section 1504(a)(2)(B) in each of the applicable CFCs (except the specified group parent) is owned directly or indirectly by one or more of the other applicable CFCs or the specified group parent.

(ii) *Indirect ownership.* For purposes of applying paragraph (d)(2)(i) of this section, stock is owned indirectly only if it is owned under section 318(a)(2)(A) through a partnership or under section 318(a)(2)(A) or (B) through an estate or trust not described in section 7701(a)(30).

(iii) *Specified group parent.* The term *specified group parent* means a qualified U.S. person or an applicable CFC.

(iv) *Qualified U.S. person.* The term *qualified U.S. person* means a United States person described in section 7701(a)(30)(A) or (C). For purposes of this paragraph (d), members of a consolidated group that file (or that are required to file) a consolidated U.S. Federal income tax return are treated as a single qualified U.S. person and individuals described in section 7701(a)(30)(A) whose filing status is married filing jointly are treated as a single qualified U.S. person.

(v) *Stock.* For purposes of this paragraph (d)(2), the term *stock* has the same meaning as “stock” in section 1504 (without regard to §1.1504-4, except as provided in paragraph (d)(2)(vi) of this section) and all shares of stock within a single class are considered to have the same value. Thus, control premiums and minority and blockage discounts within a single class are not taken into account.

(vi) *Options treated as exercised.* For purposes of this paragraph (d)(2), options that are reasonably certain to be exercised, as determined under §1.1504-4(g), are treated as exercised. For purposes of this paragraph (d)(2)(vi), options include call options, warrants, convertible obligations, put options, and any other instrument treated as an option under §1.1504-4(d), determined by replacing the term “a principal purpose of avoiding the application of section 1504 and this section” with “a principal purpose of avoiding the application of section 163(j).”

(vii) *When a specified group ceases to exist.* The principles of §1.1502-75(d)(1), (d)(2)(i) and (ii), and (d)(3)(i) through (iv) apply for purposes of determining when a specified group ceases to exist. Solely for purposes of applying these principles, references to the common parent are treated as references to the specified group parent and each applicable CFC that is treated as a specified group member for a taxable year with respect to a specified period

is treated as affiliated with the specified group parent from the beginning to the end of the specified period, without regard to the beginning or end of its taxable year.

(3) *Rules for determining a specified group member.* If two or more applicable CFCs are included in a specified group on the last day of a taxable year of each applicable CFC that ends with or within a specified period, then each applicable CFC is a *specified group member* with respect to the specified period for its entire taxable year ending with or within the specified period. If only one applicable CFC is included in a specified group on the last day of its taxable year that ends with or within the specified period, it is not a specified group member. If an applicable CFC has multiple taxable years that end with or within a specified period, this paragraph (d)(3) is applied separately to each taxable year to determine if the applicable CFC is a specified group member for such taxable year.

(e) *Rules and procedures for treating a specified group as a CFC group—(1) Scope.* This paragraph (e) provides rules and procedures for treating a specified group member as a CFC group member and for determining a CFC group for purposes of applying section 163(j) and the section 163(j) regulations.

(2) *CFC group and CFC group member—(i) CFC group.* The term *CFC group* means, with respect to a specified period, all CFC group members for their specified taxable years.

(ii) *CFC group member.* The term *CFC group member* means, with respect to a specified taxable year and a specified period, a specified group member of a specified group for which a CFC group election is in effect. However, notwithstanding the prior sentence, a specified group member is not treated as a CFC group member for a taxable year of the specified group member beginning before January 1, 2018.

(3) *Duration of a CFC group.* A CFC group continues until the CFC group election is revoked, or there is no longer a specified period with respect to the specified group. A failure to provide the information described in paragraph (e)(6) of this section does not terminate a CFC group election.

(4) *Joining or leaving a CFC group.* If an applicable CFC becomes a speci-

fied group member for a specified taxable year with respect to a specified period of a specified group for which a CFC group election is in effect, the CFC group election applies to the applicable CFC and the applicable CFC becomes a CFC group member. If an applicable CFC ceases to be a specified group member for a specified taxable year with respect to a specified period of a specified group for which a CFC group election is in effect, the CFC group election terminates solely with respect to the applicable CFC.

(5) *Manner of making or revoking a CFC group election—(i) In general.* An election is made or revoked under this paragraph (e)(5) (*CFC group election*) with respect to a specified period of a specified group. A CFC group election remains in effect for each specified period of the specified group until revoked. A CFC group election that is in effect with respect to a specified period of a specified group applies to each specified group member for its specified taxable year that ends with or within the specified period. The making or revoking of a CFC group election is not effective unless made or revoked by each designated U.S. person.

(ii) *Revocation by election.* A CFC group election cannot be revoked with respect to any specified period beginning before 60 months following the last day of the specified period for which the election was made. Once a CFC group election has been revoked, a new CFC group election cannot be made with respect to any specified period beginning before 60 months following the last day of the specified period for which the election was revoked.

(iii) *Timing.* A CFC group election must be made or revoked with respect to a specified period of a specified group no later than the due date (taking into account extensions, if any) of the original Federal income tax return for the taxable year of each designated U.S. person in which or with which the specified period ends.

(iv) *Election statement.* To make or revoke a CFC group election for a specified period of a specified group, each designated U.S. person must attach a statement to its relevant Federal income tax or information return in accordance with publications, forms, instructions, or other guidance. The statement must include the name and taxpayer identification

number of all designated U.S. persons, a statement that the CFC group election is being made or revoked, as applicable, the specified period for which the CFC group election is being made or revoked, and the name of each CFC group member and its specified taxable year with respect to the specified period. The statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance.

(v) *Effect of prior CFC group election.* A CFC group election is made solely pursuant to the provisions of this paragraph (e)(5), without regard to whether a CFC group election described in guidance under section 163(j) published on December 28, 2018, was in effect.

(6) *Annual information reporting.* Each designated U.S. person must attach a statement to its relevant Federal income tax or information return for each taxable year in which a CFC group election is in effect that contains information concerning the computation of the CFC group's section 163(j) limitation and the application of paragraph (c)(3) of this section to the CFC group in accordance with publications, forms, instructions, or other guidance.

(f) *Treatment of a CFC group member that has ECI*—(1) *In general.* If a CFC group member has ECI in its specified taxable year, then for purposes of section 163(j) and the section 163(j) regulations—

(i) The items, disallowed business interest expense carryforwards, and other attributes of the CFC group member that are ECI are treated as items, disallowed business interest expense carryforwards, and attributes of a separate applicable CFC (such deemed corporation, an *ECI deemed corporation*) that has the same taxable year and shareholders as the applicable CFC; and

(ii) The ECI deemed corporation is not treated as a specified group member for the specified taxable year.

(2) [Reserved].

(g) \* \* \*

(3) *Treatment of certain foreign income taxes.* For purposes of computing the ATI of a relevant foreign corporation for a taxable year, no deduction is taken into account for any foreign income tax (as defined in §1.960-1(b), but substituting the phrase “relevant foreign corporation”

for the phrase “controlled foreign corporation”).

(4) *Anti-abuse rule*—(i) *In general.* If a specified group member of a specified group or an applicable partnership (*specified lender*) includes an amount (*payment amount*) in income and such amount is attributable to business interest expense incurred by another specified group member or an applicable partnership of the specified group (*specified borrower*) during its taxable year, then the ATI of the specified borrower for the taxable year is increased by the ATI adjustment amount if—

(A) The business interest expense is incurred with a principal purpose of reducing the Federal income tax liability of any United States shareholder of a specified group member (including over other taxable years);

(B) Absent the application of this paragraph (g)(4), the effect of the specified borrower treating all or part of the payment amount as disallowed business interest expense would be to reduce the Federal income tax liability of any United States shareholder of a specified group member; and

(C) Either no CFC group election is in effect with respect to the specified group or the specified borrower is an applicable partnership.

(ii) *ATI adjustment amount*—(A) *In general.* For purposes of this paragraph (g)(4), the term *ATI adjustment amount* means, with respect to a specified borrower and a taxable year, the product of 3 1/3 and the lesser of the payment amount or the disallowed business interest expense, computed without regard to this paragraph (g)(4).

(B) *Special rule for taxable years or specified periods beginning in 2019 or 2020.* For any taxable year of an applicable CFC or specified taxable year of a CFC group member with respect to a specified period for which the section 163(j) limitation is determined based, in part, on 50 percent of ATI, in accordance with §1.163(j)-2(b)(2), paragraph (g)(4) (ii)(A) of this section is applied by substituting “2” for “3 1/3.”

(iii) *Applicable partnership.* For purposes of this paragraph (g)(4), the term *applicable partnership* means, with respect to a specified group, a partnership in which at least 80 percent of the interests

in profits or capital is owned, directly or indirectly through one or more other partnerships, by specified group members of the specified group. For purposes of this paragraph (g)(4)(iii), a partner's interest in the profits of a partnership is determined in accordance with the rules and principles of §1.706-1(b)(4)(ii) and a partner's interest in the capital of a partnership is determined in accordance with the rules and principles of §1.706-1(b)(4)(iii).

(h) *Election to apply safe-harbor*—(1) *In general.* If an election to apply this paragraph (h)(1) (*safe-harbor election*) is in effect with respect to a taxable year of a stand-alone applicable CFC or a specified taxable year of a CFC group member, as applicable, then, for such year, no portion of the applicable CFC's business interest expense is disallowed under the section 163(j) limitation. This paragraph (h) does not apply to excess business interest expense, as described in §1.163(j)-6(f)(2), until the taxable year in which it is treated as paid or accrued by an applicable CFC under §1.163(j)-6(g)(2)(i). Furthermore, excess business interest expense is not taken into account for purposes of determining whether the safe-harbor election is available for a stand-alone applicable CFC or a CFC group until the taxable year in which it is treated as paid or accrued by an applicable CFC under §1.163(j)-6(g)(2)(i).

(2) *Eligibility for safe-harbor election*—(i) *Stand-alone applicable CFC.* The safe-harbor election may be made for the taxable year of a stand-alone applicable CFC only if, for the taxable year, the business interest expense of the applicable CFC is less than or equal to either—

(A) The business interest income of the applicable CFC; or

(B) 30 percent of the lesser of the eligible amount or the qualified tentative taxable income of the applicable CFC.

(ii) *CFC group.* The safe-harbor election may be made for the specified period of a CFC group only if, for the specified period, no CFC group member has any pre-group disallowed business interest expense carryforward and the business interest expense of the CFC group for the specified period is less than or equal to either—

(A) The business interest income of the CFC group; or

(B) 30 percent of the lesser of the eligible amount or the qualified tentative taxable income of the CFC group.

(iii) *Currency translation.* For purposes of applying this paragraph (h), BII, BIE, and qualified tentative taxable income of a stand-alone applicable CFC or a CFC group must be determined using the U.S. dollar. If BII, BIE, or any items of income, gain, deduction, or loss that are taken into account in computing qualified tentative taxable income are maintained in a currency other than the U.S. dollar, then those items must be translated into the U.S. dollar using the average exchange rate for the taxable year or the specified taxable year, as applicable.

(3) *Eligible amount*—(i) *Stand-alone applicable CFC.* The *eligible amount* of a stand-alone applicable CFC for a taxable year is the sum of the amounts a domestic corporation would include in gross income under sections 951(a)(1)(A) and 951A(a), reduced by any deductions that would be allowed under section 245A (by reason of section 964(e)(4)) or section 250(a)(1)(B) (i), determined as if the domestic corporation has a taxable year that ends on the last date of the taxable year of the stand-alone applicable CFC, it wholly owns the stand-alone applicable CFC throughout the CFC's taxable year, it does not own any assets other than stock in the stand-alone applicable CFC, and it has no other items of income, gain, deduction, or loss.

(ii) *CFC group.* The *eligible amount* of a CFC group for a specified period is the sum of the amounts a domestic corporation would include in gross income under sections 951(a)(1)(A) and 951A(a), reduced by any deductions that would be allowed under section 245A (by reason of section 964(e)(4)) or section 250(a)(1)(B)(i), determined as if the domestic corporation has a taxable year that is the specified period, it wholly owns each CFC group member throughout the CFC group member's specified taxable year, it does not own any assets other than stock in the CFC group members, and it has no other items of income, gain, deduction, or loss.

(iii) *Additional rules for determining an eligible amount.* For purposes of paragraphs (h)(3)(i) and (ii) of this section, the amounts that would be included in gross income of a United States shareholder under sections 951(a)(1)(A) and

951A(a), and any corresponding deductions that would be allowed under section 245A (by reason of section 964(e)(4)) or section 250(a)(1)(B)(i), are determined by taking into account any elections that are made with respect to the applicable CFC(s), including under §1.954-1(d)(5) (relating to the subpart F high-tax exception) and §1.951A-2(c)(7)(viii) (relating to the GILTI high-tax exclusion). These amounts are also determined without regard to any section 163(j) limitation on business interest expense and without regard to any disallowed business interest expense carryovers. In addition, those amounts are determined by only taking into account items of the applicable CFC(s) that are properly allocable to a non-excepted trade or business under §1.163(j)-10.

(4) *Qualified tentative taxable income.* The term *qualified tentative taxable income* means, with respect to a taxable year of a stand-alone applicable CFC, the applicable CFC's tentative taxable income, and with respect to a specified period of a CFC group, the sum of each CFC group member's tentative taxable income for the specified taxable year; provided that for purposes of this paragraph (h)(4), tentative taxable income is determined by taking into account only items properly allocable to a non-excepted trade or business under §1.163(j)-10.

(5) *Manner of making a safe-harbor election*—(i) *In general.* A safe-harbor election is an annual election made under this paragraph (h)(5) with respect to a taxable year of a stand-alone applicable CFC or with respect to a specified period of a CFC group. A safe-harbor election that is made with respect to a specified period of a CFC group is effective with respect to each CFC group member for its specified taxable year. A safe-harbor election is only effective if made by each designated U.S. person with respect to a stand-alone applicable CFC or a CFC group. A safe-harbor election is made with respect to a taxable year of a stand-alone applicable CFC, or a specified period of a CFC group, no later than the due date (taking into account extensions, if any) of the original Federal income tax return for the taxable year of each designated U.S. person, respectively, in which or with which the taxable year of the stand-alone applicable CFC ends

or the specified period of the CFC group ends.

(ii) *Election statement.* To make a safe-harbor election, each designated U.S. person must attach to its relevant Federal income tax return or information return a statement that includes the name and taxpayer identification number of all designated U.S. persons, a statement that a safe-harbor election is being made pursuant to §1.163(j)-7(h) and a calculation that substantiates that the requirements for making the election are satisfied, and the taxable year of the stand-alone applicable CFC or the specified period of the CFC group, as applicable, for which the safe-harbor election is being made in accordance with publications, forms, instructions, or other guidance. In the case of a CFC group, the statement must also include the name of each CFC group member and its specified taxable year that ends with or within the specified period for which the safe-harbor election is being made. The statement must be filed in the manner prescribed in publications, forms, instructions, or other guidance.

(6) *Special rule for taxable years or specified periods beginning in 2019 or 2020.* In the case of a stand-alone applicable CFC, for any taxable year beginning in 2019 or 2020, paragraph (h)(2)(i) of this section is applied by substituting "50 percent" for "30 percent." In the case of a CFC group, for any specified period beginning in 2019 or 2020, paragraph (h)(2)(ii)(A) of this section is applied by substituting "50 percent" for "30 percent."

\* \* \* \* \*

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

(1) *Applicable partnership.* The term *applicable partnership* has the meaning provided in paragraph (g)(4)(iii) of this section.

(2) *Applicable specified taxable year.* The term *applicable specified taxable year* has the meaning provided in paragraph (c)(3)(iii) of this section.

(3) *ATI adjustment amount.* The term *ATI adjustment amount* has the meaning provided in paragraph (g)(4)(ii) of this section.

(4) - (5) [Reserved].

(6) *CFC group.* The term *CFC group* has the meaning provided in paragraph (e)(2)(i) of this section.

(7) *CFC group election.* The term *CFC group election* means the election described in paragraph (e)(5) of this section.

(8) *CFC group member.* The term *CFC group member* has the meaning provided in paragraph (e)(2)(ii) of this section.

(9) [Reserved].

(10) *Cumulative section 163(j) pre-group carryforward limitation.* The term *cumulative section 163(j) pre-group carryforward limitation* has the meaning provided in paragraph (c)(3)(iv)(A)(1) of this section.

(11) *Current group.* The term *current group* has the meaning provided in paragraph (c)(3)(iv)(A)(2) of this section.

(12) *Designated U.S. person.* The term *designated U.S. person* means—

(i) With respect to a stand-alone applicable CFC, each controlling domestic shareholder, as defined in §1.964-1(c)(5)(i) of the applicable CFC; or

(ii) With respect to a specified group, the specified group parent, if the specified group parent is a qualified U.S. person, or each controlling domestic shareholder, as defined in §1.964-1(c)(5)(i), of the specified group parent, if the specified group parent is an applicable CFC.

(13) *ECI deemed corporation.* The term *ECI deemed corporation* has the meaning provided in paragraph (f)(1)(i) of this section.

(14) *Effectively connected income.* The term *effectively connected income* (or *ECI*) means income or gain that is ECI, as defined in §1.884-1(d)(1)(iii), and deduction or loss that is allocable to, ECI, as defined in §1.884-1(d)(1)(iii).

(15) *Eligible amount.* The term *eligible amount* has the meaning provided in paragraph (h)(3)(i) of this section.

(16) *Former group.* The term *former group* has the meaning provided in paragraph (c)(3)(iv)(A)(2) of this section.

(17) *Loss member.* The term *loss member* has the meaning provided in paragraph (c)(3)(iv)(A)(2) of this section.

(18) *Payment amount.* The term *payment amount* has the meaning provided in paragraph (g)(4)(i) of this section.

(19) *Pre-group disallowed business interest expense carryforward.* The term *pre-group disallowed business interest expense carryforward* means, with respect to a CFC group member and a specified taxable year, any disallowed business in-

terest expense carryforward of the CFC group member that arose in a taxable year during which the CFC group member (or its predecessor) was not a CFC group member of the CFC group.

(20) *Qualified tentative taxable income.* The term *qualified tentative taxable income* has the meaning provided in paragraph (h)(4) of this section.

(21) *Qualified U.S. person.* The term *qualified U.S. person* has the meaning provided in paragraph (d)(2)(iv) of this section.

(22) *Relevant period.* The term *relevant period* has the meaning provided in paragraph (c)(3)(iv)(A)(2) of this section.

(23) *Safe-harbor election.* The term *safe-harbor election* has the meaning provided in paragraph (h)(1) of this section.

(24) *Specified borrower.* The term *specified borrower* has the meaning provided in paragraph (g)(4)(i) of this section.

(25) *Specified group.* The term *specified group* has the meaning provided in paragraph (d)(2)(i) of this section.

(26) *Specified group member.* The term *specified group member* has the meaning provided in paragraph (d)(3) of this section.

(27) *Specified group parent.* The term *specified group parent* has the meaning provided in paragraph (d)(2)(iii) of this section.

(28) *Specified lender.* The term *specified lender* has the meaning provided in paragraph (g)(4)(i) of this section.

(29) *Specified period*—(i) *In general.* Except as otherwise provided in paragraph (k)(29)(ii) of this section, the term *specified period* means, with respect to a specified group—

(A) If the specified group parent is a qualified U.S. person, the period ending on the last day of the taxable year of the specified group parent and beginning on the first day after the last day of the specified group's immediately preceding specified period; or

(B) If the specified group parent is an applicable CFC, the period ending on the last day of the specified group parent's required year described in section 898(c)(1), without regard to section 898(c)(2), and beginning on the first day after the last day of the specified group's immediately preceding specified period.

(ii) *Short specified period.* A specified period begins no earlier than the first date on which a specified group exists. A specified period ends on the date a specified group ceases to exist under paragraph (d)(2)(vii) of this section. If the last day of a specified period, as determined under paragraph (k)(29)(i) of this section, changes, and, but for this paragraph (k)(29)(ii), the change in the last day of the specified period would result in the specified period being longer than 12 months, the specified period ends on the date on which the specified period would have ended had the change not occurred.

(30) *Specified taxable year.* The term *specified taxable year* means, with respect to an applicable CFC that is a specified group member of a specified group and a specified period, a taxable year of the applicable CFC that ends with or within the specified period.

(31) *Stand-alone applicable CFC.* The term *stand-alone applicable CFC* means any applicable CFC that is not a specified group member.

(32) *Stock.* The term *stock* has the meaning provided in paragraph (d)(2)(v) of this section.

(1) *Examples.* The following examples illustrate the application of this section. For each example, unless otherwise stated, no exemptions from the application of section 163(j) are available, no foreign corporation has ECI, and all relevant taxable years and specified periods begin after December 31, 2020.

(1) *Example 1. Specified taxable years included in specified period of a specified group*—(i) *Facts.* As of June 30, Year 1, USP, a domestic corporation, owns 60 percent of the common stock of FP, which owns all of the stock of FC1, FC2, and FC3. The remaining 40 percent of the common stock of FP is owned by an unrelated foreign corporation. FP has a single class of stock. FP acquired the stock of FC3 from an unrelated person on March 22, Year 1. The acquisition did not result in a change in FC3's taxable year or a close of its taxable year. USP's interest in FP and FP's interest in FC1 and FC2 has been the same for several years. USP has a taxable year ending June 30, Year 1, which is not a short taxable year. Each of FP, FC1, FC2, and FC3 are applicable CFCs. Pursuant to section 898(c)(2), FP and FC1 have taxable years ending May 31, Year 1. Pursuant to section 898(c)(1), FC2 and FC3 have taxable years ending June 30, Year 1.

(ii) *Analysis*—(A) *Determining a specified group and specified period of the specified group.* Pursuant to paragraph (d) of this section, FP, FC1, FC2, and FC3 are members of a specified group, and FP is the specified group parent. Because the specified

group parent, FP, is an applicable CFC, the specified period of the specified group is the period ending on June 30, Year 1, which is the last day of FP's required year described in section 898(c)(1), without regard to section 898(c)(2), and beginning on July 1, Year 0, which is the first day following the last day of the specified group's immediately preceding specified period (June 30, Year 0). See paragraph (k)(29)(i)(B) of this section.

(B) *Determining the specified taxable years with respect to the specified period.* Pursuant to paragraph (d)(3) of this section, because each of FP and FC1 are included in the specified group on the last day of their taxable years ending May 31, Year 1, and such taxable years end with or within the specified period ending June 30, Year 1, FP and FC1 are specified group members with respect to the specified period ending June 30, Year 1, for their entire taxable years ending May 31, Year 1, and those taxable years are specified taxable years. Similarly, because each of FC2 and FC3 are included in the specified group on the last day of their taxable years ending June 30, Year 1, and such taxable years end with or within the specified period ending June 30, Year 1, FC2 and FC3 are specified group members with respect to the specified period ending June 30, Year 1, for their entire taxable years ending June 30, Year 1, and those taxable years are specified taxable years. The fact that FC3 was acquired on March 22, Year 1, does not prevent FC3 from being a specified group member with respect to the specified period for the portion of its specified taxable year before March 22, Year 1.

(2) *Example 2. CFC groups—(i) Facts.* The facts are the same as in *Example 1* in paragraph (l)(1)(i) of this section except that, in addition, a CFC group election is in place with respect to the specified period ending June 30, Year 1.

(ii) *Analysis.* Because a CFC group election is in place for the specified period ending June 30, Year 1, pursuant to paragraph (e)(2)(ii) of this section, each specified group member is a CFC group member with respect to its specified taxable year ending with or within the specified period. Accordingly, FP, FC1, FC2, and FC3 are CFC group members with respect to the specified period ending June 30, Year 1, for their specified taxable years ending May 31, Year 1, and June 30, Year 1, respectively. Pursuant to paragraph (e)(2)(i) of this section, the CFC group for the specified period ending June 30, Year 1, consists of FP, FC1, FC2, and FC3 for their specified taxable years ending May 31, Year 1, and June 30, Year 1, respectively. Pursuant to paragraph (c)(2) of this section, a single section 163(j) limitation is computed for the specified period ending June 30, Year 1. That section 163(j) calculation will include FP and FC1's specified taxable years ending May 31, Year 1, and FC2 and FC3's specified taxable years ending June 30, Year 1.

(3) *Example 3. Application of anti-abuse rule—(i) Facts.* USP, a domestic corporation, owns all of the stock of CFC1 and CFC2. Thus, USP is the specified group parent of a specified group, the specified group members of which are CFC1 and CFC2. USP has a calendar year taxable year. All specified group members also have a calendar year taxable year and a functional currency of the U.S. dollar. CFC1 is organized in, and a tax resident of,

a jurisdiction that imposes no tax on certain types of income, including interest income. With respect to Year 1, USP expects to pay no residual U.S. tax on its income inclusion under section 951A(a) (GILTI inclusion amount) and expects to have unused foreign tax credits in the category described in section 904(d)(1)(A). A CFC group election is not in effect for Year 1. With a principal purpose of reducing USP's Federal income tax liability in subsequent taxable years, on January 1, Year 1, CFC1 loans \$100x to CFC2. On December 31, Year 1, CFC2 pays interest of \$10x to CFC1 and repays the principal of \$100x. Absent the application of paragraph (g)(4)(i) of this section, all \$10x of CFC2's interest expense would be disallowed business interest expense and, therefore, CFC2 would have \$10x of disallowed business interest expense carryforward to Year 2. In Year 2, CFC2 disposes of one of its businesses at a substantial gain that gives rise to tested income (within the meaning of section 951A(c)(2)(A) and §1.951A-2(b)(1)). As a result of the gain being included in the ATI of CFC2, absent the application of paragraph (g)(4)(i) of this section, CFC2 would be allowed to deduct the entire \$10x of disallowed business interest expense carryforward and therefore reduce the amount of its tested income. Also, USP would pay residual U.S. tax on its GILTI inclusion amount in Year 2, without regard to the application of paragraph (g)(4)(i) of this section.

(ii) *Analysis.* The \$10x of business interest expense paid in Year 1 is a payment amount described in paragraph (g)(4)(i) of this section because it is between specified group members, CFC1 and CFC2. Furthermore, the requirements of paragraphs (g)(4)(i)(A), (B), and (C) of this section are satisfied because the \$10x of business interest expense is incurred with a principal purpose of reducing USP's Federal income tax liability; absent the application of paragraph (g)(4)(i) of this section, the effect of CFC2 treating the \$10x of business interest expense as disallowed business interest expense in Year 1 would be to reduce USP's Federal income tax liability in Year 2; and no CFC group election is in effect with respect to the specified group in Year 1. Because the requirements of paragraphs (g)(4)(i)(A), (B), and (C) of this section are satisfied, CFC2's ATI for Year 1 is increased by the ATI adjustment amount, or \$33.33x, which is the amount equal to  $3 \frac{1}{3}$  multiplied by \$10x (the lesser of the payment amount of \$10x and the disallowed business interest expense of \$10x). As a result, the \$10x of business interest expense is not disallowed business interest expense of CFC2 in Year 1, and therefore does not give rise to a disallowed business interest expense carryforward to Year 2.

(m) *Applicability dates—(1) General applicability date.* Except as provided in paragraph (m)(2) of this section, this section applies for a taxable year of a foreign corporation beginning on or after November 13, 2020.

(2) *Exception.* Paragraphs (a), (c)(1), (c)(2)(i) and (ii), and (c)(3) through (5), (d), (e), (f)(1), (g)(3) and (4), (h), and (k) (1) through (3), (6) through (8), and (10)

through (32) of this section apply for a taxable year of a foreign corporation beginning on or after March 22, 2021.

(3) *Early application—(i) Rules for paragraphs (b) and (g)(1) and (2) of this section.* Taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in paragraphs (b) and (g)(1) and (2) of this section for a taxable year beginning after December 31, 2017, and before November 13, 2020, provided that those taxpayers and their related parties consistently apply all of those rules and the rules described in paragraph (m)(4) of this section for that taxable year. If a taxpayer and its related parties apply the rules described in paragraph (m)(4) of this section, as contained in T.D. 9905 (§§1.163(j)-0 through 1.163(j)-11, effective November 13, 2020), they will be considered as applying the rules described in paragraph (m)(4) of this section for purposes of this paragraph (m)(3)(i).

(ii) *Rules for certain other paragraphs in this section.* Taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in paragraphs (a), (c)(1), (c)(2)(i) and (ii), and (c)(3) through (5), (d), (e), (f)(1), (g)(3) and (4), (h), and (k) (1) through (3), (6) through (8), and (10) through (32) of this section for a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of those rules and the rules described in paragraph (m)(4) of this section for that taxable year and for each subsequent taxable year. If a taxpayer and its related parties apply the rules described in paragraph (m)(4) of this section, as contained in T.D. 9905 (§§1.163(j)-0 through 1.163(j)-11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), they will be considered as applying the rules described in paragraph (m)(4) of this section for purposes of this paragraph (m)(3)(ii).

(4) *Additional rules that must be applied consistently.* The rules described in this paragraph (m)(4) are the section 163(j) regulations and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1,

1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.382-7, 1.383-0, 1.383-1, 1.469-9, 1.469-11, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-36, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1) and 1.1504-4.

(5) *Election for prior taxable years and specified periods.* Notwithstanding paragraph (e)(5)(iii) or (h)(5)(i) of this section, in the case of a specified period of a specified group or a taxable year of a stand-alone applicable CFC that ends with or within a taxable year of a designated U.S. person ending before November 13, 2020, a CFC group election or a safe-harbor election may be made on an amended Federal income tax return filed on or before the due date (taking into account extensions, if any) of the original Federal income tax return for the first taxable year of each designated U.S. person ending on or after November 13, 2020.

Par. 8. Section 1.163(j)-10 is amended by:

1. Redesignating paragraph (c)(5)(ii)(D) as paragraph (c)(5)(ii)(D)(1).
2. Adding a subject heading for paragraph (c)(5)(ii)(D).
3. Adding paragraph (c)(5)(ii)(D)(2).
4. Redesignating paragraph (f) as paragraph (f)(1).
5. Adding a subject heading for paragraph (f).
6. Revising the subject heading for redesignated paragraph (f)(1).
7. Adding paragraph (f)(2).

The revisions and additions read as follows:

*§1.163(j)-10 Allocation of interest expense, interest income, and other items of expense and gross income to an excepted trade or business.*

\*\*\*\*\*

- (c) \*\*\*
- (5) \*\*\*
- (ii) \*\*\*

(D) *Limitations on application of look-through rules.* \*\*\*

(2) *Limitation on application of look-through rule to C corporations.* Except as provided in §1.163(j)-9(h)(4)(iii) and (iv) (for a REIT or a partnership making the election under §1.163(j)-9(h)(1) or

(7), respectively), for purposes of applying the look-through rules in paragraph (c)(5)(ii)(B) and (C) of this section to a non-consolidated C corporation (upper-tier entity), that upper-tier entity may not apply these look-through rules to a lower-tier non-consolidated C corporation if a principal purpose for borrowing funds at the upper-tier entity level or adding an upper-tier or lower-tier entity to the ownership structure is increasing the amount of the taxpayer's basis allocable to excepted trades or businesses. For example, P wholly and directly owns S1 (the upper-tier entity), which wholly and directly owns S2. Each of S1 and S2 is a non-consolidated C corporation to which the small business exemption does not apply, and S2 is engaged in an excepted trade or business. With a principal purpose of increasing the amount of basis allocable to its excepted trades or businesses, P has S1 (rather than S2) borrow funds from a third party. S1 may not look through the stock of S2 (and may not apply the asset basis look-through rule described in paragraph (c)(5)(ii)(B)(2)(iv) of this section) for purposes of P's allocation of its basis in its S1 stock between excepted and non-excepted trades or businesses; instead, S1 must treat its stock in S2 as an asset used in a non-excepted trade or business for that purpose. However, S1 may look through the stock of S2 for purposes of S1's allocation of its basis in its S2 stock between excepted and non-excepted trades or businesses.

\*\*\*\*\*

(f) *Applicability dates.*

(1) *In general.* \*\*\*

(2) *Paragraph (c)(5)(ii)(D)(2).* The rules contained in paragraph (c)(5)(ii)(D)(2) of this section apply for taxable years beginning on or after March 22, 2021. However, taxpayers may choose to apply the rules in paragraph (c)(5)(ii)(D)(2) of this section to a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules in the section 163(j) regulations as contained in T.D. 9905 (§§1.163(j)-0 through 1.163(j)-11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-

1, 1.382-2, 1.382-5, 1.382-6, 1.383-0, 1.383-1, 1.469-9, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4 contained in T.D. 9905 as modified by T.D. 9943, to that taxable year and each subsequent taxable year.

Par. 9. Section 1.469-4 is amended by adding paragraph (d)(6) to read as follows:

*§1.469-4 Definition of activity.*

\*\*\*\*\*

(d) \*\*\*

(6) *Activities described in section 163(d)(5)(A)(ii).* With respect to any taxpayer that is an individual, trust, estate, closely held C corporation or personal service corporation, an activity described in §1.469-1T(e)(6) and subject to section 163(d)(5)(A)(ii) that involves the conduct of a trade or business which is not a passive activity of the taxpayer and with respect to which the taxpayer does not materially participate may not be grouped with any other activity or activities of the taxpayer, including any other activity described in §1.469-1T(e)(6) and subject to section 163(d)(5)(A)(ii).

\*\*\*\*\*

Par. 10. Section 1.469-9 is amended by adding paragraphs (b)(2)(ii)(A) and (B) to read as follows:

*§1.469-9 Rules for certain rental real estate activities.*

\*\*\*\*\*

- (b) \*\*\*
- (2) \*\*\*
- (ii) \*\*\*

(A) *Real property development.* The term *real property development* means the maintenance and improvement of raw land to make the land suitable for subdivision, further development, or construction of residential or commercial buildings, or to establish, cultivate, maintain or improve timberlands (that is, land covered by timber-producing forest). Improvement of land may include any clearing (such as through the mechanical separation and removal of boulders, rocks, brush, brushwood, and underbrush

from the land); excavation and gradation work; diversion or redirection of creeks, streams, rivers, or other sources or bodies of water; and the installation of roads (including highways, streets, roads, public sidewalks, and bridges), utility lines, sewer and drainage systems, and any other infrastructure that may be necessary for subdivision, further development, or construction of residential or commercial buildings, or for the establishment, cultivation, maintenance or improvement of timberlands.

(B) *Real property redevelopment.* The term *real property redevelopment* means the demolition, deconstruction, separation, and removal of existing buildings, landscaping, and infrastructure on a parcel of land to return the land to a raw condition or otherwise prepare the land for new development or construction, or for the establishment and cultivation of new timberlands.

\*\*\*\*\*

Par. 11. Section 1.469-11 is amended by revising paragraphs (a)(1) and (4) to read as follows:

*§1.469-11 Applicability date and transition rules.*

(a) \*\*\*

(1) The rules contained in §§1.469-1, 1.469-1T, 1.469-2, 1.469-2T, 1.469-3, 1.469-3T, 1.469-4, but not §1.469-4(d)(6), 1.469-5 and 1.469-5T, apply for taxable years ending after May 10, 1992. The rules contained in §1.469-4(d)(6) apply for taxable years beginning on or after March 22, 2021. However, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in §1.469-4(d)(6) to a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules in the section 163(j) regulations as contained in T.D. 9905 (§§1.163(j)-0 through 1.163(j)-11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.383-0, 1.383-1, 1.469-9, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4, contained in T.D. 9905 as modified by T.D. 9943, to that taxable year and each subsequent taxable year.

0, 1.383-1, 1.469-9, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4 contained in T.D. 9905 as modified by T.D. 9943, to that taxable year and each subsequent taxable year.

\*\*\*\*\*

(4) The rules contained in §1.469-9(b)(2), other than paragraphs (b)(2)(ii)(A) and (B), apply to taxable years beginning on or after November 13, 2020. Section 1.469-9(b)(2)(ii)(A) and (B) applies to taxable years beginning on or after March 22, 2021. However, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in §1.469-9(b)(2), other than paragraphs (b)(2)(ii)(A) and (B), to a taxable year beginning after December 31, 2017, and on or before November 13, 2020 and may choose to apply the rules in §1.469-9(b)(2)(ii)(A) and (B) to taxable years beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules in the section 163(j) regulations contained in T.D. 9905 (§§1.163(j)-0 through 1.163(j)-11, effective November 13, 2020) as modified by T.D. 9943 (effective January 13, 2021), and, if applicable, §§1.263A-9, 1.263A-15, 1.381(c)(20)-1, 1.382-1, 1.382-2, 1.382-5, 1.382-6, 1.383-0, 1.383-1, 1.469-9, 1.704-1, 1.882-5, 1.1362-3, 1.1368-1, 1.1377-1, 1.1502-13, 1.1502-21, 1.1502-79, 1.1502-91 through 1.1502-99 (to the extent they effectuate the rules of §§1.382-2, 1.382-5, 1.382-6, and 1.383-1), and 1.1504-4, contained in T.D. 9905 as modified by T.D. 9943, to that taxable year and each subsequent taxable year.

\*\*\*\*\*

Par. 12. Section 1.1256(e)-2 is added to read as follows:

*§1.1256(e)-2 Special rules for syndicates.*

(a) *Allocation of losses.* For purposes of section 1256(e)(3), *syndicate* means any partnership or other entity (other than

a corporation that is not an S corporation) if more than 35 percent of the losses of such entity during the taxable year are allocated to limited partners or limited entrepreneurs (within the meaning of section 461(k)(4)).

(b) *Determination of loss amount.* For purposes of section 1256(e)(3), the amount of losses to be allocated under paragraph (a) of this section is calculated without regard to section 163(j).

(c) *Example.* The following example illustrates the rules in this section:

(1) *Facts.* Entity is an S corporation that is equally owned by individuals A and B. A provides all of the goods and services provided by Entity. B provided all of the capital for Entity but does not participate in Entity's business. For the current taxable year, Entity has gross receipts of \$5,000,000, non-interest expenses of \$4,500,000, and interest expense of \$600,000.

(2) *Analysis.* Under paragraph (b) of this section, Entity has a net loss of \$100,000 (\$5,000,000 minus \$5,100,000) for the current taxable year. One half (50 percent) of this loss is allocated to B, a limited owner. Therefore, for the current taxable year, Entity is a syndicate within the meaning of section 1256(e)(3)(B).

(d) *Applicability date.* This section applies to taxable years beginning on or after March 22, 2021. However, taxpayers and their related parties, within the meaning of sections 267(b) (determined without regard to section 267(c)(3)) and 707(b)(1), may choose to apply the rules in this section for a taxable year beginning after December 31, 2017, and before March 22, 2021, provided that those taxpayers and their related parties consistently apply all of the rules of this section to that taxable year and each subsequent taxable year.

Sunita Lough,  
Deputy Commissioner for Services  
and Enforcement.

Approved: December 30, 2020.

David J. Kautter,  
Assistant Secretary of the Treasury  
(Tax Policy).

(Filed by the Office of the Federal Register on January 13, 2021, 4:15 p.m., and published in the issue of the Federal Register for January 19, 2020, 85 F.R. 5496)

## T.D. 9945

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

## Guidance under Section 1061

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Final regulations.

**SUMMARY:** This document contains final regulations that provide guidance under section 1061 of the Internal Revenue Code (Code). Section 1061 recharacterizes certain net long-term capital gains of a partner that holds one or more applicable partnership interests as short-term capital gains. An applicable partnership interest is an interest in a partnership that is transferred to or held by a taxpayer, directly or indirectly, in connection with the performance of substantial services by the taxpayer, or any other related person, in any applicable trade or business. These final regulations also amend existing regulations on holding periods to clarify the holding period of a partner's interest in a partnership that includes in whole or in part an applicable partnership interest and/or a profits interest. These regulations affect taxpayers who directly or indirectly hold applicable partnership interests in partnerships and the passthrough entities through which the applicable partnership interest is held.

**DATES:** *Effective date:* These regulations are effective on January 13, 2021.

*Applicability date:* For dates of applicability, see §§1.702-1(g), 1.704-3(f), 1.1061-1(b), 1.1061-2(c), 1.1061-3(f), 1.1061-4(d), 1.1061-5(g), 1.1061-6(e), and 1.1223-3(g).

**FOR FURTHER INFORMATION CONTACT:** Kara K. Altman or Sonia K. Kothari at (202) 317-6850 or Wendy L. Kribell at (202) 317-5279 (not toll-free numbers).

## SUPPLEMENTARY INFORMATION:

### Background

This document contains final regulations under section 1061 of the Code to amend the Income Tax Regulations (26 CFR part 1). Section 1061 was added to the Code on December 22, 2017, by section 13309 of Public Law 115-97, 131 Stat. 2054 (2017), commonly referred to as the Tax Cuts and Jobs Act (TCJA). Section 1061 applies to taxable years beginning after December 31, 2017. Section 1061 recharacterizes certain net long-term capital gain with respect to applicable partnership interests (*APIs*) as short-term capital gain.

On August 14, 2020, the Department of the Treasury (Treasury Department) and the IRS published a notice of proposed rulemaking (REG-107213-18) in the **Federal Register** (85 FR 49754) containing proposed regulations under sections 702, 704, 1061, and 1223 of the Code (proposed regulations). The Treasury Department and the IRS received written and electronic comments responding to the proposed regulations. No public hearing was requested or held. All comments are available at [www.regulations.gov](http://www.regulations.gov) or upon request. After full consideration of all comments timely received, this Treasury decision adopts the proposed regulations with modifications in response to the comments as described in the Summary of Comments and Explanation of Revisions section of this preamble.

### Summary of Comments and Explanation of Revisions

Most of the comments addressing the proposed regulations are summarized in this Summary of Comments and Explanation of Revisions. However, non-substantive comments or comments merely summarizing or interpreting the proposed regulations, recommending statutory revisions, or addressing provisions outside the scope of these final regulations are not discussed in this preamble.

The final regulations retain the structure of the proposed regulations, with certain revisions. Section 1.1061-1 provides definitions of the terms used in §§1.1061-1 through 1.1061-6 of these final regulations (*Section 1061 Regulations* or final

regulations). Section 1.1061-2 provides rules and examples regarding APIs and applicable trades or businesses (*ATBs*). Section 1.1061-3 provides guidance on the exceptions to the definition of an API, including the capital interest exception. Section 1.1061-4 provides guidance on the computation of the *Recharacterization Amount* and gives computation examples. Section 1.1061-5 provides guidance regarding the application of section 1061(d) to transfers to certain related parties. Section 1.1061-6 provides reporting rules. Because the application of section 1061 requires a clear determination of the holding period of a partnership interest that is, in whole or in part, an API, the final regulations also provide clarifying amendments to §1.1223-3. Additional clarifying amendments to §§1.702-1(a)(2) and 1.704-3(e) are also provided.

Part I of this Summary of Comments and Explanation of Revisions provides an overview of the statutory provisions and defined terms used in the proposed and final regulations. Part II describes the comments received and revisions made in response to those comments with respect to the following four areas of the proposed regulations: (1) the capital interest exception; (2) the treatment of capital interests acquired with loan proceeds; (3) the *Lookthrough Rule* for certain API dispositions; and (4) transfers of APIs to *Section 1061(d) Related Persons*. Part III discusses additional comments received and revisions made in other areas of the proposed regulations. Part IV summarizes comments received on issues related to section 1061 that are beyond the scope of the regulations and are under study. Part V discusses applicability dates for the final regulations. In addition to the revisions made in response to comments, clarifying changes have been made throughout the final regulations.

### I. Overview and Defined Terms

A. Section 1061(a): Recharacterization Amount, Owner Taxpayer, and Related Concepts

#### 1. Recharacterization Amount

Section 1061(a) recharacterizes as short-term capital gain the difference be-

tween a taxpayer's net long-term capital gain with respect to one or more APIs and the taxpayer's net long-term capital gain with respect to these APIs if paragraphs (3) and (4) of section 1222, which define the terms long-term capital gain and long-term capital loss, respectively, for purposes of subtitle A of the Code, are applied using a three-year holding period instead of a one-year holding period. The regulations refer to this difference as the Recharacterization Amount. This recharacterization is made regardless of any election in effect under section 83(b).

## 2. Owner Taxpayers and Passthrough Entities

The regulations provide that the person who is subject to Federal income tax on the Recharacterization Amount is required to calculate such amounts and refer to this person as the *Owner Taxpayer*. Although an API can be held directly by an Owner Taxpayer, it also may be held indirectly through one or more passthrough entities (*Passthrough Entities*). A Passthrough Entity may be a partnership, trust, estate, S corporation, or a passive foreign investment company (PFIC) with respect to which the shareholder has a qualified electing fund (QEF) election in effect. An *API Holder* is any person who holds an API. The regulations provide a framework for determining the Recharacterization Amount when an API is held through one or more tiers of Passthrough Entities (tiered structure).

## 3. Gains and Losses Subject to Section 1061

Section 1061(a) applies to a taxpayer's net long-term capital gain with respect to one or more APIs held during the taxable year. The regulations provide that the determination of a taxpayer's net long-term capital gain with respect to the taxpayer's APIs held during the taxable year includes the taxpayer's combined net distributive share of long-term capital gain or loss from all APIs held during the taxable year and the Owner Taxpayer's long-term capital gain and loss from the disposition of any APIs during the taxable year. The regulations generally refer to long-term capital gains and losses recognized with

respect to an API as *API Gains and Losses*. However, API Gains and Losses do not include long-term capital gain determined under sections 1231 and 1256, qualified dividends described in section 1(h)(11)(B), and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in section 1222, such as capital gain characterized under the identified mixed straddle rules described in section 1092(b).

*Unrealized API Gains and Losses* means, with respect to a Passthrough Entity's assets, all unrealized capital gains and losses that would be realized if those assets were disposed of for fair market value in a taxable transaction and allocated to an API Holder with respect to its API, taking into account the principles of section 704(c). In a tiered structure, API Gains and Losses and Unrealized API Gains and Losses retain their character as API Gains and Losses as they are allocated through the tiers.

### B. Section 1061(c)(1): Definition of an Applicable Partnership Interest

Section 1061(c)(1) provides that an API is a partnership interest held by, or transferred to, a taxpayer, directly or indirectly, in connection with the performance of substantial services by the taxpayer, or by any other related person, in any ATB. For this purpose, the regulations define a *Related Person* as a person or entity who is treated as related to another person or entity under section 707(b) or 267(b). Both section 1061(c)(1) and the regulations provide that an API does not include certain partnership interests held by employees of entities that are not engaged in an ATB.

The regulations provide that an API means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or by a Passthrough Taxpayer, or by a Related Person, including services performed as an employee, in any ATB unless an exception applies. There may be one or more Passthrough Entities between the partnership that originally issued the API and the Passthrough Entity in which the Owner Taxpayer

holds its indirect interest in the API. Each Passthrough Entity in the tiered structure is treated as holding an API under the regulations, that is, each Passthrough Entity is an API Holder as is the Owner Taxpayer. An API Holder may be an individual, partnership, trust, estate, S corporation (as defined in section 1361(a)(1)), or a PFIC with respect to which the shareholder has a QEF election in effect under section 1295.

Section 1061(c)(1), similar to section 1061(a), uses the term "taxpayer." The proposed regulations provide that an Owner Taxpayer is the taxpayer for purposes of section 1061(a). The regulations further provide that the reference to "taxpayer" in section 1061(c)(1) also includes a *Passthrough Taxpayer*. A Passthrough Taxpayer is a Passthrough Entity that is treated as a taxpayer for the purpose of determining the existence of an API, regardless of whether such Passthrough Taxpayer itself is subject to Federal income tax. Generally, if an interest in a partnership is transferred to a Passthrough Taxpayer in connection with the performance of its own services, the services of its owners, or the services of persons related to either such Passthrough Taxpayer or its owners, the interest is an API as to the Passthrough Taxpayer. The Passthrough Taxpayer's ultimate owners will be treated as Owner Taxpayers, unless otherwise excepted.

A partnership interest is an API if it was transferred in connection with the performance of substantial services. The regulations presume that services are substantial with respect to a partnership interest transferred in connection with services. This presumption is based on the assumption, for purposes of section 1061, that the parties have economically equated the services performed or to be performed with the potential value of the partnership interest transferred. The regulations provide that, subject to certain exceptions, once a partnership interest is an API, it remains an API and never loses its API character.

### C. Section 1061(c)(2): Definition of an Applicable Trade or Business

Under section 1061, for an interest in a partnership to be an API, the interest must be held or transferred in connection with the performance of substantial services

in an ATB. An ATB is defined in section 1061(c)(2) as any activity conducted on a regular, continuous, and substantial basis consisting, in whole or in part, of raising or returning capital, and either (i) investing in (or disposing of) specified assets (or identifying specified assets for such investing or disposition), or (ii) developing specified assets. The regulations refer to these actions, respectively, as *Raising or Returning Capital Actions* and *Investing or Developing Actions* (collectively, *Specified Actions*). The regulations provide that an activity is conducted on a regular, continuous, and substantial basis if it meets the *ATB Activity Test*. The ATB Activity Test is met if the total level of activity (conducted in one or more entities) meets the level of activity required to establish a trade or business for purposes of section 162.

In applying the ATB Activity Test, the regulations provide that it is not necessary for both Raising or Returning Capital Actions and Investing or Developing Actions to occur in a single taxable year. In that regard, the combined Specified Actions are considered together to determine if the ATB Activity Test is met.

Section 1061(c)(3) provides that specified assets (*Specified Assets*) are securities, as defined in section 475(c)(2) (without regard to the last sentence thereof), commodities, as defined in section 475(e)(2), real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing. The definition of Specified Assets in the regulations generally tracks the statutory language. It also includes an option or derivative contract on a partnership interest to the extent that the partnership interest represents an interest in other Specified Assets.

#### D. Section 1061(c)(4) and Other Exceptions to API Treatment

Section 1061 includes four exceptions to the treatment of a profits interest as an API and the regulations add an additional exception.

First, the statutory definition of an API in section 1061(c)(1) excludes an interest

held by a person who is employed by another entity that is conducting a trade or business (other than an ATB) and provides services only to such other entity.

Second, section 1061(c)(4)(A) provides that an API does not include any interest in a partnership directly or indirectly held by a corporation. The regulations provide that the term "corporation" for purposes of section 1061(c)(4)(A) does not include an S corporation for which an election under section 1362(a) is in effect or a PFIC with respect to which the shareholder has a QEF election under section 1295 in effect.

Third, section 1061(c)(4)(B) provides that an API does not include a capital interest which provides a right to share in partnership capital commensurate with (i) the amount of capital contributed (determined at the time of receipt of such partnership interest), or (ii) the value of such interest subject to tax under section 83 upon the receipt or vesting of such interest (the capital interest exception). The regulations provide that long-term capital gains and losses with respect to an API Holder's capital investment in a Passthrough Entity, referred to as *Capital Interest Gains and Losses* (which can include allocations and disposition amounts meeting the requirements), are not subject to recharacterization under section 1061. As explained in more detail in Part II.A. of this Summary of Comments and Explanation of Revisions, to meet this exception to API treatment, the proposed regulations require allocations to API Holders (or Passthrough Entities that hold an API in a lower-tier Passthrough Entity) to be made in the same manner as to certain other partners. The final regulations provide a revised and simplified rule that looks to whether allocations are commensurate with capital contributed.

Fourth, section 1061(b) provides that to the extent provided by the Secretary, section 1061 will not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.

Finally, the regulations provide that an interest in a partnership that was an API in the hands of the seller will not be treated as an API in the hands of the purchaser if the interest is acquired by a bona fide purchaser who (i) does not provide services

in the Relevant ATB to which the acquired interest relates, (ii) is unrelated to any service provider, and (iii) acquired the interest for fair market value.

#### E. Section 1061(d): Transfer of API to a Section 1061(d) Related Person

Section 1061(d)(1) provides that if a taxpayer transfers an API, directly or indirectly, to a related person described in section 1061(d)(2), the taxpayer must include in gross income (as short term capital gain) the excess of so much of the taxpayer's long term capital gains with respect to such interest for the taxable year attributable to the sale or exchange of any asset held for not more than 3 years as is allocable to such interest over any amount treated as short term capital gain under section 1061(a).

A related person for purposes of section 1061(d)(2) (a *Section 1061(d) Related Person*) is defined more narrowly than a related person for purposes of section 1061(c)(1) and includes only members of the taxpayer's family within the meaning of section 318(a)(1), the taxpayer's colleagues (those who provided services in the ATB during certain time periods) and, under the regulations, a Passthrough Entity to the extent that a member of the taxpayer's family or a colleague is an owner.

#### F. Section 1061(e): Reporting

Section 1061(e) provides that the Secretary "shall require such reporting (at the time and in the manner prescribed by the Secretary) as is necessary to carry out the purposes of [section 1061]." The regulations set forth the reporting requirements and include rules for providing information required to compute the Recharacterization Amount when there is a tiered structure.

#### G. Regulatory Authority

Section 1061(f) provides that the Secretary "shall issue such regulations or other guidance as is necessary or appropriate to carry out the purposes of [section 1061]." The legislative history indicates that such guidance is to address the prevention of abuse of the purposes of the provision. See H.R. Conf. Rep. No. 115-466 at 422

(2017) (Conference Report); *see also* Joint Committee on Taxation, General Explanation of Public Law 115-97, JCS-1-18, at 203 (2017) (Blue Book). The Conference Report and the Blue Book also state that the guidance is to address the application of the provision to tiered structures of entities. *See id.*

## II. Primary Changes to the Proposed Regulations

The majority of comments received on the proposed regulations relate to four areas: (1) the capital interest exception; (2) the treatment of capital interests acquired with loan proceeds; (3) the Lookthrough Rule for certain API dispositions; and (4) transfers of APIs to Section 1061(d) Related Persons. After considering these comments, the Treasury Department and the IRS have determined that changes in approach are required for each of these sections of the final regulations. The remainder of this section generally describes the comments received in these areas and the changes made in response. While all comments timely received were considered, comments are not described in detail to the extent that the ancillary concerns raised by the commenter were resolved by the changes made to the final regulations.

### A. Capital Interest Exception

Section 1061(c)(4)(B) provides that an API does not include certain capital interests. The proposed regulations implement the capital interest exception by excepting from recharacterization long-term capital gains and losses that represent a return on an API Holder's capital invested in a Passthrough Entity. The proposed regulations refer to these amounts as Capital Interest Gains and Losses, and include in that definition *Capital Interest Allocations*, *Passthrough Interest Capital Allocations*, and *Capital Interest Disposition Amounts* that meet the requirements of proposed §1.1061-3(c)(3) through (6).

The majority of comments received regarding the capital interest exception suggested that the rules in the proposed regulations are too rigid and do not reflect many common business arrangements, resulting in many capital interest holders being denied eligibility for the exception.

Commenters described a variety of concerns, detailed in this Part II.A.

The final regulations provide a revised and simplified rule that looks to whether allocations are commensurate with capital contributed. An allocation will be considered a Capital Interest Allocation if the allocation to the API Holder with respect to its capital interest is determined and calculated in a similar manner to the allocations with respect to capital interests held by similarly situated *Unrelated Non-Service Partners* who have made significant aggregate capital contributions.

### 1. Capital Interest Allocations, In General

Proposed §1.1061-3(c)(3) provides that for an allocation to be treated as a Capital Interest Allocation or a Passthrough Interest Capital Allocation, the allocation must be one made in the same manner to all partners. As described further in part II.A.2. of this Summary of Comments and Explanation of Provisions, proposed §1.1061-3(c)(4) further provides, in part, that Capital Interest Allocations are allocations of long-term capital gain or loss made to an API Holder and to Unrelated Non-Service Partners based on their respective capital account balances where the Unrelated Non-Service Partners have a significant aggregate capital account balance equal to five percent or more of the aggregate capital account balance of the partnership are the time the allocations are made. The proposed regulations also indicate that in general, an allocation will be deemed to satisfy the "same manner" requirement if, under the partnership agreement, the allocation is based on the relative capital accounts of the partners (or Passthrough Entity owners) who are receiving the allocation in question and the terms, priority, type and level of risk, rate of return, and rights to cash or property distributions during the partnership's operations and on liquidation are the same. Allocations to an API Holder may be subordinated to allocations to Unrelated Non-Service Partners or reduced by the cost of services provided by such API Holder or a Related Person. Under proposed §1.1061-3(c)(3)(ii), in the case of a partnership that maintains capital accounts under §1.704-1(b)(2)(iv), the allocation must be tested based on that partner's capital account. In the case of a

Passthrough Entity that is not a partnership (or a partnership that does not maintain capital accounts under §1.704-1(b)(2)(iv)), if the Passthrough Entity maintains and determines accounts for its owners using principles similar to those provided under §1.704-1(b)(2)(iv), those accounts will be treated as a capital account for purposes of the proposed regulations.

Several commenters noted that requiring allocations be made in accordance with partners' overall section 704(b) capital accounts in a fund does not comport with the commercial reality of how most venture capital, private equity funds, and hedge funds make their allocations, and would preclude API Holders from ever utilizing the capital interest exception. One commenter noted that many bona fide partnerships use targeted allocations and questioned whether it is fair to exclude partnerships that do not maintain section 704(b) capital or similar accounts from the capital interest exception when those capital accounts lack economic significance in the business arrangement. The commenter asked the same question about partnerships that maintain capital accounts using generally accepted accounting principles (GAAP).

Several commenters objected to the "same manner" requirement on the grounds that it did not properly implement section 1061(c)(4)(B), which provides, in part, that an API "shall not include any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with... the amount of capital contributed" by such partner. Commenters explained that while fund managers may earn an economic return on both their capital investment and their APIs, they generally do not have the same economic rights with respect to their capital investment that the limited partners in the fund have with respect to their capital investment. For example, commenters indicated that an API Holder may be entitled to tax distributions, may have different allocations of expenses, may be subject to regulatory allocations (for example, minimum gain chargeback, as described in §1.704-2), and may have different withdrawal or liquidity rights, which might be more or less favorable than those provided to Unrelated Non-Service Partners. Commenters indicated there could

be varying liquidity rights between Unrelated Non-Service Partners and noted that API Holders' capital may be subject to more risk than Unrelated Non-Service Partners' capital in that API Holders may bear the first risk of loss. In the case of hedge funds, commenters noted that limited partners may invest at different times and, as such, earn a return that may not be comparable to other limited partners' returns.

In addition, several commenters explained that economic rights and allocations in private equity and venture capital funds are frequently determined and made on a deal-by-deal basis, including allocations made in a tiered structure by an API Holder that is a Passthrough Entity, and that funds may have multiple classes of interests with different rights and obligations, meaning that economic rights and allocations are rarely, if ever, aligned with respect to all partners based on the partners' section 704(b) capital accounts.

For the aforementioned reasons, several commenters recommended that the "same manner" requirement be eliminated and replaced with a rule that permits distributions and allocations to an API Holder, who contributes capital to a fund, to be "commensurate" with capital contributed by Unrelated Non-Service partners. Similarly, one commenter suggested that the only requirement be that an allocation to an API Holder be calculated and determined in a similar manner as the allocations to similarly situated Unrelated Non-Service Partners. Several commenters suggested that funds should be able to establish that they satisfied the "commensurate" standard using any reasonable method.

Commenters also recommended that the scope of the term "cost of services" as used in the proposed regulations be further explained, noting that situations where API Holders' capital investments are not subject to management fees, while other investors' interests are subject to management fees, should not prevent the API Holders' capital interests from qualifying for the capital interest exception. Commenters recommended that the final regulations clarify the meaning of the term "cost of services" and specify that an API Holder's capital investment that is not subject to incentive payments or to man-

agement fees may still be eligible for the capital interest exception.

Because private equity and hedge funds operate differently, commenters suggested that there should be separate rules, tailored to each structure, with respect to the capital interest exception. The commenters alluded to the notion that, although private equity and hedge funds each operate within a certain blueprint, there are many variations.

The Treasury Department and the IRS generally agree with commenters that under the test in the proposed regulations, it might be difficult for some common business arrangements to meet the capital interest exception and that a partner comparison, based on capital contributed rather than the partners' section 704(b) capital accounts, would be more accurate in determining whether an interest qualifies for the capital interest exception. Accordingly, the final regulations provide that Capital Interest Allocations must be commensurate with capital contributed in order to qualify for the capital interest exception. The final regulations replace the requirement that allocations be made to all partners in the same manner with a requirement that an allocation to an API Holder with respect to its capital interest must be determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated Unrelated Non-Service Partners who have made significant aggregate capital contributions. In this regard, the allocations and distribution rights with respect to API Holders' capital interests and the capital interests of Unrelated Non-Service Partners who have made significant aggregate capital contributions must be reasonably consistent. The similar manner test may be applied on an investment-by-investment basis or on the basis of allocations made to a particular class of interests. The final regulations retain the factors used in the proposed regulations to determine whether allocations and distribution rights are made in a similar manner among partners: the amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority, the type and level of risk associated with capital contributed, and the rights to cash or property distributions during the partnership's operations and on liquidation. The

final regulations maintain the rule that an allocation to an API Holder will not fail to qualify solely because the allocation is subordinated to allocations made to Unrelated Non-Service Partners or because an allocation to an API Holder is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership. The final regulations also clarify the meaning of cost of services for this purpose. The fact that API Holders are not charged management fees on their capital or that their capital is not subject to allocations of API items will not prevent the API Holder's capital interest from being eligible for the capital interest exception. Similarly, an allocation to an API Holder will not fail if an API Holder has a right to receive tax distributions while Unrelated Non-Service Partners do not have such a right, where such distributions are treated as advances against future distributions.

The final regulations extend these concepts to allocations made through tiered structures. The final regulations remove the terms Passthrough Capital Allocation, Passthrough Interest Capital Allocation, and Passthrough Interest Direct Investment Allocation, and instead provide that an allocation made to a Passthrough Entity that holds an API in a lower-tier Passthrough Entity will be considered a Capital Interest Allocation if made in accordance with the principles applicable in determining Capital Interest Allocations. Under the final regulations, Capital Interest Allocations retain their character when allocated to an upper-tier partnership so long as they are allocated among the partners in the upper-tier partnership with respect to such partners' capital interests in a manner that is respected under section 704(b) (taking the principles of section 704(c) into account).

Because the revised rules provide sufficient flexibility for all structures, the final regulations do not adopt the suggestion to provide a separate set of rules for private equity and hedge funds. The Treasury Department and the IRS continue to study other issues raised by the commenters, including the application of the similar manner requirement to S corporations and the application of the capital interest exception to co-invest vehicles.

The Treasury Department and the IRS request any additional comments on the

application of the capital interest exception in the final regulations.

## 2. Unrelated Non-Service Partner Requirement

As discussed in the prior section, proposed §1.1061-3(c)(4) provides additional guidance on Capital Interest Allocations. Under the proposed regulations, Capital Interest Allocations are allocations of long-term capital gain or loss made under the partnership agreement to an API Holder and to Unrelated Non-Service Partners based on their respective capital accounts and which meet other requirements. Unrelated Non-Service Partners are defined in proposed §1.1061-1(a) as partners who have not provided services to the Relevant ATB and who are not, and have never been, related to any API Holder in the partnership or any person who provides, or has provided, services in the Relevant ATB. Proposed §1.1061-3(c)(4) specifies that Capital Interest Allocations must be made in the same manner to API Holders and to Unrelated Non-Service Partners with a significant aggregate capital account balance (defined as five percent or more of the aggregate capital account balance of the partnership at the time the allocations are made). Proposed §1.1061-3(c)(4)(iii) provides that the allocations to the API Holder and the Unrelated Non-Service Partners must be clearly identified both under the partnership agreement and on the partnership's books and records as separate and apart from allocations made to the API Holder with respect to its API. The partnership agreement and the partnership books and records must also clearly demonstrate that the requirements for an allocation to be considered a Capital Interest Allocation have been met.

For allocations made on a deal-by-deal or class-by-class basis, commenters noted that it is unclear if the requirement that allocations be made in the same manner to API Holders and Unrelated Non-Service Partners with a significant aggregate capital account balance applies to each deal or class, or if it applies only to a fund generally. One commenter suggested that as an alternative to a strict percentage test, funds should also be able to satisfy the test by establishing that the return on a class of equity was determined at arm's

length. Another commenter noted that a specific number or percentage of Unrelated Non-Service Partners must comprise the test group to prevent easy avoidance of the statute but questioned whether the five percent threshold for the test group is the appropriate threshold. The commenter also asked for clarification on the effect of the rule in proposed §1.1061-3(c)(3)(ii) (C) that a capital account, for these purposes, does not include the contribution of amounts attributable to loans made by other partners or the partnership when comparing the allocations made to API Holders and Unrelated Non-Service Partners.

One commenter stated that many funds would be unable to meet the requirement that allocations to the API Holder and the Unrelated Non-Service Partners be clearly identified in the partnership agreement because their agreements use liquidating distributions to govern an API Holder's rights with respect to its API rather than allocations. The commenter recommended that the requirement be considered satisfied if the distribution provision clearly identified capital interest distributions separate and apart from distributions with respect to APIs. Several other commenters suggested that the rule requiring the allocations to be clearly identified both under the partnership agreement and on the partnership's books and records be disjunctive, that is, that the allocations be clearly demarcated in either the partnership agreement or on the partnership's books and records. Commenters noted that in order to meet the partnership agreement reporting requirement, a fund would have to update its partnership agreements, which could be done only by negotiating with the Unrelated Non-Service Partners. Initiating those negotiations could cause partners to want to negotiate other partnership items, which could take time and alter the agreements. These commenters thus suggested grandfathering existing partnership agreements or providing a transition period for funds to update their agreements to comply with this requirement.

The final regulations retain the requirement that Capital Interest Allocations to an API Holder be compared to Capital Interest Allocations made to Unrelated Non-Service Partners, as well as the requirement that Capital Interest Alloca-

tions be made to Unrelated Non-Service Partners with a significant capital account balance, including the five percent threshold. The Treasury Department and the IRS considered a number of alternatives and determined that the five percent threshold adequately insures that there is a significant comparison to meet the statutory exception that an API does not include a capital interest which provides the API Holder with a right to share in partnership capital commensurate with the amount of capital contributed. In accordance with the provision that the similar manner test in the final regulations may be applied on an investment-by-investment or class-by-class basis, the final regulations specify that the Unrelated Non-Service Partner requirement can also be applied on an investment-by-investment basis, or on a class-by-class basis. The final regulations move the definition of Capital Interest Allocations to the definition section of the final regulations but retain the requirement that allocations with respect to, and corresponding to, contributed capital be clearly identified under both the partnership agreement and in the partnership's books and records as separate and apart from allocations made to the API Holder with respect to its API, and specify that the books and records must be contemporaneous. Documenting the allocations in the partnership agreement and in contemporaneous books and records is a necessary corollary to the rule requiring Capital Interest Allocations to be made in a similar manner between API Holders and Unrelated Non-Service Partners with a significant interest, because it shows that the partnership's Unrelated Non-Service Partners considered these allocations a valid return on their contributed capital.

The final regulations do not include a rule that would grandfather existing partnership agreements or provide a transition period for partnerships to update their agreements. Because the final regulations more closely align the capital interest exception to standard industry practice, the number of partnership agreements that will need to be amended is reduced. Allocations made to an API Holder that do not meet the requirements of these final regulations will not be considered Capital Interest Allocations. Finally, due to the revisions made to the capital interest excep-

tion in these final regulations, the Treasury and the IRS have determined that it is not necessary to clarify the effect that the rule disregarding contributions made with the proceeds of loans by other partners or by the partnership has on the comparison of the allocation made to API Holders and Unrelated Non-Service Partners.

### 3. Capital Interest Disposition Amounts

If an owner disposes of an interest in a Passthrough Entity that is composed of a capital interest and an API, proposed §1.1061-3(c)(6) provides a mechanism for the owner to determine the portion of long-term capital gain or loss recognized on the disposition that is treated as a Capital Interest Disposition Amount and thus, a Capital Interest Gain or Loss.

The final regulations clarify the determination of an API Holder's Capital Interest Disposition Amount when the API Holder transfers a Passthrough Entity interest that is comprised of both an API and a capital interest at a gain and would be allocated only capital loss as a Capital Interest Allocation if all of the assets of the Passthrough Entity had been sold for their fair market value in a fully taxable transaction immediately before the interest transfer. In such an instance, the final regulations provide that all of the long-term capital gain attributable to the interest transfer is API Gain. Conversely, if such API Holder recognizes long-term capital loss on the transfer of a Passthrough Entity interest and would be allocated only capital gain as a Capital Interest Allocation if all of the assets of the Passthrough Entity had been sold for their fair market value in a fully taxable transaction immediately before the interest transfer, the final regulations provide that all of the long-term capital loss attributable to the interest transfer is API Loss. The final regulations provide additional rules where a transferred Passthrough Entity interest results in a gain and the transferor would have been allocated both Capital Interest Gain and API Gain as well as where a transferred Passthrough Entity interest results in a loss and the transferor would have been allocated both Capital Interest Loss and API Loss. In such instances, a fraction is used to determine the portion of the transferred interest gain or loss char-

acterized as a Capital Interest Disposition Amount.

Commenters noted a concern that Example 5 in proposed regulation §1.1061-3(c)(7)(v), did not adequately address basis proration upon a partial interest sale where a partner holds a partnership interest comprised of both an API and a capital interest. Specifically, one commenter noted that Example 5's reliance on the equitable apportionment approach of §1.61-6(a) could lead to a situation where the characterization of the gain or loss attributable to the sale of a portion of the partner's partnership interest differs from the characterization of that partner's distributive share of asset gain or loss if all of the assets of the Passthrough Entity were sold for their fair market value in a fully taxable transaction. Another commenter suggested applying the specific identification rules in §1.1223-3 applicable to publicly traded partnership units to transfers of private interests. These commenters noted that because the issue illustrated in Example 5 has ramifications beyond section 1061, further study should occur before proceeding with the position stated in Example 5.

The Treasury Department and the IRS continue to study the issue noted with respect to Example 5 and have removed the example in the interim as many of the concerns raised on the sale of a partial partnership interest extend beyond section 1061.

### 4. Unrealized API Gains and Losses

Proposed §1.1061-1(a) defines Unrealized API Gains and Losses as all unrealized capital gains and losses, including both short-term and long-term, that would be allocated to an API Holder with respect to its API if all relevant assets were disposed of for fair market value in a taxable transaction on the relevant date. Proposed §1.1061-2(a)(1)(ii) provides rules for the treatment of Unrealized API Gains and Losses, including the requirement to determine Unrealized API Gains and Losses in tiered structures. Proposed §1.1061-3(c)(3)(iii) provides that Capital Interest Allocations and Passthrough Interest Capital Allocations do not include amounts treated as API Gains and Losses or Unrealized API Gains and Losses.

A commenter stated that the requirement to determine Unrealized API Gains and Losses in tiered structures is not reasonable because an upper-tier Passthrough Entity would not be able to require every uncontrolled lower-tier Passthrough Entity in the chain to revalue its assets under the principles of §1.704-1(b)(2)(iv)(f). The commenter recommended that the mandatory section 1061 revaluation rules be eliminated. The commenter requested instead that the existing rules for revaluations under the section 704(b) and 704(c) regulations govern Unrealized API Gains and Losses. Alternatively, the commenter suggested that anti-abuse regulations be written to address revaluations in chains of controlled tiered partnerships.

The final regulations remove the mandatory revaluation rules and adopt the commenter's suggestion that Unrealized API Gains and Losses be determined according to the existing rules governing unrealized gains and losses, including section 704(c) principles. Accordingly, the final regulations provide that the term Unrealized API Gains and Losses means, with respect to a Passthrough Entity's assets, all unrealized capital gains and losses that would be (i) realized if those assets were disposed of for fair market value in a taxable transaction on the relevant date, and (ii) allocated to an API Holder with respect to its API, taking into account the principles of section 704(c).

Because the proposed regulations provide that Capital Interest Allocations are made based on partners' relative section 704(b) capital accounts, several commenters questioned whether Unrealized API Gains and Losses that are reflected in an API Holder's capital account could generate Capital Interest Allocations, including book Capital Interest Allocations, before these amounts are recognized. Commenters explained that these issues are particularly relevant for hedge funds and described their operations and incentive structure. When an API Holder in a hedge fund receives incentive allocations with respect to the API, its capital account is increased by the amount of the incentive allocation, and Unrelated Non-Service Partners' capital accounts are decreased. This increase is coupled with allocations of taxable income and gain and also allocations of unrealized gain (reverse

section 704(c) allocations). Commenters also requested additional guidance on the treatment of realized and unrealized gains from an API which are contributed to, or reinvested in, a partnership.

The final regulations continue to provide that Unrealized API Gains and Losses are not included in Capital Interest Gains and Losses. In response to comments, the final regulations clarify that if an API Holder is allocated API Gain by a Passthrough Entity, to the extent that an amount equal to the API Gain is reinvested in Passthrough Entity by the API Holder (either as the result of an actual distribution and recontribution of the API Gain amount or the retention of the API Gain amount by the Passthrough Entity), the amount will be treated as a contribution to the Passthrough Entity for a capital interest that may produce Capital Interest Allocations for the API Holder, provided such allocations otherwise meet the requirements to be a Capital Interest Allocation.

#### B. Capital contributions made with the proceeds of partnership or partner loans.

Proposed §1.1061-3(c)(3)(ii)(C) provides that for purposes of proposed §§1.1061-1 through 1.1061-6, a capital account does not include the contribution of amounts directly or indirectly attributable to any loan or other advance made or guaranteed, directly or indirectly, by any other partner, the partnership, or a Related Person with respect to any other partner or the partnership. Repayments on the loan are included in capital accounts as those amounts are paid by the partner, provided that the loan is not repaid with the proceeds of another similarly sourced loan. *Id.*

Several commenters criticized this treatment, suggesting that the exclusion of these amounts from the partner's capital account inhibits common and reasonable business practices, and creates barriers to entry for service partners, particularly those who are less represented based on age, gender, or race or do not have ready access to capital. One commenter noted that it is typical for fund managers to either extend loans to their employees, or to guarantee loans issued to such employees by third parties, so that employees may invest in the manager's own investment

funds. Similarly, another commenter stated that the proposed regulations would introduce a substantial impediment to raising capital for commercial real estate investment by creating a disincentive for general partners to finance or support the financing of the participation of its employees in its commercial real estate investments. The commenter claimed that contributions made in this manner are a significant source of capital available for real estate investment and also an important factor in attracting third party capital because they create an alignment of interest between the limited partners and the general partner and its employees.

Commenters noted that neither the statute nor the legislative history indicates that the use of loan proceeds to make a capital contribution precludes the interest from being included in a partner's capital account and contended that adding such a rule is not justified by the commensurate with capital statutory language of the capital interest exception. To the contrary, commenters argued that the authors of the TCJA were familiar with prior proposals regarding profits interests that contained exceptions for loaned capital and their decision not to include such an exception in section 1061 is an indication that the choice was intentional. Instead, one commenter maintained that Congress addressed any concerns through the rule that a service provider's rights with respect to its contributed capital must match the rights of other non-service partners with respect to their shares of contributed capital.

Some commenters recognized that the exclusion from capital accounts of contributions attributable to partner or partnership loans is an attempt to control the perceived abuse of limited partners loaning the general partner of the partnership an amount of capital that entitles the general partner to a portion of the partnership's profits in order to avoid the application of section 1061 and fit within the capital interest exception. Commenters noted that section 1061(f) provides the Secretary with authority to issue guidance as is necessary or appropriate to carry out the purposes of section 1061 and that the legislative history indicates that such guidance is to address the prevention of abuse of the purposes of the provision.

Other commenters, suggesting that the policy behind the capital interest exception is to ensure a partner has capital at risk to qualify for the exception, acknowledged that there are fact patterns in which a partner might be considered less at risk. One commenter pointed to the at-risk limitation on losses under section 465, noting that a service provider would not be considered at-risk with respect to contributed capital that is financed through a loan from another partner, even if the loan were fully recourse to the service provider. By contrast, a partner is considered at-risk when an investment is funded by a third-party loan for which the partner has personal liability. Another commenter noted that the proposed regulations' treatment of a capital interest funded through a loan from the issuing partnership is consistent with the treatment of partnership loans under other areas of Subchapter K. The commenter pointed out that the contribution of a partner's own promissory note generally does not increase the partner's basis in its partnership interest under section 722. Similarly, pursuant to §1.704-1(b)(2)(iv)(d)(2), the partner's capital account will be increased with respect to the promissory note only when there is a taxable disposition of the note by the partnership or when the partner makes principal payments on such note, provided that the note is not readily tradable on an established securities market.

Despite recognizing these concerns regarding abuse, commenters maintained that the loan proceeds exclusion should be eliminated because general income tax principles, such as those in sections 83 and 7872, are sufficient to determine whether a loan-financed arrangement should not qualify for the capital interest exception. Other commenters suggested that if limitations must be imposed, the rule should be narrowly tailored, recommending that only loans that are nonrecourse or lack substantial security be excluded from the capital interest exception. Commenters also suggested that guarantees should not be treated in the same manner as a loan, particularly in the context of a recourse loan or a loan from a third-party bank. Another commenter suggested that if the loan or guarantee operates under normal arm's-length standards, it should be eligible to support a capital contribution. Another

commenter noted that the proposed regulations are silent on loans that are fully secured with partnership assets.

The Treasury Department and the IRS remain concerned that capital contributions made with the proceeds of loans made or guaranteed by another partner, the partnership, or a Related Person with respect to such partner or partnership could lead to abuse of the capital interest exception. Therefore, the final regulations do not adopt the suggestions to remove the rule. However, the Treasury Department and the IRS agree with commenters that the potential for abuse is reduced when a loan or advance is made by another partner (or Related Person with respect to such other partner, other than the partnership) to an individual service provider if the individual service provider is personally liable for the repayment of such loan or advance. Accordingly, the final regulations provide that an allocation will be treated as a Capital Interest Allocation if the allocation is attributable to a contribution made by an individual service provider that, directly or indirectly, results from, or is attributable to, a loan or advance from another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other than the partnership) to such individual service provider if the individual service provider is personally liable for the repayment of such loan or advance as described in the final regulations. The final regulations apply a similar approach with respect to loans or advances made by a partner in the partnership (or a Related Person to such partner, other than the partnership) to a wholly owned entity that is disregarded as separate from an individual service provider where the individual service provider that owns such disregarded entity is personally liable for the repayment of any borrowed amounts that are not repaid by the disregarded entity. The final regulations provide that an individual service provider is personally liable for the repayment of a loan or advance made by a partner (or any Related Person, other than the partnership) if (i) the loan or advance is fully recourse to the individual service provider; (ii) the individual service provider has no right to reimbursement from any other person; and (iii) the loan or advance is not guaranteed by any other person. The Treasury Depart-

ment and the IRS continue to study the treatment of guarantees generally in light of questions about who the borrower is for Federal tax purposes.

A commenter noted that the proposed regulations' treatment of loans, together with the section 704(b) capital account approach being taken with respect to the capital interest exception, could mean that a partner who borrows from a related person to make even a small portion of his or her capital contribution might be denied the capital interest exception with respect to his or her entire capital interest. A few commenters recommended that if the treatment of related party loans is retained in the final regulations, adjustments should be made to ensure that partners are able to receive appropriate credit for capital contributions they make that are not attributable to loans. Another commenter stated that the proposed regulations did not provide a tracing regime to connect loan proceeds with capital contributions. One commenter suggested that final regulations clarify how to treat a partner that fully funded a capital contribution with loan proceeds but repaid such amounts before there was a capital interest allocation, including whether a revaluation would change the answer. The commenter recommended that it would be appropriate to treat the partner's capital account as funded at the time of actual contribution. Finally, the commenter recommended that final regulations include a transition rule related to related party loans made, advanced, guaranteed, or repaid before final regulations are issued. The Treasury Department and the IRS considered these comments and believe that the concerns raised in them are resolved by the commensurate with capital approach to the capital interest exception taken in the final regulations because this approach does not rely on a comparison of allocations based on the partners' overall section 704(b) capital accounts.

#### C. Lookthrough Rule for Certain API Dispositions

Proposed §1.1061-4(b)(9) provides a limited Lookthrough Rule that may apply to the sale of an API where capital gain is recognized and the holding period of the API is more than three years. In the

case of a disposition of a directly held API with a holding period of more than three years, the proposed Lookthrough Rule applies if the assets of the partnership in which the API is held meet the Substantially All Test. The Substantially All Test is met if 80 percent or more of the assets of the partnership in which the API is held, based on fair market value, are assets that would produce capital gain or loss that is not described in proposed §1.1061-4(b)(6) if disposed of by the partnership, and that have a holding period of three years or less. In the case of a tiered structure in which an API Holder holds its API through one or more Passthrough Entities, the Lookthrough Rule applies if the API Holder disposes of a Passthrough Interest held for more than three years and recognizes capital gain, and either: (i) the Passthrough Entity through which the API is directly or indirectly held has a holding period in the API that is three years or less, or (ii) the Passthrough Entity through which the API is held has a holding period in the API of more than three years and the assets of the partnership in which the API is held meet the Substantially All Test.

The Treasury Department and the IRS received several comments stating that, although the application of the Lookthrough Rule for directly-held APIs is reasonable, the application of the Lookthrough Rule for indirectly-held APIs is punitive and imposes an unreasonable and significant administrative burden. The commenters recommended that the scope of the Lookthrough Rule for indirectly-held APIs be limited, particularly in the case of indirectly-held APIs where the relevant taxpayer does not control a partnership that issued the API. Another commenter questioned the authority for the Lookthrough Rule but noted that it is consistent with partnership tax principles and that the proposed regulation would be easily manipulated without the rule.

Commenters suggested that the proposed regulations be amended in one or more of the following ways: (i) limit the Lookthrough Rule to situations in which a Passthrough Entity controls all of the relevant lower-tier Passthrough Entities (or only applying it to lower-tier Passthrough Entities that it controls); (ii) limit the Lookthrough Rule for indirectly held APIs to situations in which the API is held by

a lower-tier Passthrough Entity for three years or less; (iii) limit the application of the Lookthrough Rule to situations in which assets that produce capital gain or loss of a type taken into account under section 1061 are a material amount (greater than 50 percent) of the value of the underlying assets of the partnership; (iv) eliminate the Substantially All Test in the context of tiered structures (that is, determine the applicability of the Substantially All Test with respect to the assets held by the partnership whose interest was sold); (v) amend the Substantially All Test so that a transferring taxpayer who has held its interest for more than three years will be required to look through to the underlying assets' character only if 80 percent or more of the assets held directly or indirectly by the Passthrough Entity have a holding period of three years or less; (vi) make information reporting related to the Lookthrough Rule mandatory for partnerships and S corporations and for required PFIC annual information statements regardless of whether a Passthrough Entity has issued or holds an API; (vii) provide a de minimis rule by which an upper-tier partnership holding a five percent or less interest in the lower-tier partnership would be allowed to use its holding period in the lower-tier partnership; and (viii) as a part of the de minimis rule, not require revaluations of lower-tier partnerships when an Owner Taxpayer disposes of an upper-tier interest that holds five percent or less of a lower-tier partnership. A commenter recommended that the Lookthrough Rule approach calculations in tiered structures from the lower-tier entities up, aligning with the approach to tiered structures elsewhere in the proposed regulations, and allowing the rule to appropriately accommodate lower-tier gains from assets whose sale proceeds are treated as capital gains without regard to section 1222(3) and (4).

After considering the comments, the Treasury Department and the IRS agree that the Lookthrough Rule as proposed could be difficult for Owner Taxpayers and Passthrough Entities to apply, particularly in the context of tiered structures. However, the Treasury Department and the IRS remain concerned that taxpayers could avoid section 1061 by transferring assets to, and issuing APIs from, existing partnerships. Accordingly, the final regu-

lations retain the Lookthrough Rule, but instead of applying the Lookthrough Rule to the disposition of an API held for more than three years and where the Substantially All Test is met, the final regulations limit the application of the Lookthrough Rule to situations where, at the time of disposition of an API held for more than three years, (1) the API would have a holding period of three years or less if the holding period of such API were determined by not including any period prior to the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates (this rule does not apply to the disposition of an API to the extent that the gain recognized upon the disposition of the API is attributable to any asset not held for portfolio investment on behalf of third party investors); or (2) a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a). The Lookthrough Rule similarly applies with respect to a Passthrough Interest issued by an S corporation or a PFIC to the extent the Passthrough Interest is treated as an API. The final regulations also simplify the method for applying the Lookthrough Rule.

Commenters also stated that the Lookthrough Rule raises a concern that going concern value in a lower-tier entity might be subject to ordinary income rates if an upper-tier partnership interest is sold, the Lookthrough Rule applies, and the upper-tier partnership owns a lower-tier partnership interest. These commenters recommended that gain associated with goodwill or enterprise value retain the holding period of the partnership interest itself, as opposed to the underlying assets, and that the Lookthrough Rule apply only to the gain associated with the hypothetical liquidation of the underlying assets. The Treasury Department and the IRS continue to study this issue and may address it in future guidance.

One commenter requested clarification that the phrase "total net capital gain" in proposed §1.1061-4(b)(9)(ii)(C)(I) refers to "net long-term capital gain" and that short- and long-term capital gains and losses cannot be netted against each other. The final regulations do not include this

language. The Treasury Department and the IRS believe that the concerns raised by the commenter are alleviated by the simplified Lookthrough Rule adjustment in the final regulations.

#### D. Section 1.1061-5: Transfers to Related Parties

Proposed §1.1061-5(a) provides that if an Owner Taxpayer transfers any API, or any Distributed API Property, directly or indirectly, to a Section 1061(d) Related Person, or if a Passthrough Entity in which an Owner Taxpayer holds an interest, directly or indirectly, transfers an API to a Section 1061(d) Related Person, regardless of whether gain is otherwise recognized on the transfer under the Code, the Owner Taxpayer must include in gross income as short-term capital gain, the excess of: (1) the Owner Taxpayer's net long-term capital gain with respect to such interest for such taxable year determined as provided in proposed §1.1061-5(c), over (2) any amount treated as short-term capital gain under proposed §1.1061-4 with respect to the transfer of such interest (that is, any amount included in the Owner Taxpayer's API One Year Disposition Gain Amount and not in the Owner Taxpayer's Three Year Disposition Gain Amount with respect to the transferred interest). Proposed §1.1061-5(b) provides that for purposes of section 1061(d), the term transfer includes contributions, distributions, sales and exchanges, and gifts.

Several commenters addressed whether section 1061(d) should be interpreted as an acceleration provision or merely a recharacterization provision. With certain exceptions, the proposed regulations require that gain be accelerated on the transfer of an API to a Section 1061(d) Related Person, regardless of whether the transfer is otherwise a taxable transaction for Federal income taxes or whether gain is otherwise realized or recognized under the Code on the transfer. One commenter supported this treatment, noting that section 1061(d)(1) is literally worded as an income acceleration provision while acknowledging that others have viewed the language as a recharacterization provision, such as section 751(a). Another commenter noted that neither the text nor the legislative history shed any light on

its purpose and stated that the provision's language is susceptible to numerous different readings. The commenter noted that section 1061(d) could be read as a narrow recharacterization lookthrough provision similar to section 751, a recharacterization and assignment of income provision that provides for nonrecognition transfers and requires the transferor rather than the transferee to include API Gain when ultimately realized, a recharacterization and acceleration provision, or a proration provision. The commenter did not provide a recommendation, but noted that the proposed regulations create many traps for the unwary. The commenter stated that the broad definition of transfer in the proposed regulations combined with the overriding of nonrecognition treatment could lead to significant, adverse tax impacts on transferors as well as otherwise uninvolved, passive interest holders in a variety of transactions. The commenter suggested that the Treasury Department and the IRS carefully consider whether the effect of the proposed regulations is appropriate and aligns with section 1061(d)'s language, function, and origins.

Other commenters argued that applying section 1061(d) to transactions where gain is not otherwise recognized is inconsistent with the statutory language. One commenter stated that section 1061(d) itself does not refer to any nonrecognition provisions, nor does it contain any express statement of intent to override nonrecognition treatment. This commenter and others noted that section 1061(d) operates by reference to the taxpayer's long-term capital gains, which as defined in section 1223(3) include only gains that are recognized for U.S. Federal income tax purposes. Consequently, these commenters argued that the statute by its terms does not apply to situations in which the taxpayer has no actual long-term capital gain with respect to such interest. Commenters also noted that the legislative history does not provide support for treating section 1061(d) as an acceleration provision. Previous carried interest provisions included language that explicitly overrode nonrecognition; section 1061 as enacted contains no such language.

One commenter stated that it is not necessary to accelerate gain on the transfer of an API to a Section 1061(d) Related

Person, noting that the API in the hands of the transferee is still subject to section 1061(a) because an API includes interests held by or transferred to the taxpayer in connection with the performance of a substantial service by the taxpayer or a related person.

Commenters also raised a variety of concerns about the proposed regulation's definition of transfer. Commenters recommended that the term transfer be further defined to address potential cases involving indirect transfers of an API, such as the admission of new partners into the partnership, the withdrawal of old partners from the partnership, the transfer of an employee between teams, or an award to a high performer. One commenter explained that, in these circumstances, because there is no change in the relative economic position between fund managers and third-party investors, there should be no requirement for the fund manager or employees of the fund manager to recognize unrealized built-in gain. Commenters also recommended that the final regulations consider whether a forfeiture of an API is a transfer for purposes of section 1061(d) but stated that such an interpretation would be overbroad. One commenter noted that forfeiture and reallocations involve circumstances in which the partners' legal and economic interests in the partnership's Unrealized API Gains are contingent rather than fixed. Where a partner's interest in Unrealized API Gains is contingent, the commenter argued that it is not appropriate to tax a partner on a reduction in that interest under section 1061(d).

Another commenter asked for clarification that the distribution of an API by a direct API Holder to an Owner Taxpayer (indirect API Holder) would be exempt from the application of section 1061(d). The commenter noted that section 1061(a) would continue to apply to the distributed API and that this treatment would be consistent with the rules related to Distributed API Property in §1.1061-4. Under those rules, a distribution of property by a Passthrough Entity to an API Holder is not subject to recharacterization under section 1061 but the Distributed API Property continues to be subject to section 1061. The commenter argued that this rule would also treat similarly situated taxpay-

ers the same, rather than treating distributees of Distributed API Property differently from Owner Taxpayers who receive a distribution of an API from a partnership.

Another commenter asked for clarification that the definition of gift refers to transfers which are gifts for income tax purposes (rather than for gift tax purposes). The commenter noted that many common estate planning techniques involve transfers of assets to grantor trusts with the transferor as the grantor and the grantor's family members as beneficiaries of the trust, and that these types of transfers often result in a completed gift for gift tax purposes but do not constitute a transfer of ownership for income tax purposes.

Commenters also recommended that the final regulations exclude specific nonrecognition transactions, including (i) transfers resulting from the death of an Owner Taxpayer; (ii) gifts to a non-grantor trust by an Owner Taxpayer; and (iii) transfers resulting from a change in tax status of a grantor trust. One commenter noted that, in light of section 1061(d)'s specific reference to section 318(a)(1), and not to section 318(a)(2), a gift to a non-grantor trust for the benefit of a taxpayer's spouse, children, grandchildren or parents should not be considered an "indirect transfer" that would trigger the application of section 1061(d). The commenter noted that Congress's use of the phrase "directly or indirectly" does not warrant disturbing the conclusion that a transfer to a non-grantor trust does not constitute an acceleration event for purposes of section 1061(d). This commenter suggested in the alternative that if a transfer to a non-grantor trust is an acceleration event for purposes of section 1061(d), only upon a subsequent distribution of the API out of the non-grantor trust should the acceleration event occur.

After considering the comments, the Treasury Department and the IRS have determined that while section 1061(d) can reasonably be interpreted as an acceleration provision, in the absence of clear language to the contrary, it is more appropriate to apply section 1061(d) only to transfers in which long-term capital gain is recognized under chapter 1 of the Code. Interpreting section 1061(d) as only a recharacterization provision is consistent with the statutory language that looks to

so much of the taxpayer's long-term capital gain with respect to such interest for such taxable year as is attributable to the sale or exchange of any asset held. This treatment also prevents the acceleration of gain in the many non-abusive nonrecognition transactions described by commenters. Furthermore, it is not necessary to accelerate gain on the transfers of an API to a Section 1061(d) Related Person in a non-taxable transaction because the API will remain an API in the hands of the transferee under §1.1061-2(a). Accordingly, the final regulations provide that the Section 1061(d) Recharacterization Amount includes only long-term capital gain that the Owner Taxpayer recognizes under chapter 1 of the Code upon a transfer through a sale or exchange of an API to a Section 1061(d) Related Person.

Proposed §1.1061-5(c) provides a formula for calculating the Owner Taxpayer's short-term capital gain upon a transfer of an API to a Section 1061(d) Related Person based upon a hypothetical sale of all of the partnership's property in a fully taxable transaction. A commenter noted that because the calculation is not based on the Recharacterization Amount under a hypothetical liquidation, it includes amounts excluded from the Recharacterization Amount, such as capital interest gains and losses. The commenter recommended that the formula be amended so that it is based upon the Recharacterization Amount in a hypothetical partnership liquidation, and that the final regulations contain an exception from taxation for transactions in which the Owner Taxpayer's deemed distributions with respect to the Owner Taxpayer's API on a hypothetical liquidation basis are the same immediately before and after the transaction (not including any deemed distributions due to changes in debt allocations). Another commenter suggested that, in order to avoid double-counting in a tiered structure, there should be a cap on the amount that would be taxed equal to the gain that would be realized if the directly transferred API were sold for its fair market value by the Owner Taxpayer.

Another commenter noted that the proposed regulations provide that section 1061(d) applies to transfers of APIs by Passthrough Entities and to transfers of Distributed API Property by Owner Tax-

payers, but that the rules do not provide guidance on how to calculate the amount to be included. The commenter suggested that, in the case of a transfer of an API by a Passthrough Entity, the inclusion amount should be the amount that would be allocated to each of the Passthrough Entity's direct or indirect Owner Taxpayers in a deemed taxable sale of assets by the lower-tier entity in which the Passthrough Entity holds its API, and that the amounts that such Passthrough Entity includes in the API One Year Distributive Share Amount, but not in the API Three Year Distributive Share Amount, for each Owner Taxpayer should be subtracted from the aforementioned amounts to calculate an Owner Taxpayer's recharacterization amount under section 1061(d). In the case of a transfer of Distributed API Property by an Owner Taxpayer, the commenter suggested that the inclusion amount should be the amount of long-term capital gain that the Owner Taxpayer would have recognized on a taxable sale for cash at the Distributed API Property's fair market value.

The Treasury Department and the IRS appreciate these thoughtful suggestions. The final regulations have revised and simplified the computation of the inclusion amount in §1.1061-5(c) and have added the term Section 1061(d) Recharacterization Amount. The final regulations provide that, if section 1061(d) applies, an Owner Taxpayer's Section 1061(d) Recharacterization Amount is the Owner Taxpayer's share of the amount of net long-term capital gain from assets held for three years or less that would have been allocated to the Owner Taxpayer with respect to the transferred API if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property immediately prior to the Owner Taxpayer's transfer of the API (or a portion of such gain if only a portion of the API is transferred).

A commenter requested clarification as to whether "capital gain recognized" on an otherwise taxable transfer in proposed §1.1061-5(c)(2) means that the amount recharacterized under section 1061(d) includes only gain that would otherwise be treated as long-term gain or whether it sets the total amount of short-term gain on the transfer. The final regulations provide that

the long-term gain that is recharacterized to short-term under section 1061(d) is the lesser of (i) the amount of net long-term capital gain recognized by the Owner Taxpayer upon the transfer of such interest, or (ii) the Section 1061(d) Recharacterization Amount as computed under §1.1061-5(c). Thus, only gain that would otherwise be treated as long-term gain is recharacterized under section 1061(d).

Proposed §1.1061-5(d) provides that the basis of a transferred API or transferred Passthrough Interest (in the case of a transferred Indirect API) is increased by the additional gain recognized. A commenter requested that the rule be revised to explicitly coordinate with section 743 so that the basis adjustments will be allocated to the assets that result in the gain recognition. The concerns raised in this comment are resolved because the final regulations limit the application of section 1061(d) to transactions in which gain is recognized.

Another commenter recommended that the final regulations explicitly exclude amounts that would be subject to the Capital Interest Exception. The final regulations do not adopt this comment because the Capital Interest Exception is an exception to the definition of an API. Therefore, such a rule is not needed. Commenters also recommended that the final regulations explicitly exclude amounts specified in proposed §1.1061-4(b)(6) (designated as §1.1061-4(b)(7) in the final regulations) from the calculation of the Section 1061(d) Recharacterization Amount. One commenter noted that the scope of section 1061(d)(1) is broader than the tax result that would occur if the partnership had actually sold all its property, noting that neither the statute nor the proposed regulations exclude section 1231 gains (and other excluded gains such as those under section 1256) from the Section 1061(d) Recharacterization Amount. Another commenter argued that section 1061(d) should not recharacterize section 1231 gain, stating that while the statutory language in section 1061(d) provides arguable authority for including section 1231 gains in the computation of the Section 1061(d) Recharacterization Amount, the approach is hard to justify from a policy perspective. The commenter argued that because section 1061(d) is aimed at

preventing an API Holder from circumventing section 1061(a), the regulations should not impose on taxpayers a result under section 1061(d) that is worse than if section 1061(a) had applied to assets sold by the partnership. The commenter recommended that “long-term capital gains” should be interpreted consistently for purposes of section 1061(a) and section 1061(d), and that long-term capital gain recognized with respect to section 1231 assets should not be recharacterized under either paragraph.

The final regulations adopt these comments and provide that the Section 1061(d) Recharacterization Amount does not include amounts not taken into account for purposes of section 1061 under §1.1061-4(b)(7).

Proposed §1.1061-5(c)(1) provides that if an Owner Taxpayer transfers an Indirect API and is subject to section 1061(d), the computation of the Section 1061(d) Recharacterization Amount must be applied at the level of any lower-tier Passthrough Entities. One commenter recommended that this rule be aligned with the rules for tiered partnerships elsewhere in the proposed regulations, such as the Lookthrough Rule, which explicitly states that it applies only to the “assets of the partnership in which the API is held.” A commenter recommended that the final regulations clarify whether the transfer of a distributed asset held, or deemed to be held, by the partnership for three years or less is subject to section 1061(d). Another commenter noted that there is no principled reason for not applying section 1061(d) in tiered partnerships to transfers of Distributed API Property by Passthrough Entities to Section 1061(d) Related Persons of the ultimate Owner Taxpayer.

Under the final regulations, the Section 1061(d) Recharacterization Amount is computed by the Owner Taxpayer. The transfer of a distributed asset held, or deemed to be held, by a Passthrough Entity for three years or less is subject to section 1061(d). The final regulations clarify that for purposes of section 1061(d), an Owner Taxpayer will be treated as transferring the Owner Taxpayer’s share of any Indirect API or Distributed API Property if the Indirect API or Distributed API Property is transferred by the API Holder to a person that is a Section 1061(d) Related

Person with respect to the Owner Taxpayer. The final regulations also provide that the rules for determining the Section 1061(d) Recharacterization Amount also apply to the transfer of a Passthrough Interest issued by an S corporation or PFIC to the extent the Passthrough Interest is treated as an API.

Proposed §1.1061-5(e) defines a Section 1061(d) Related Person as: (i) a person that is a member of the taxpayer’s family within the meaning of section 318(a)(1); (ii) a person that performed a service within the current calendar year or the preceding three calendar years in a Relevant ATB to the API transferred by taxpayer; or (iii) a Passthrough Entity to the extent that a person described in paragraph (e)(1)(i) or (ii) owns an interest, directly or indirectly. One commenter recommended that the definition of Section 1061(d) Related Person be amended to exclude a Passthrough Entity to the extent that a member of the taxpayer’s family or colleague is an owner, noting that language is not in the statute and is not discussed in the legislative history. The final regulations do not adopt this comment. Section 1061(d)(1) provides that the inclusion required by section 1061(d) applies if a taxpayer transfers any API, directly or indirectly, to a person related to the taxpayer.

### III. *Additional Comments Received and Revisions Made*

#### A. Sections 1.1061-1 and 1.1061-2: Definitions, Operational Rules, and Examples

##### 1. Definitions, In General

A commenter expressed the view that the interrelated new terms and definitions make the proposed regulations difficult to read and comprehend in some places. The final regulations largely retain the terms and definitions provided in §1.1061-1(a) but simplify many of the computational rules and concepts used to determine the Recharacterization Amount and the Section 1061(d) Recharacterization Amount. The terms and definitions provide a helpful roadmap to the regulations and are also needed to provide Owner Taxpayers, Passthrough

Entities, and the IRS with a common vocabulary that can be used to describe the necessary computations and reporting requirements. The final regulations make clarifying changes throughout the definitions, including providing that a Passthrough Entity can also be a trust or estate. Terms have also been added and removed in accordance with the revisions discussed elsewhere in this Summary of Comments and Explanation of Revisions.

A commenter noted that the preamble to the proposed regulations provides that “taxpayer” means Owner Taxpayer in sections 1061(a) and (d), and both Owner Taxpayer and Passthrough Taxpayer in section 1061(c)(1). The commenter further noted that the proposed regulations use the definition of “person” as that term is generally used under section 7701(a)(1). The commenter requested that the final regulations provide explicit definitions of “taxpayer” and “person” in each relevant part because the terms have different meanings in different contexts.

The final regulations do not adopt this comment because defining taxpayer and person in different ways in each relevant section would introduce unnecessary complexity. However, the use of these terms has been modified in certain places in the final regulations to alleviate confusion.

#### 2. Operational Rules

##### a. Definition of API; An API remains an API

Proposed §1.1061-1(a) provides that API means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or by a Passthrough Taxpayer, or by any Related Person, including services performed as an employee, in any ATB unless an exception applies, and that for purposes of this definition, an interest in a partnership also includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations.)

A commenter expressed concern that defining an interest in a partnership to include a financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership, could include investment management contracts that provide for a fee based on the assets of a fund partnership and not a carried interest or other performance allocation, creating a risk that the sale of a management company or indirect sale of a management contract could be subject to section 1061. This in turn could cause the enterprise value of the management company to be taxed at ordinary income rates. The commenter recommended that the definition of API be modified to exclude financial instruments or contracts that merely reference the value of partnership assets or that provide for fee income that is subject to ordinary income tax treatment.

Because financial instruments can replicate the performance of a partnership interest, the inclusion of such items in the definition of an API is necessary for purposes of implementing section 1061. Accordingly, the final regulations do not adopt this comment. As stated in Part IV of this Summary of Comments and Explanation of Revisions, the Treasury Department and the IRS continue to study the impact of section 1061 on the taxation of enterprise value related to the transfer or exchange of partnership interests and management contracts.

Proposed §1.1061-2(a)(1)(i) provides that once a partnership interest qualifies an API, the partnership interest remains an API unless and until the requirements of one of the exceptions to qualification of a partnership interest as an API are satisfied. A commenter questioned whether this provision is valid given that it is not explicit in the statute, but reasoned that the rule is implicit in the statutory scheme and is necessary to prevent avoidance of the statute.

The Treasury Department and the IRS agree with the commenter that this rule is implicit in the statutory scheme. Neither the statute nor the legislative history provide a time limit or other means of ending API treatment beyond the exceptions to qualification as an API. Consequently, no modifications have been made to §1.1061-2(a)(1)(i).

b. Presumption that services are substantial

Proposed §1.1061-2(a)(1)(iv) provides that if a partnership interest is transferred to or held by an Owner Taxpayer, Passthrough Taxpayer, or any Related Person in connection with the performance of services, the Owner Taxpayer, the Passthrough Taxpayer, or the Related Person is presumed to have provided substantial services for purposes of section 1061. Commenters suggested that presuming all services to be substantial is overbroad and recommended that the presumption be removed. In addition, one commenter recommended the inclusion of non-exclusive safe harbors that service partners could rely on to determine that partnership interests they hold or that have been transferred to them are not in connection with the performance of substantial services. Another commenter recommended adding a means to rebut the presumption that the services are substantial.

The final regulations retain the proposed rule's presumption that all services provided for a partnership interest are substantial services for purposes of section 1061. However, the Treasury Department and the IRS will continue to study and consider possible circumstances under which the presumption might be rebutted as well as the possibility of providing safe harbors for circumstances under which the presumption will not apply. These considerations may be addressed in future guidance.

c. Application of the ATB Activity Test

i. In general, ATB

Proposed §1.1061-1(a) provides that applicable trade or business (ATB) means any activity for which the ATB Activity Test with respect to Specified Actions is met, and includes all Specified Actions taken by Related Persons, including combining activities occurring in separate partnership tiers or entities as one ATB. Proposed §1.1061-1(a) defines an Owner Taxpayer as the person subject to Federal income tax on net gain with respect to an API or an Indirect API during the taxable year, including an owner of a Passthrough Taxpayer unless the owner of

the Passthrough Taxpayer is a Passthrough Entity itself or is excepted under proposed §1.1061-3(a), (b), or (d).

ii. ATB Activity Test

Proposed §1.1061-2(b)(1) provides that the ATB Activity Test is satisfied if Specified Actions are conducted by one or more Related Persons and the total level of activity, including the combined activities of all Related Persons, satisfies the level of activity that would be required to establish a trade or business under section 162. Proposed §1.1061-1(a) provides that Specified Actions means Raising or Returning Capital Actions and Investing or Developing Actions. Raising or Returning Capital Actions means actions involving raising or returning capital but does not include Investing or Developing Actions. Investing or Developing Actions means actions involving either (i) investing in (or disposing of) Specified Assets (or identifying Specified Assets for such investing or disposition), or (ii) developing Specified Assets.

Commenters requested clarification that joint ventures of a real estate developer involving a single stand-alone project at a single location will not satisfy the ATB Activity Test. One of these commenters recommended that the definition of Raising or Returning Capital should be refined so that it includes only raising or returning capital activities in which the business earns compensation based on either capital committed, capital contributed, or capital invested. Another commenter noted that additional guidance may be needed to make the statute more administrable because real estate held for rental or investment is a Specified Asset but holding the property may not constitute a trade or business under section 162.

The final regulations do not adopt these comments. Whether a single project or raising of capital involves the level of activity needed to constitute a trade or business under section 162 is dependent on the facts and circumstances unique to the project or raising of capital. Furthermore, guidance under section 162 is beyond the scope of these regulations.

Example 6 of proposed §1.1061-2(b)(2)(vi) describes a situation in which A manages a hardware store that Partnership

owns. A is issued a profits interest in Partnership in connection with A's services. Partnership owns the building in which the hardware store operates. The example notes that the building is held by Partnership not for rental or investment, but to conduct Partnership's hardware business and, thus, the building is not a Specified Asset. The example provides that the partnership maintains and manages a certain amount of working capital for its business, but notes that working capital is not taken into account for the purpose of determining whether the ATB Activity Test is met. A commenter suggested that another example should be added to analyze how to apply the ATB Activity Test where the facts are changed so that the business is held in a C corporation, the partnership only holds the C corporation stock, and the holding partnership is held by an investment partnership. The commenter stated that the ATB Activity Test should not be met by the holding partnership and the manager should not be an API Holder.

The final regulations do not adopt this comment. Depending on the specific facts and circumstances of the situation, the Treasury and the IRS believe that the ATB Activity Test could be met by such a holding partnership and the manager might be an API Holder.

A commenter requested clarification regarding what activities occurring in separate partnership tiers or entities will be considered combined and treated as one ATB, and recommended that the regulations be amended to include an example illustrating how the ATB and API rules work in this situation. The commenter recommended that the application of section 1061 be limited to an Owner Taxpayer solely with respect to partnership interests that serve as compensation for services relating to Specified Assets. Another commenter requested simplifying safe harbors for activities conducted in multiple entities either in the same chain or in a brother-sister chain.

The Treasury Department and the IRS continue to study these issues and may consider providing future guidance on these matters. However, the Treasury Department and the IRS note the definition of ATB includes any and all activities, no matter how minimal, conducted by entities that are Related Persons to each other,

for purposes of determining whether the ATB Activity Test is met, and if that test is met, then each such participating entity is considered to be engaged in an ATB.

Another commenter requested clarification that businesses that do not both raise or return capital and engage in either investment or development activities do not satisfy the ATB Activity Test, and that the regular, continuous, and substantial standard applies independently to each prong of the ATB Activity Test. The commenter suggested that because the proposed regulations aggregate activities of one or more entities and related parties, the final regulations should not include the statement that the fact that either Raising or Returning Capital Actions or Investing or Developing Actions are only infrequently taken does not preclude the test from being satisfied if the combined Specified Actions meet the test. The commenter expressed concern that this language combined with the rule that Raising or Returning Capital Actions and Investing or Developing Actions are not required to be taken in each taxable year could cause the activities of a fund sponsor's affiliates to satisfy the raising or returning capital prong with respect to any of the sponsored funds.

The final regulations do not adopt this comment. It is necessary for both the Raising or Returning Capital Actions and Investing or Developing Actions to be present for the ATB Activity Test to be satisfied. The aggregation rule and the language regarding infrequent actions are necessary to prevent abuse of section 1061. Without these rules, activities could be spread among multiple related entities with the intent of not satisfying the ATB Activity Test.

### iii. Definition of Specified Assets

Proposed §1.1061-1(a) defines Specified Assets as: (i) securities, including interests in partnerships qualifying as securities (as defined in section 475(c)(2) without regard to the last sentence thereof); (ii) commodities (as defined in section 475(e)(2)); (iii) real estate held for rental or investment; (iv) cash or cash equivalents; (v) an interest in a partnership to the extent that the partnership holds Specified Assets; and, (vi) options or derivative contracts with respect to any of the foregoing.

Commenters requested additional guidance on the treatment of partnerships that engage in the production, storage, transportation, processing, or marketing of physical commodities in the ordinary course of business (including hedges with respect to the commodities). The commenters requested that such partnerships not be treated as engaged in Investing and Developing Actions as a result of such activities, and that Specified Assets only include commodities that are themselves actually actively traded on an established financial market, not merely commodities of the same type as commodities that are or can be actively traded on an established financial market.

The final regulations do not adopt this comment; however, the Treasury Department and the IRS continue to study this issue and may address it in future guidance.

Another commenter noted that it is unclear whether the rule treating a derivative contract with respect to a partnership interest as a partnership interest for purposes of applying section 1061 is needed to appropriately administer section 1061. The commenter noted that the proposed regulation's position regarding such a derivative injects unnecessary complexity into the tax system, and stated that because payments made before termination of a swap are almost always ordinary income, it may not make economic or tax sense to use such a financial instrument in lieu of a partnership interest in an attempt to avoid section 1061.

The final regulations do not adopt this comment. While the use of a derivative contract in this circumstance may be rare, the Treasury and the IRS are concerned that the potential for abuse exists. Consequently, the treatment of a derivative contract as a partnership interest for purposes of applying section 1061 is necessary to prevent the circumvention of, and compliance with, section 1061.

## B. Section 1.1061-3: Exceptions to the Definition of API

### 1. Corporate Exception

Section 1061(c)(4)(A) provides that an API "shall not include any interest in a partnership directly or indirectly held by a corporation." In implementing this

exception, proposed §1.1061-3(b)(2) provides that a corporation does not include an entity for which an election was made to treat the entity as a Passthrough Entity, and that therefore, an S corporation for which an election under 1362(a) is in effect and a PFIC with respect to which the shareholder has a QEF election under section 1295 in effect (such entity is a QEF with respect to the shareholder), are not treated as corporations for purposes of section 1061. One commenter approved of this decision, noting that section 1061(f) provides ample authority for excluding S corporations and PFICs from the term corporation. The commenter noted that allowing such structures to benefit from the corporate exception would allow section 1061 to be entirely circumvented. Another commenter, discussing PFICs subject to QEF elections, noted that the exclusion of QEFs from the definition of corporation for purposes of section 1061 is consistent with section 1(h)(9) and (h)(10).

One commenter disagreed regarding authority, noting that the ability to treat QEFs and S corporations as subject to section 1061 is subject to substantial doubt and contrary to the plain text of the statute. The commenter also noted that Notice 2018-18, 2018-2 I.R.B. 443, and the provision's legislative history offer no reason why S corporations should, or should not, qualify for the exception. Another commenter said that a legislative clarification should be sought prior to including a rule in the final regulations providing that S corporations are subject to section 1061.

The Treasury Department and the IRS agree with commenters that the exclusion of S corporations and QEFs from the corporate exception is necessary to avoid circumvention of section 1061. Accordingly, no change has been made to this section of the final regulations. As explained in the preamble to the proposed regulations, section 1061(f) provides that the Secretary has authority to issue regulations or other guidance as is necessary or appropriate to carry out the purposes of section 1061. Both the Conference Report and the Blue Book further direct the Treasury Department and the IRS to issue regulations to address the prevention of abuse of the purposes of the provision. The grant of authority in section 1061(f) is sufficient to issue regulations providing that the ex-

ception in section 1061(c)(4)(A) does not include S corporations and PFICs with respect to which shareholders have QEF elections in effect. See also section 1(h)(9) and (10).

## 2. Unrelated Purchaser Exception

Proposed §1.1061-3(d) provides that if a taxpayer acquires an interest in a partnership (target partnership) by taxable purchase for fair market value that, but for the exception in §1.1061-3(d), would be an API, the taxpayer will not be treated as acquiring an API if, immediately before the purchase (1) the taxpayer is not related within the meaning of section 267(b) or 707(b) to any person who provides services in the Relevant ATB, or any service providers who provide services to or for the benefit of the target partnership or a lower-tier partnership in which the target partnership holds a direct or indirect interest; (2) section 1061(d) does not apply to the transaction (as provided in §1.1061-5); and (3) the taxpayer has not provided in the past, does not then provide, and does not anticipate providing services in the future to, or for the benefit of, the target partnership, directly or indirectly, or any lower-tier partnership in which the target partnership holds a direct or indirect interest.

A few commenters stated that the proposed regulations are unclear as to whether the exception applies only to an API that is directly acquired or whether it also applies to an API in which the buyer acquired an indirect interest through an upper-tier partnership. One commenter recommended that final regulations provide that the exception applies to both APIs purchased directly as well as APIs purchased indirectly, noting that the unrelated purchaser might not be able to rely on Rev. Rul. 87-115, 1987-2 C.B. 163, to adjust the basis of the underlying fund assets to prevent the recognition of built-in gain, as fund sponsors generally do not make section 754 elections at the fund level. Further, the commenter suggested that the final regulations provide that the exception applies regardless of whether the lower-tier partnership interest is acquired after the third-party purchases the interest in the upper-tier partnership or acquires the upper-tier partnership interest by con-

tribution. Another commenter suggested that the exception be extended to interests in other Passthrough Entities.

The final regulations do not adopt these comments because of the complexity of administering the unrelated purchaser exception through tiers of Passthrough Entities. The final regulations make non-substantive clarifying changes to the rule.

The preamble to the proposed regulations provides that the exception does not apply to an Unrelated Non-Service Partner who becomes a partner by making a contribution to a Passthrough Entity that holds an API and in exchange receives an interest in the Passthrough Entity's API, stating that, in this case, allocations to the Unrelated Non-Service Partner with respect to the API are API Gains and Losses and retain their character as API Gains and Losses. One commenter noted that this exception to the unrelated purchaser exception is not explained in the proposed regulations' preamble and suggested that the exception to the exception is most likely intended to refer to a situation in which an investor makes a contribution in form to an upper-tier partnership, which then distributes an API with respect to a lower-tier partnership to the contributing upper-tier partner. The commenter notes that these transfers might be a purchase of the API by the investor from the upper-tier partnership. The Treasury Department and the IRS intend that the third-party purchaser exception be limited to API purchases and not apply when a third party contributes cash or property to a Passthrough Entity holding an API in a transaction qualifying for nonrecognition under section 721(a), or any similar provision, resulting in the contributor receiving allocations attributable to the transferee Passthrough Entity's API.

## C. Section 1.1061-4: Computing the Recharacterization Amount

### 1. Computation of the Recharacterization Amount

Proposed §1.1061-4(a)(1) provides that the Recharacterization Amount equals the Owner Taxpayer's One Year Gain Amount less the Owner Taxpayer's Three Year Gain Amount. The Owner Taxpayer's One Year Gain Amount is the sum of the Own-

er Taxpayer's combined net API One Year Distributive Share Amount from all APIs held during the taxable year and the Owner Taxpayer's API One Year Disposition Amount. An Owner's Taxpayer's Three Year Gain Amount is equal to the Owner Taxpayer's combined net API Three Year Distributive Share Amount from all APIs held during the taxable year and the Owner Taxpayer's API Three Year Disposition Amount. The API One Year and Three Year Distributive Share Amounts exclude Capital Interest Gains and Losses. Capital Interest Disposition Amounts are not included in the computation of the API One Year and Three Year Disposition Amounts because they relate to the disposition of a Capital Interest rather than an API.

Proposed §1.1061-4(a)(3)(i) provides that the API One Year Distributive Share Amount equals the API Holder's distributive share of net long-term capital gain from the partnership for the taxable year, including capital gain or loss on the disposition of all or a part of an API, with respect to the partnership interest held by the API Holder calculated without the application of section 1061 less, to the extent included in the amount determined under proposed §1.1061-4(a)(3)(i)(A), the aggregate of amounts that are excluded from section 1061 under proposed §1.1061-4(b)(6), the *API Holder's Transition Amount* for the taxable year; and Capital Interest Gains and Losses as determined under proposed §1.1061-3(c)(2).

One commenter stated that the definition of API One Year Distributive Share Amount does not allow for this amount to be a loss. For example, if an Owner Taxpayer holds two APIs and one partnership allocates the taxpayer a loss and the other a gain, the loss does not offset the gain because the API One Year Distributive Share Amount for the partnership that allocated the taxpayer a loss will be zero. The commenter recommended allowing the API One Year Distributive Share Amount to be less than zero. The final regulations adopt this suggestion by revising the computation for the API One Year Distributive Share Amount to include both capital gain and loss. In addition, the commenter suggested that the final regulations provide that if each of the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount is greater

than zero but the API One Year Distributive Share Amount is less than the API Three Year Distributive Share Amount, no portion of the API One Year Distributive Share Amount is recharacterized as short-term capital gain. The final regulations adopt this suggestion by providing that if the One Year Gain Amount and the Three Year Gain Amount are both greater than zero but the One Year Gain Amount is less than the Three Year Gain Amount, none of the One Year Gain Amount is included in the Recharacterization Amount for the taxable year. In addition to adopting this comment, the final regulations make minor clarifying changes to the computation rules.

Commenters raised several additional concerns related to the computation rules. One commenter recommended that regulations provide guidance on how losses limited by section 1211 affect the Recharacterization Amount. Another commenter noted that the proposed regulations do not address how net capital gain is computed or the order of steps in doing so under section 1(h)(1). The commenter stated that because section 1061(a) recharacterizes what would have been long-term capital gain as short-term capital gain, it is apparent that section 1061(a) must be applied somewhere in the process before the application of section 1(h). Further, the proposed regulations do not address §1.1(h)-1, which provides a look-through rule when a partnership interest is sold, to determine what portion of the gain on sale will be treated as collectibles gain or section 1250 capital gain. The commenter also noted that, although section 1231 and section 1256 gains are excluded from section 1061 by the proposed regulations, a sale of a partnership interest holding such assets is not excluded, and all the gain is subject to section 1061(a) unless section 751(a) applies. Finally, the commenter stated that there is no provision in the proposed regulations addressing suspension of the holding period of an API when an API owner seeks to obtain a more-than-three-year holding period without undertaking additional risk – that is, the hedging of the API. The commenter recommended that an express rule be provided, such as the rule provided in §1.1400Z2(a)-1(b) for interests in partnerships self-certified as qualified opportunity funds.

The Treasury Department and the IRS continue to study the issues raised by these comments in regard to the computation rules and may address them in future guidance.

## 2. Distributed API Property

Proposed §1.1061-1(a) provides that Distributed API Property means property distributed by a Passthrough Entity to an API Holder with respect to the API if the holding period, as determined under sections 735 and 1223, in the API Holder's hands is three years or less at the time of disposition of the property by the API Holder.

A commenter questioned whether the Treasury Department and the IRS have the authority to treat Distributed API Property as subject to section 1061(a). The commenter further stated that in order for the rule to be a valid exercise of regulatory authority, distributed property for this purpose should exclude property that, if sold by the partnership, would be excluded from section 1061, such as property that would generate 1231 and 1256 gains.

The final regulations continue to treat Distributed API Property as subject to section 1061(a) under the authority of section 1061(f). However, the Treasury Department and the IRS agree with the commenter that long-term capital gain from the disposition of Distributed API Property that, if sold by the partnership, would be excluded from section 1061, such as 1231 and 1256 gain, qualified dividends described in section 1(h)(11)(B), and any other capital gain that is characterized as long-term or short-term without regard to the holding period rules in section 1222, should not be recharacterized under section 1061(a). The final regulations clarify this point by excluding these items from the calculation of the API One Year Disposition Amount. Additionally, because a Passthrough Entity does not calculate an API One Year Disposition Amount, the final regulations clarify that for purposes of calculating the API One Year Distributive Share Amount, an API Holder's distributive share of net long-term capital gain from the partnership includes capital gain or loss on the disposition of Distributed API

Property or all or part of an API by an API Holder that is a Passthrough Entity.

Another commenter suggested that the final regulations explicitly provide rules for the treatment of Distributed API Property when the Distributed API Property is distributed from one Passthrough Entity to another and the upper-tier entity disposes of the Distributed API Property. The commenter also requested confirmation in the final regulations that partnerships should subtract capital gain or loss from property that had been Distributed API Property but no longer is at the time of disposition when calculating the API One Year Distributive Share Amount because such gain is excluded from the calculation of the Recharacterization Amount.

The final regulations partially adopt this comment by revising the computation of the One Year Distributive Share Amount to explicitly include dispositions of API Distributed Property by a partnership or other Passthrough Entity. The final regulations do not adopt the suggestion to explicitly provide that partnerships should subtract capital gain or loss from property that had been Distributed API Property but no longer is at the time of disposition when calculating the API One Year Distributive Share Amount. The definition of Distributed API Property provides that it only applies to property with a holding period of three years or less on the date of disposition by an API Holder. Any property with a greater than three-year holding period is therefore not Distributed API Property. A special rule for Distributed API Property distributed to an upper-tier entity by a lower-tier entity is unnecessary because the definition of API Holder includes a Passthrough Entity.

Commenters noted that the proposed regulations are unclear as to how the Distributed API Property rules apply where an API Holder owns both a profits interest and a capital interest in a partnership, and recommended that the final regulations clarify that a distribution to a partner is not Distributed API Property to the extent that it is distributed with respect to the portion of the partner's interest qualifying for the Capital Interest Exception. One commenter suggested that such guidance should also address how to apply the recommended rule in the context of tiered structures.

The Treasury Department and the IRS continue to study this issue and may address it in future guidance.

### 3. Special Rules for Capital Gain Dividends from Regulated Investment Companies (RICs) and Real Estate Investment Trusts (REITs)

The preamble to the proposed regulations recognizes that long-term capital gain treatment should be available for a capital gain dividend paid by a RIC or REIT to the extent that the capital gain dividend is attributable to assets held for more than three years or is attributable to assets that are not subject to section 1061. Proposed §1.1061-4(b)(4) facilitates this treatment by allowing a RIC or REIT to disclose two additional amounts based on modified computations of the RIC's or REIT's net capital gain. First, the RIC or REIT may disclose the amount of the capital gain dividend that is attributable to the RIC's or REIT's net capital gain excluding any amounts not taken into account for purposes of section 1061 under proposed §1.1061-4(b)(6) from the computation. Second, the RIC or REIT may disclose the amount of the capital gain dividend that is attributable to the RIC's or REIT's net capital gain both (1) excluding any amounts not taken into account for purposes of section 1061 under proposed §1.1061-4(b)(6) from the computation, and (2) substituting three years for one year in applying section 1222. The proposed regulations allow a RIC or REIT to disclose these two additional amounts in writing to its shareholders with its section 852(b)(3)(C)(i) capital gain dividend statement or section 857(b)(3)(B) capital gain dividend notice.

One commenter suggested that it would be extremely rare for a RIC to have shareholders for whom this provision is relevant and stated that requiring this additional reporting would be unnecessarily burdensome as it creates a third type of capital gain that RICs would need to track and report. Consequently, the commenter requested that final regulations continue to permit, but not require, RICs to report this information if they have a shareholder for whom such amounts are relevant. In addition, the commenter noted that most funds will not calculate this information at the time capital gain dividends are reported

on Forms 1099-DIV. The commenter requested that final regulations allow reporting on a written statement furnished to the applicable shareholder on request, without tying the reporting of such amounts to the reporting of capital gain dividends.

Another commenter suggested that RICs and REITs should be permitted to disclose these additional amounts, upon request by a shareholder, and report the One Year Amounts Disclosure and Three Year Amounts Disclosure (as those terms are defined in proposed §1.1061-6(c)) until the extended due date of their returns.

The final regulations retain the rules as proposed but designate them as §1.1061-4(b)(5). As suggested by these commenters, the final regulations retain the option to disclose to shareholders the two additional amounts (that is the final regulations do not make disclosure mandatory). The final regulations do not adopt the suggestion to allow RICs and REITs to disclose these additional amounts only upon the request of a shareholder because such treatment may allow a RIC or REIT to choose to provide information only to certain shareholders but not to other shareholders. The Treasury Department and the IRS continue to study comments suggesting that the disclosure of this information be separated from the reporting of capital gain dividends and may issue guidance in the future. In the interim, the final regulations retain the rule that the disclosures are to be provided with the section 852(b)(3)(C)(i) capital gain dividend statement or section 857(b)(3)(B) capital gain dividend notice.

### 4. Computation of the Recharacterization Amount for Owner Taxpayers with interests in QEFs

The proposed regulations provide special rules for Owner Taxpayers that hold their APIs indirectly through PFICs for which they have made a QEF election. Specifically, under proposed §1.1061-4(b)(5), the API One and Three Year Distributive Share Amounts include an Owner Taxpayer's section 1293(a)(1) inclusions from QEFs, reduced by amounts that are excluded from section 1061(a) if the QEF complies with the reporting rules under §1.1061-6(d). These reporting rules provide that QEFs may provide informa-

tion to allow Owner Taxpayers to compute their Recharacterization Amount. If a QEF fails to provide such information, an Owner Taxpayer includes its entire pro rata share of the QEF's net capital gain in its API One Year Distributive Share Amount and no portion of its pro rata share of the QEF's net capital gain is ultimately included in its API Three Year Distributive Share Amount. One commenter made several suggestions regarding the computation of an Owner Taxpayer's API One Year Distributive Share Amount and API Three Year Distributive Share Amount with respect to a QEF's net capital gain. Broadly, the commenter expressed a concern that the corporate-level capital gain netting rules applicable to QEFs are not consonant with the requirement that the Recharacterization Amount be computed at the Owner Taxpayer level. A QEF determines its net capital gain at the corporate level, and may do so in one of three ways: first, the QEF may calculate and report the amount of each category of long-term capital gain described in section 1(h) of the Code; second, the QEF may report its net capital gain for the year and state that it is subject to the highest capital gain rate of tax applicable to the shareholder; or third, the QEF may determine its current earnings and profits (E&P) and report the entire amount as ordinary earnings. Section 1.1293-1(a)(2). A QEF's net capital gain is limited to its current E&P, regardless of how it computes such amount under §1.1293-1(a)(2) (QEF E&P limitation). Section 1293(e)(2). The commenter had several suggestions on how to clarify or improve the rules under section 1061 applicable to QEFs.

First, the commenter suggested that the three year QEF net capital gain provision was not entirely clear, particularly in regard to the API Three Year Distributive Share Amount. The commenter recommended that the final regulations clarify that an Owner Taxpayer includes in its API Three Year Distributive Share Amount the same base amount as determined for the API One Year Distributive Share Amount (as adjusted to reflect only net long-term capital gains and losses calculated by substituting a greater-than-three-year holding period for a greater-than-one-year holding period).

The Treasury Department and the IRS confirm that an Owner Taxpayer's API Three Year Distributive Share Amount is based on the amount computed for its API One Year Distributive Share Amount and adjusted to include only items that would be treated as a long-term gain or loss if three years were substituted for one year in paragraphs (3) and (4) of section 1222 if the QEF satisfies certain reporting obligations. *See* §1.1061-6(d). However, the final regulations revise proposed §1.1061-4(b)(5) (designated as §1.1061-4(b)(6) in the final regulations) to more precisely identify the inputs for computing an Owner Taxpayer's API One and Three Year Distributive Share Amounts and illustrate an Owner Taxpayer's API Three Year Distributive Share Amount computation with respect to a QEF. Specifically, §1.1061-4(b)(6)(i) provides that an Owner Taxpayer's inclusion under section 1293(a)(1)(B) that is taken into account in determining the API One Year Distributive Share Amount with respect to a QEF is limited to the QEF's E&P by section 1293(e)(2) and that the section 1293(a)(1)(B) inclusion may be reduced by the Owner Taxpayer's share of the excess (if any) of the Capital Interest Gain over Capital Interest Loss with respect to the QEF as well as amounts not taken into account for purposes of section 1061 pursuant to §1.1061-4(b)(7). In either case, however, §1.1061-4(b)(6)(i) permits such reductions only if a QEF has provided an Owner Taxpayer with the relevant information necessary for the Owner Taxpayer to determine those amounts.

Additionally, §1.1061-4(b)(6)(ii) of the final regulations provides that the minuend of an Owner Taxpayer's API Three Year Distributive Share Amount computation (under §1.1061-4(a)(3)(ii)) includes its entire amount determined under §1.1061-4(b)(6)(i) (one year QEF net capital gain). The final regulations further provide that if the QEF does not provide the Owner Taxpayer with information necessary under §1.1061-6(d) to determine the amount of its section 1293(a)(1)(B) inclusion (less any allowed reductions) with respect to the QEF that would be included in its API One and Three Year Distributive Share Amounts, then the entire amount of the Owner Taxpayer's one year QEF net capital gain (less any allowed reductions) is

also included in the subtrahend of its API Three Year Distributive Share Amount formula (under §1.1061-4(a)(3)(ii)(A)). This results in an Owner Taxpayer's entire section 1293(a)(1)(B) inclusion (less any allowed reductions) being treated as short-term capital gain. However, if the QEF provides the Owner Taxpayer with the additional necessary information, then the Owner Taxpayer includes only the amount of its one year QEF net capital gain amount that would not be treated as long-term capital gain substituting a greater-than-three-year holding period in applying paragraphs (3) and (4) of section 1222 in the subtrahend of this formula (under §1.1061-4(a)(3)(ii)(A)). This can result in a portion of an Owner Taxpayer's section 1293(a)(1)(B) inclusion being characterized as long-term capital gain with the balance being treated as short-term capital gain.

To illustrate, assume an Owner Taxpayer owns an interest in a QEF that holds an API; the Owner Taxpayer owns no other API directly or indirectly. The QEF generates both long- and short-term capital gain in its taxable year, none of which are amounts described in §1.1061-4(b)(7) or Capital Interest Gains; the Owner Taxpayer's pro rata share of the QEF's long-term capital gain is \$100, \$70 of which would not be long-term capital gain if a greater-than-three-year holding period were used in applying paragraphs (3) and (4) of section 1222, and its share of the QEF's short-term capital gain (determined without regard to section 1061) is \$15. Before applying section 1061, under §1.1293-1(a)(2), the Owner Taxpayer's pro rata share of the QEF's net capital gain is \$100. Under §1.1061-4(b)(6)(i), with respect to the QEF, the Owner Taxpayer's one year QEF net capital gain amount, and thus its API One Year Distributive Share Amount, is \$100. In its API Three Year Distributive Share Amount computation with respect to the QEF, this \$100 is the minuend (under §1.1061-4(a)(3)(ii)). If the QEF does not provide the Owner Taxpayer with information to determine how much of its pro rata share of the QEF's net capital gain would constitute long-term capital gain if a greater-than-three-year holding period were used in applying paragraphs (3) and (4) of section 1222, the Owner Taxpayer would include all \$100 under §1.1061-

4(a)(3)(ii)(A) in the subtrahend of its computation. This results in an API Three Year Distributive Share Amount of \$0 with respect to the QEF (that is: \$100 under §1.1061-4(a)(3)(ii) introductory text, minus \$100 under §1.1061-4(a)(3)(ii)(A)) and a Recharacterization Amount of \$100 (that is, \$100 API One Year Distributive Share Amount minus \$0 API Three Year Distributive Share Amount). However, if the QEF does provide the Owner Taxpayer with this information, the Owner Taxpayer includes \$70 in the subtrahend of its API Three Year Distributive Share Amount computation with respect to the QEF under §1.1061-4(a)(3)(ii)(A). This results in an API Three Year Distributive Share Amount of \$30 (that is: \$100 under §1.1061-4(a)(3)(ii) introductory text, minus \$70 under §1.1061-4(a)(3)(ii)(A)) and a \$70 Recharacterization Amount (that is: \$100 API One Year Distributive Share Amount minus \$30 API Three Year Distributive Share Amount).

Additionally, the commenter asked that the final regulations harmonize the QEF reporting rules with the reporting rules applicable to other Passthrough Entities. Specifically, the commenter requested that if a QEF does not report relevant information, then QEF shareholders that are Owner Taxpayers should be able to substantiate amounts included in the API One Year Distributive Share Amount and Three Year Distributive Share Amount, as well as items excluded from section 1061(a), through alternative means.

The Treasury Department and the IRS have concluded that, when coupled with §1.1061-6(d), the QEF reporting rules in §1.1295-1(g) provide a sufficiently comprehensive framework for information reporting and no additional rule for section 1061 is necessary. Under §1.1295-1(g)(1), for a PFIC to be treated as a QEF by its shareholders it must provide either an annual statement including the shareholder's pro rata share of the QEF's net capital gain for the year or a statement that it has granted its shareholders access to its books and records (or other documents) for the purpose of determining those amounts; under §1.1295-1(g)(3), the same information must be reported to indirect PFIC shareholders on an intermediary statement. Under §1.1295-1(g)(2), in "rare and unusual circumstances," a PFIC

can provide alternative documentation if it obtains a private letter ruling from, and enters into a closing agreement with, the IRS. In addition to these reporting requirements, §1.1061-6(d) permits (but does not require) a QEF to provide its shareholders that are Owner Taxpayers with additional information for the purpose of determining the Owner Taxpayer's API One Year Distributive Share Amount and Three Year Distributive Share Amount.

The Treasury Department and the IRS have determined that the reporting mechanisms under §§1.1295-1(g) and 1.1061-6(d) provide sufficient avenues for an Owner Taxpayer to obtain information from a QEF to determine its API One Year Distributive Share Amount and Three Year Distributive Share Amount. A special rule allowing Owner Taxpayers to substantiate QEF information through alternative means for purposes of section 1061 would also run counter to §1.1295-1(g), which generally requires a QEF, and not its shareholders, to report information for purposes of section 1293. As a result, to reconcile the optional nature of QEF reporting as compared with reporting requirements of other Passthrough Entities, the final regulations revise §1.1061-6(b)(2)(ii) to provide that a Passthrough Entity from which information is requested must provide such information, but only to the extent the information is necessary for the requesting Passthrough Entity to meet its reporting and filing requirements under §1.1061-6. The final regulations also revise §1.1061-6(d) to provide that Owner Taxpayers are not permitted to separately substantiate amounts with respect to a QEF under §1.1061-6(a)(2). Accordingly, the comments suggesting changes to the QEF reporting rules under section 1061 are not adopted.

The commenter also suggested that the final regulations should provide guidance on how to apportion the QEF E&P limitation for purposes of section 1061. Specifically, the commenter suggested that the QEF E&P limitation should be apportioned according to the shareholder's relative share of the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount with respect to the QEF. The commenter also suggested that consideration be given to bypassing netting at the PFIC level, with guidance

to be provided on how to allocate the QEF E&P limitation at the Owner Taxpayer level.

The QEF E&P limitation is imposed by section 1293(e)(2) and is taken into account in determining a shareholder's pro rata share of the net capital gains of a QEF that is required to be included in a shareholder's income pursuant to section 1293(a)(1). Netting of losses must therefore be carried out before determining the net capital gain of a QEF that is required to be included by a shareholder. The Treasury Department and the IRS recognize the complexity regarding apportioning the QEF E&P limitation for purposes of section 1061. This issue is particularly acute in light of the different types of capital gain and loss relevant for purposes of section 1061 that may be included in a QEF's net capital gain, including one- and three-year capital gains and losses, and amounts excluded from section 1061 under §1.1061-4(b)(7) or under the capital interest exception. Further complication arises from the fact that a loss may arise either from a QEF's ordinary business operations, or from one or more of the four categories listed in the prior sentence.

In this regard, the Treasury Department and the IRS considered several possible ways of apportioning the QEF E&P limitation. One possibility would be to adopt an approach that apportions the QEF E&P limitation between the relevant types of capital gains for purposes of section 1061 on a pro rata basis, which the Treasury Department and the IRS determined would be appropriate in many circumstances, though not all. For example, if a loss arises from a QEF's ordinary business operations while its capital gain income is derived from an API, there may be no direct link between the ordinary loss and the API-derived capital gain. In such a case a pro rata approach may be appropriate. Alternatively, for other circumstances, the Treasury Department and the IRS considered apportioning a QEF's E&P limitation based on more specific ordering rules. For example, if a loss were related to one or more categories of capital gain, allocation first to those categories might be appropriate. Another possible approach would be to allocate the loss giving rise to the E&P limitation in the manner that most closely approximates how an Owner Taxpayer

would be permitted to allocate the loss if the QEF's gains and losses were derived directly by the Owner Taxpayer and the Owner Taxpayer's income was limited to otherwise-long-term capital gain income. In light of the complexity regarding the different scenarios under which a pro rata approach or an alternative approach would be more appropriate, the Treasury Department and the IRS have determined that this issue warrants further study and welcome comments in this regard. Until the Treasury Department and the IRS issue further guidance on this issue, taxpayers may adopt any reasonable method for apportioning the QEF E&P limitation for purposes of section 1061 taking into account these considerations.

Finally, the commenter requested that the Treasury Department and the IRS provide a rule that would identify an Owner Taxpayer's distributive share of a QEF's net capital gain from a Passthrough Entity attributable to the Owner Taxpayer's qualifying capital interest and API. The Treasury Department and the IRS continue to study this issue and may address it in future guidance.

#### 5. Items Not Taken Into Account for Purposes of Section 1061

Proposed §1.1061-4(b)(6) provides that certain items of long-term capital gain and loss are excluded from the calculation of the API One Year Distributive Share Amount and the API Three Year Distributive Share Amount. Specifically, long-term capital gain and long-term capital loss determined under section 1231 or 1256, qualified dividends included in net capital gain for purposes of section 1(h)(11)(B), and capital gains or losses that are characterized as long-term or short-term without regard to the holding period rules in section 1222 are excluded from these calculations.

Two commenters questioned the exclusion of long-term capital gain determined under section 1231 from recharacterization under section 1061. Those commenters discussed the discrepancies in language between section 1061(a)(1) and 1061(a)(2), noting that only section 1061(a)(2) refers to section 1222. Both commenters suggested that the treatment of section 1231 gains in the proposed reg-

ulations is contrary to the statutory text of section 1061. The first commenter stated that section 1061(a)(1) applies to net long-term capital gain and noted that other portions of section 1061 indicate that it is supposed to apply to gains that are taxed at favorable rates for disposition of investment assets. This commenter argued that the reference to section 1222 in section 1061(a)(2) can be read as excluding certain section 1222 gains from the reach of section 1061(a), rather than limiting section 1061(a) to such gains by implication. The commenter noted that if a determination is made that section 1061(a) does apply to section 1231, then regulations need to address the holding periods of section 1231 and how the netting rules of section 1231 interact with section 1061.

The second commenter suggested that, under the proposed regulations, the portion of any net section 1231 gains attributable to APIs could arguably be included in the amount described in section 1061(a)(1). The commenter stated that this would lead to nonsensical results if net section 1231 gains are included in the amount described in section 1061(a)(1) but excluded from the amount described in section 1061(a)(2). Because of the conflicting statutory language in sections 1061(a)(1) and 1061(a)(2), the commenter recommended that the treatment of section 1231 gains be reconsidered, suggesting that one approach would be to include the net 1231 gain attributable to APIs in the section 1061(a) computation after recomputing this amount by substituting 3 years for 1 year.

In contrast, several commenters supported the proposed regulation's treatment of qualified dividends and long-term capital gains determined under section 1231 and 1256 as not subject to recharacterization under section 1061 and recommended these provisions be finalized as proposed. Commenters noted that this treatment aligns with the clear language of the statute and is consistent with Congressional intent. One commenter stated that section 1256 amounts should not be subject to section 1061(a) because they are not gains that are taxed at favorable rates that arise from the disposition of assets. Another commenter noted that the statutory references to section 1223(3) and (4) raise the question of section 1061's potential effect

on other Code provisions without regard to section 1222. The commenter indicated that some provisions have their own holding period, such as section 1231, while others, such as section 1256, just mandate tax treatment. The commenter stated that this results in a haphazard inclusion or exclusion of items from section 1061 and noted that because the section 1061 legislative history is devoid of guidance on this issue, the approach taken in the proposed regulations is reasonable but a technical correction from Congress would be welcome.

The final regulations do not adopt suggestions that section 1231 gain should be subject to recharacterization under section 1061(a) and maintain the rules in proposed §1.1061-4(b)(6), which is designated as 1.1061-4(b)(7) in the final regulations. As stated in the preamble to the proposed regulations, section 1231 gains and losses are treated as long-term based on the operation of section 1231, and not by reference to paragraphs (3) and (4) of section 1222. Similarly, section 1256 provides for specific character treatment and does not calculate gain by reference to section 1222. Accordingly, the Treasury Department and the IRS have determined that it is appropriate to exclude these amounts from both the One Year and Three Year Gain Amounts. In contrast, because section 1061(d)(1) looks to the excess of long-term capital gains with respect to the transferred interest to the sale or exchange of any asset held for not more than three years as is allocable to such interest over what is otherwise short-term capital gain under section 1061(a), and does not reference section 1222, these amounts are captured in transactions to which section 1061(d) applies. The final regulations do not adopt the suggestion to provide guidance on section 1231 holding periods or netting rules because such guidance would be beyond the scope of these final regulations.

One commenter suggested that proposed §1.1061-4(b), which excludes certain items from the calculation of the API One Year and Three Year Distributive Share Amounts, should be modified to explicitly reference both One Year Disposition Gains and One Year Distributive Share Amounts in providing for an exclusion of section 1231 property from

the scope of section 1061. The commenter suggested that the Treasury Department and the IRS should also determine whether a similar modification is appropriate for the exclusion for section 1256 property.

The final regulations do not adopt this comment. The API One Year Disposition Amount includes long-term capital gains and losses recognized by an Owner Taxpayer on the disposition of all or a portion of an API. Pursuant to section 741, the sale or exchange of a partnership interest, including an API, is the sale or exchange of a capital asset. Accordingly, the character of the gain is determined with reference to section 1222. The items listed in §1.1061-4(b)(7), including section 1231 gain, are excluded from the calculation of the API One Year and Three Year Distributive Share Amounts because they are not determined without regard to section 1222. Furthermore, asymmetrical tax treatment occasionally is a result of the difference between the sale of a partnership interest and the sale of assets by a partnership.

One commenter noted that under section 197(f), acquired goodwill is treated as depreciable property, thereby causing gain recognized on the sale of acquired goodwill to be treated as section 1231 gain. By contrast, self-created goodwill does not qualify as an amortizable intangible under section 197; therefore, any gain recognized on the sale of the self-created goodwill is not section 1231 gain. Instead, it is treated as a capital asset giving rise to capital gain upon a sale or exchange. Consequently, under the proposed regulations, gain on the sale of acquired goodwill is excluded from the Recharacterization Amount while gain on the sale of self-created goodwill is not excluded. The commenter recommended that in addition to the exclusion for section 1231 gain, the regulations should provide that any gain recognized on the sale of goodwill held in connection with the conduct of a trade or business (whether or not determined under section 1231) is also excluded from the Recharacterization Amount because there is no evidence Congress intended to subject self-created goodwill held in connection with a trade or business to section 1061.

The final regulations do not adopt this comment. The disparate treatment of purchased and self-created goodwill is pre-

scribed by section 197 and nothing in section 1061 changes this treatment.

## 6. Holding Periods

Proposed §1.1061-4(b)(8) clarifies that the relevant holding period of either an asset or an API is determined under all provisions of the Code or regulations that are relevant to determining whether the asset or the API has been held for the long-term capital gain holding period by applying those provisions as if the holding period were three years instead of one year. For this purpose, the relevant holding period is the direct owner's holding period in the asset sold.

The final regulations maintain this rule as proposed. One commenter requested clarification that the modification of a partnership agreement does not itself create a new holding period for the API. The final regulations do not adopt this comment as section 1061 does not generally change the holding period of an asset.

## 7. API Holder Transition Amounts and Partnership Transition Amounts

The proposed regulations provide that a partnership that was in existence as of January 1, 2018, could irrevocably elect to treat all long-term capital gains and losses recognized from the disposition of all assets held by the partnership for more than three years as of January 1, 2018, as Partnership Transition Amounts. An amount of long-term gain or loss treated as a Partnership Transition Amount and included in the allocation of long-term capital gains and losses under sections 702 and 704 to an API Holder with respect to its interest in a Passthrough Entity was treated as an API Holder Transition Amount. API Holder Transition Amounts were not taken into account for purposes of determining the Recharacterization Amount. The preamble to the proposed regulations also requests comments on whether a transition rule is needed and whether the Partnership Transition Amount rules are useful or whether another approach would be more helpful in easing transition difficulties.

Several commenters questioned the need for an elective transition rule. One commenter noted that while they appreciated the Treasury Department and the

IRS seeking to minimize the burdens associated with the change in law, they did not believe the transition rules would measurably lessen the recordkeeping burden on funds. The commenter also noted that whether and for whom the transition rules would be beneficial is unpredictable. Another commenter recommended that final regulations include an example illustrating, or otherwise better explaining, the importance of the API Holder Transition Amount rules, that is, what benefits the API Holder Transition Amount rules are intended to confer on taxpayers. No commenter provided an example of the potential applicability of the API Holder Transition Amount rules. After considering the comments, the Treasury Department and the IRS have determined that the Partnership Transition Amount rules are unnecessary. Accordingly, the final regulations do not include these rules.

## D. Section 1.1061-6: Reporting Requirements

Proposed §1.1061-6(a) provides filing and reporting requirements for Owner Taxpayers and Passthrough Entities. Proposed §1.1061-6(a)(1) provides that an Owner Taxpayer must file such information with the IRS as the Commissioner may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that the Owner Taxpayer is in compliance with section 1061 and the regulations. Proposed §1.1061-6(b)(1) provides that a Passthrough Entity must file such information with the IRS as the Commissioner may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that the Passthrough Entity and its partners have complied with section 1061 and the regulations and that a Passthrough Entity that has issued an API must furnish to the API Holder, including an Owner Taxpayer, such information at such time and in such manner as is necessary to determine the One Year Gain Amount and the Three Year Gain Amount with respect to the Owner Taxpayer that directly or indirectly holds the API.

Proposed §1.1061-6(a)(2) provides that if a Passthrough Entity does not furnish the information that an Owner Taxpayer needs to determine its Recharac-

terization Amount and meet its reporting requirements, and the Owner Taxpayer is not able to otherwise substantiate all or a part of those amounts to the satisfaction of the Secretary, then (i) the negative adjustments under proposed §1.1061-4(a)(3)(i)(B) necessary to calculate the API One Year Distributive Share Amount will be deemed to equal zero, and (ii) the negative adjustment to the API One Year Distributive Share Amount for purposes of determining the API Three Year Distribution Amount under proposed §1.1061-4(a)(3)(ii)(B) will be deemed to equal zero.

Proposed §1.1061-6(b)(2) provides that a Passthrough Entity that holds an interest in a lower-tier entity and needs information from the lower-tier entity to meet its reporting obligations under the proposed regulations must request such information from that entity by the later of the 30th day after the close of the taxable year to which the information request relates or within 14 days after the date of a request for information from an upper-tier Passthrough Entity and the lower-tier entity must respond by the due date (including extensions) of the Schedule K-1 for the taxable year. Proposed §1.1061-6(b)(2)(vii) provides that a Passthrough Entity that fails to comply with the reporting rules in the proposed regulations or as further required in forms, instructions, or other guidance will be subject to penalties.

One commenter stated that the reporting rules are based on the assumption that there will be a limited number of individuals who are in control and who have access to all relevant factual information. Consequently, the rules are extensive and smaller partnerships and non-controlled partnerships may have difficulty complying without significant cost and expense. The commenter suggested this argued in favor of exempting small partnerships from these rules.

A few commenters stated that lower-tier passthrough entities are not required to furnish information until the due date of their returns and that this deadline does not permit upper-tier entities sufficient time to incorporate lower-tier passthrough entity information into their reporting. Further, the commenter noted that the regulations appear to prevent Owner Taxpayers from excluding anything from the API One Year Distributive Share Amount

even if only part of the information cannot be substantiated. The commenter recommended that for groups of non-controlled entities, the requester should be allowed any reasonable approach to substantiate the information and suggested that issues from non-compliant tiers should be resolved by having the IRS impose failure to furnish penalties on those tiers. Finally, the commenter recommended guidance on how to substantiate unreported amounts.

Several commenters suggested that the information reporting requirements are onerous and that denying exclusions from recharacterization for non-compliance is too harsh a penalty for Owner Taxpayers and upper-tier partnerships who are unable to secure the necessary information from lower-tier partnerships, particularly where an Owner Taxpayer or upper-tier partnership has no control over whether the reporting requirements are met by the lower-tier partnership. One commenter argued that there is no indication in the statute or legislative history that this is what Congress intended. The commenter noted that the TCJA conference report indicates that Congress intended section 6031(b) penalties to apply to a failure to report to partners and those penalties are sufficient to deter non-compliance while not acting to change the character of distributive share items.

A few commenters noted that the reporting requirements will require significant amendments to partnership agreements and reporting systems. These commenters requested that the effective date for the reporting requirements and associated penalties be delayed until at least 12 months after the year end in which the regulations are finalized to give funds and API Holders time to amend their operations and establish proper information reporting systems, particularly in light of the increased reporting requirements resulting from partner tax capital account reporting, Forms K-2 and K-3, the section 163(j) limitation, and other recent guidance.

One commenter suggested that the regulations should provide a de minimis exception to the reporting requirements, especially in tiered partnership arrangements. The commenter suggested that if a limited partner owns less than five percent of a fund, there should be limitations on reporting requirements to those partners,

arguing that information reporting is costly in a tiered fund context and the lower-tiered funds may not want to dedicate the resources to provide the proper reporting for such small fund interests.

The final regulations do not adopt these comments. The reporting rules, including the zero presumptions, are necessary to effectively administer section 1061 and the regulations. The Treasury Department and the IRS note that the amounts required to be reported under the reporting rules may be substantiated by any reasonable means if a Passthrough Entity fails to report the necessary information to the Owner Taxpayer. Similarly, a de minimis rule or an exception for small partnerships would frustrate Owner Taxpayers' ability to correctly determine the Recharacterization Amount and the IRS's ability to administer the statute. For these reasons, the Treasury Department and the IRS also decline to provide a delay in the applicability date for the reporting rules.

The final regulations retain the reporting rules as proposed with minor clarifying changes, including the changes discussed in paragraph III.C.4 of this preamble with respect to QEF reporting. In addition, the final regulations provide that if an Owner Taxpayer requires information from a Passthrough Entity to determine the Section 1061(d) Recharacterization Amount, the Owner Taxpayer should request such information from that entity. The Passthrough Entity is required to provide the information to the extent requested by an API Holder and necessary to determine the Owner Taxpayer's Section 1061(d) Recharacterization Amount. Finally, the final regulations substitute "Commissioner" for "Secretary of the Treasury" in §1.1061-6(a)(2) to avoid any misperception that any office or bureau within the Treasury Department other than the IRS is responsible for examining taxpayers' returns.

#### E. Securities Partnerships

The proposed regulations include an amendment to §1.704-3(e), which provides that a method for aggregating gains and losses by a securities partnership will not be considered reasonable unless it takes into account the application of section 1061. Specifically, the proposed

regulations require partnerships that use the partial or full netting approaches described in §1.704-3(e) to establish accounts to track API Holders' Capital Interest Gains and Losses, Unrealized API Gains and Losses, and API Gains and Losses. A commenter questioned whether these rules were necessary, given the likelihood of hedge fund managers to leave a fund before the three-year holding period expires. Another commenter noted that funds would need to implement sophisticated tracking mechanisms to distinguish between Capital Interest Gains and Losses and API Gains and Losses. The commenter thought that such tracing conflicted with the principles of aggregation provided by §1.704-3(e).

Another commenter recommended that the final regulations confirm that partnerships can change their section 704(c) aggregation method in order to address section 1061 in a manner consistent with the regulations and that any such change would not violate the requirement to use the same aggregation approach once an approach is adopted. The commenter requested that the final regulations provide examples illustrating the intended application of the creation of separate accounts for APIs and capital interests.

The final regulations provide a simplified rule in §1.704-3(e) that states that section 1061 must be taken into account in applying the aggregation rule for securities partnerships, but does not provide a specific method for doing so. The Treasury Department and the IRS continue to study the comments received on this issue and may provide additional guidance in the future.

#### *IV. Additional Areas Under Study*

##### **A. Section 1061(b) Exception**

Section 1061(b) provides that “[t]o the extent provided by the Secretary, [section 1061(a)] shall not apply to income or gain attributable to any asset not held for portfolio investment on behalf of third party investors.” The proposed regulations reserve with respect to the application of section 1061(b). The preamble to the proposed regulations states that the Treasury Department and the IRS generally believe that the section 1061(b) exception is effec-

tively implemented in the proposed regulations with the exception to section 1061 for Passthrough Interest Direct Investment Allocations. The preamble further requested comments on the application of section 1061(b) and whether the proposed regulations' exclusion for Passthrough Interest Direct Investment Allocations properly implements the exception.

One commenter suggested that the Passthrough Interest Direct Investment Allocations would exempt certain family offices from section 1061(a) but stated that the exception is too narrow to account for all types of family offices. The commenter noted that section 1061(b) is not intended to cover family offices managed by a professional investment manager who is not a family member and who receives an API because the family members are third-party investors with respect to the professional investment manager. Several commenters suggested that additional guidance under section 1061(b) is needed for family offices, management companies, and other partnerships that do not hold assets for portfolio investment on behalf of third-party investors. One commenter argued that the Treasury Department and the IRS should not reserve on section 1061(b) because carried interests as used in asset management businesses were the particular focus of Congress as it contemplated carried interest proposals.

One commenter noted that it had recommended prior to the issuance of the proposed regulations that the authority under section 1061(b) should be exercised to confirm that section 1061(a) does not apply to recharacterize income or gain attributable to the value of intangibles, including goodwill, created or used in an ATB. The commenter recognized that the Passthrough Interest Direct Investment Allocation rules in the proposed regulations operate in part to implement an exception for enterprise value, but recommended that final regulations should provide specifically that section 1061(a) does not apply to recharacterize income or gain attributable to enterprise value. Furthermore, the commenter argued that the enterprise value exception should apply to allocations through tiers and should not require allocations in accordance with partner capital accounts if the intangible

asset is not held for portfolio investment on behalf of third-party investors.

As discussed in Part II.A. of this Summary of Comments and Explanation of Revisions, the final regulations modify the rules related to the capital interest exception, including removing the Passthrough Interest Direct Investment Allocation rules. As discussed in Part II.C. of this Summary of Comments and Explanation of Revisions, the final regulations provide that the delayed holding period prong of the Lookthrough Rule does not apply to the disposition of an API to the extent that the gain recognized upon the disposition is attributable to any asset not held for portfolio investment on behalf of third party investors. The Treasury Department and the IRS continue to study the comments regarding section 1061(b) and may address the application of the provision in future guidance, including whether section 1061(a) applies to recharacterize income or gain attributable to enterprise value. The Treasury Department and the IRS request additional comments related to section 1061(b).

##### **B. Small Partnerships**

In the preamble to the proposed regulations, the Treasury Department and the IRS requested comments and suggestions on whether a simplified method for determining and calculating the API Gain or Loss should be provided for small partnerships and if so, the criteria that should be used to determine which partnerships should be eligible to use the simplified method. One commenter stated that a small partnership exception is critically important to the integrity of the entire section 1061 regulatory regime. The commenter also noted that given the burdensome nature of the reporting requirements that could apply to small business taxpayers, a modification of these requirements for either “small partnerships” or “small partners” would appear to be justified. As discussed in the section on reporting requirements, a commenter also recommended a de minimis exception to the reporting requirements for passthrough entities in which a limited partner owns five percent, or less, of a fund. The Treasury Department and the IRS continue to study this issue and may address this in future guidance. The Treasury Department and the IRS request

additional comments and suggestions on whether a simplified method for determining and calculating the API Gain or Loss should be provided for small partnerships and if so, the criteria that should be used to determine which partnerships should be eligible to use the simplified method.

#### V. *Applicability Dates*

The final regulations retain the applicability dates as proposed. Accordingly, the final regulations generally apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. Section 1.1061-3(b)(2) (i) applies to taxable years beginning after December 31, 2017. Section 1.1061-3(b)(2)(ii) applies to taxable years beginning after August 14, 2020. An Owner Taxpayer or Passthrough Entity may choose to apply the final regulations in their entirety to a taxable year beginning after December 31, 2017, provided that they consistently apply the final regulations in their entirety to that year and all subsequent years.

With respect to an API in a partnership with a fiscal year ending after December 31, 2017, section 706 determines the capital gains and losses the Owner Taxpayer includes in income with respect to an API after December 31, 2017. Section 706 provides that the taxable income of a partner for a taxable year includes amounts required by sections 702 and 707(c) with respect to a partnership based on the income, gain, loss, deduction, or credit of a partnership for any taxable year ending within or with the taxable year of the partner. Accordingly, if a calendar year Owner Taxpayer has an API in a fiscal year partnership whose taxable year ends after December 31, 2017, section 1061 applies to the Owner Taxpayer's distributive share of long-term capital gain or loss with respect to the API in calendar year 2018 regardless of whether the partnership disposed of the property giving rise to the gains and losses in the period prior to January 1, 2018. *See* §1.706-1(a).

#### Special Analyses

##### 1. *Regulatory Planning and Review—Economic Analysis*

Executive Orders 12866, 13563, and 13771 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, of reducing costs, of harmonizing rules, and of promoting flexibility.

These regulations have been designated as economically significant under Executive Order 12866 pursuant to the Memorandum of Agreement (April 11, 2018) between the Treasury Department and the Office of Management and Budget (OMB) regarding review of tax regulations.

##### A. *Need for Final Regulations*

These final regulations provide certainty and clarity to taxpayers affected by statutory changes introduced in section 1061 by TCJA. The Treasury Department and the IRS have received questions and comments regarding the meaning of various provisions in section 1061 and issues not explicitly addressed in the statute. The Treasury Department and the IRS have determined that such comments warrant the issuance of further guidance.

##### B. *Background*

Section 1061 of the Internal Revenue Code (Code), enacted by TCJA, characterizes certain long-term capital gains recognized with respect to an API as short-term capital gains. Short-term capital gains are generally taxed at a higher rate than long-term capital gains.

Section 1061 defines an API as an interest in a partnership transferred to or held by the taxpayer in connection with the performance of substantial services by the taxpayer, or any other related person, in any “applicable trade or business” (ATB). Under section 1061 the term ATB encompasses a range of financial service activities. Specifically, an ATB is any activity conducted on a regular, continuous, and substantial basis which consists, in whole or in part, of raising or returning capital, and either (i) investing in (or disposing of)

“specified assets” (or identifying specified assets for such investing or disposition), or (ii) developing specified assets. “Specified assets” are certain securities, certain commodities, real estate held for rental or investment, cash or cash equivalents, options or derivative contracts with respect to any of the foregoing, and an interest in a partnership to the extent of the partnership's proportionate interest in any of the foregoing.

Prior to the TCJA, the Internal Revenue Code made no distinction between capital gains allocated to APIs versus other partnership interests and partnership assets. Generally, the required holding period to obtain the lower long-term capital gains tax rate was one year for all partnership interests and partnership capital assets. Under the new provision, the required holding period for an API must be greater than three years to obtain long-term capital gains treatment.

The Treasury Department and the IRS previously published proposed regulations under section 1061 (“proposed regulations”).

##### C. *Overview of the final regulations*

The final regulations provide taxpayers with definitional and computational guidance regarding the application of section 1061. In particular, the final regulations provide a number of definitions, including the term ‘taxpayer’ for the purpose of determining the existence of an API. Additionally, the regulations clarify the rules for certain exceptions to section 1061, including the exception for capital interests, and provide for an additional exception for bona fide purchases of APIs by an unrelated party who is not a service provider. The final regulations also provide rules for calculating the recharacterized gain amount.

##### D. *Economic analysis*

###### 1. *Baseline*

In this analysis, the Treasury Department and the IRS assess the benefits and costs of the final regulations relative to a no-action baseline reflecting anticipated Federal income tax-related behavior in the absence of these final regulations.

## 2. Summary of Economic Effects

The final regulations provide certainty and consistency in the application of section 1061 by providing definitions and clarifications regarding the statute's terms and rules. An economically efficient tax system generally aims to treat income and expense derived from similar economic decisions consistently across taxpayers and activities in order to reduce incentives for individuals and businesses to make choices based on tax rather than market incentives. In the absence of the guidance provided in these final regulations, taxpayers would bear the burden of interpreting the statute and the chances that different taxpayers might interpret the statute differently would be exacerbated. For example, two similarly situated taxpayers might interpret the statutory provisions pertaining to the definition of taxpayer or the capital interest exception differently, causing one to enter into a partnership that another comparable taxpayer might decline because of a different interpretation of how the income will be treated under section 1061. If this opportunity did not go to the more productive taxpayer, this lack of clarity results in an economically inefficient pattern of activity. An economic loss may also arise if all taxpayers have identical interpretations of the tax treatment of particular income streams under the statute but which differ slightly from the interpretation that Congress intended for these income streams. In this case, guidance provides value by bringing economic decisions closer in line with the intent and purpose of the statute.

The final regulations include multiple substantive changes compared to the proposed regulations. The Treasury Department and the IRS view these changes as favorable to taxpayers, providing more flexibility and reducing burden and complexity. In particular, the final rules governing the capital interest exception are more flexible to better accommodate common business practices, which vary considerably across industries. Compared to the proposed regulations, the final regulations considerably narrow the range of related party transactions triggering 1061 recharacterization, and the associated compliance burden. Finally, compared to the proposed regulations, the Look-

through Rule on the sale of APIs included in the final regulations is a more narrowly targeted anti-abuse rule, only imposing a compliance burden on taxpayers that appear to have engaged in abusive practices with the primary aim of avoiding section 1061(a) recharacterization.

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

## 3. Economic Analysis of Specific Provisions

### a. Provisions Not Substantially Revised from the Proposed Regulations

#### i. Definition of taxpayer

The statute requires taxpayers to make a number of determinations, including the determination of the existence of an API, and the calculation of the section 1061 amount, or amount of long-term gain recharacterized under section 1061. However, the term “taxpayer” is not defined in either section 1061 or in the Conference Report. Comments received by the Treasury Department and IRS highlight the importance of the definition of the term taxpayer for purposes of section 1061. Without guidance, taxpayers could use different approaches to define “taxpayer,” leading otherwise similar taxpayers to experience different degrees of complexity, and to report different recharacterized amounts.

The final regulations include two definitions of taxpayer to address the level at which the determination of the existence of an API is made and the level at which the calculation of the section 1061 amount is made. The final regulations define the Owner Taxpayer as the person generally required to pay tax on the gain or loss with respect to the API. Under the final regulations, the section 1061 calculation is only performed by the person (the Owner Taxpayer) who must pay tax on the gains and losses recognized with respect to the API. The final regulations also introduce the term Passthrough Taxpayer. A Passthrough Taxpayer is an entity that does not itself generally pay tax on capital gains but must determine when an API exists and allocate income, gain, deduction

and loss to its owners. Both the Owner Taxpayer and the Passthrough Taxpayer are treated as taxpayers for the purpose of determining whether an API exists.

The Treasury Department and the IRS considered and rejected two alternative approaches to the definition of taxpayer outlined in received comments, the “aggregate approach” and the “full entity approach”. Under the aggregate approach, a partnership is not treated as a taxpayer for purposes of section 1061. Instead, section 1061 is applied solely to the partners that are ultimately subject to tax on the partnership's items of capital gain and loss. A concern with using this approach for the purpose of determining whether an API exists is that it could incentivize partners to use tiered ownership structures to avoid section 1061 recharacterization. For example, an upper tier partnership may receive an interest in a lower-tier fund in connection with the upper-tier partnership's performance of services in an ATB. Partners of the upper-tier partnership may contend that they did not receive their interest in the upper-tier partnership in connection with the services performed by the upper-tier partnership. Stopping such avoidance strategies would require complex rules and potentially burdensome reporting requirements when tiered ownership structures are involved.

Under the “full entity approach”, the partnership is treated as a taxpayer for purposes of both determining the existence of an API and calculating the section 1061 recharacterization amount. Treating the partnership as a taxpayer for purposes of calculating the section 1061 recharacterization amount was found to be more burdensome than the approach taken in the final regulations for three reasons. First, using the full entity approach for determining the section 1061 recharacterization amount may lead to increased recharacterization of gains under section 1061 because individuals would not be able to net gains and losses across multiple APIs. Second, the administrative burden on both the taxpayer and the IRS would be increased in cases of tiered ownership. Under the full entity approach, a separate section 1061 calculation would be required at each level at which an API is held in a tiered partnership structure. Finally, the full entity approach may add

complexity and burden in cases in which an exception to section 1061 applies, such as if a corporation is a direct or indirect partner. Because corporations are excluded from section 1061, any amount recharacterized at the partnership level would need to be tracked as it is allocated to partners to ensure that corporate or other excepted partners are not subject to the three-year holding period under section 1061.

The Treasury and the IRS have concluded that the chosen alternative, incorporating the concepts of Owner Taxpayer and Passthrough Taxpayer, is less burdensome than other alternatives and provides helpful certainty to taxpayers.

#### ii. Clarification of the treatment of an API purchased by an unrelated party

The statute states that capital gain or loss recognized by a taxpayer on the sale of an API held for more than one year is subject to section 1061. The statute also provides guidance for ongoing treatment under section 1061 when the API is purchased by, or transferred to, a related party or another service provider. However, the statute does not provide guidance for the taxpayer who purchases an API and is neither a service provider to the relevant ATB, nor related to the seller of the API. The final regulations add an exception to section 1061 and provide that the term API does not include an interest in a partnership that would be treated as an API but is held by a bona fide purchaser of the interest who does not currently and has never provided services in the relevant ATB and who is not related to a person who provides services currently or has provided services in the past. By clarifying the treatment of an API that is sold at arm's length, the final regulations reduce uncertainty and compliance burdens for taxpayers entering into these transactions. The Treasury Department and the IRS have determined that this exception is consistent with the purpose of section 1061, which applies to service providers and persons related to service providers and which is not meant to apply to bona fide purchasers of a partnership interest who do not provide services.

The Treasury Department and the IRS considered not providing this exception.

However, it was determined that failure to provide this exception would treat unrelated purchasers of an API in an inequitable fashion, and that continued treatment of the partnership interest as an API would be inconsistent with the purpose of section 1061 because unrelated purchasers did not receive their interest in connection with the performance of substantial services.

#### b. Provisions Substantially Revised from the Proposed Regulations

##### i. Capital interest exception

Section 1061(c)(4)(B) provides that the definition of an API does not include “any capital interest in the partnership which provides the taxpayer with a right to share in partnership capital commensurate with—(i) the amount of capital contributed (determined at the time of receipt of such partnership interest) or (ii) the value of the interest included in income under section 83 upon the receipt or vesting of such interest.” However, the statute does not provide guidance on what it means for a right to share in partnership capital to be “commensurate” with the amount of capital contributed.

The final regulations clarify that allocations are deemed commensurate with capital contributed if, under the partnership agreement, the allocation to an API Holder is calculated in a similar manner as the allocations to similarly situated Unrelated Non-Service Partners. This may be determined on an investment-by-investment or class-by-class basis. To qualify as a benchmark for comparison, the Unrelated Non-Service Partners must hold a significant investment, defined as at least five percent of the partnership. In the absence of these regulations, taxpayers might face confusion, along with substantial compliance cost, in calculating their qualifying capital interest. Further, partners with realized gains would be incentivized to engage in a series of inefficient transactions in order to minimize tax.

The Treasury Department and the IRS considered alternative interpretations of “commensurate with capital contributed.” In particular, the proposed regulations provide that an allocation is “commensurate with capital” if the allocation is based on the relative section 704(b) capital ac-

counts of the partners under the partnership agreement. The proposed regulations then provide multiple rules for calculating an API holder's capital account, including a rule disallowing unrealized API capital gains in calculating the API holder's capital account, and a rule for determining the capital account when an API is held through another partnership. In light of numerous comments, the Treasury Department and the IRS have determined that the proposed regulations were too rigid and were not well suited to the wide variety of common business practices regarding ownership structure, accounting conventions, and compensation arrangements. Specifically, many partnerships subject to section 1061 do not maintain section 704(b) capital accounts. For many other partnerships, the capital account of one partner may relate to economic rights associated with multiple separate investments held by a partnership, while the capital account of another partner may relate to economic rights associated with a separate set of investments held by a partnership. For these reasons, the Treasury Department and the IRS have determined that the section 704(b) capital accounts of partners provide a poor means of measuring commensurate economic capital interest rights.

The proposed regulations also prohibited use of the capital interest exception if a capital contribution was funded with related party loan proceeds. Commenters noted that it is a common business practice in industries subject to Section 1061 for employees to require new partners to make substantial capital contributions, which are often acquired through a loan. This arrangement, designed not to avoid tax but to align the incentives of general partners and limited partners, would be unduly penalized under the proposed regulations, incentivizing firms to choose a less efficient ownership and governance structure. The final regulations amend the rule to allow an individual service provider's capital contributions to be funded with loan proceeds from partners and persons related to partners if the individual service provider is personally liable for the loan, meaning the loan is fully recourse to the individual service provider, the individual service provider has no right to be reimbursed by any person, and no person has

guaranteed the individual service's provider's loan. The Treasury Department and the IRS believe the final rules address abusive avoidance strategies, while imposing less burden on taxpayers engaged in standard business practices relative to not allowing any contributions from proceeds from related part loans to be eligible for the capital interest exception.

#### ii. Lookthrough Rule on sale of APIs

Section 1061(a) provides that if one or more APIs are held by a taxpayer at any time during the taxable year, the excess (if any) of (1) the taxpayer's net long-term capital gain with respect to such interests for such taxable year, over (2) the taxpayer's net long-term capital gain with respect to such interests for that taxable year computed by applying paragraphs (3) and (4) of sections 1222 by substituting "3 years" for "1 year," must be treated as short-term capital gain, notwithstanding section 83 or any election in effect under section 83(b). The House Report explains that section 1061 "imposes a three-year holding period (not the generally applicable one-year holding period) in the case of long-term capital gain from applicable partnership interests." Neither section 1061 nor the Reports, however, explicitly provides what the relevant holding period is for purposes of section 1061(a) for the sale of an API with assets of different holding periods.

The final regulations include a Lookthrough Rule that is triggered if a transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a). Under this Lookthrough Rule, all gain not attributable to assets held for more than three years is subject to recharacterization under section 1061(a). Additionally, the Lookthrough Rule applies if the API disposition would be subject to Section 1061(a) recharacterization using a holding period not beginning until the date that Unrelated Non-Service Partners legally commit to contribute substantial capital to the applicable partnership. Without this rule, fund managers might attempt to avoid the recharacterization of gains by establishing partnerships and leaving them inactive for three years before attracting investment from limited

partners, thereby circumventing Section 1061.

The Treasury Department and the IRS considered and rejected alternative approaches, including applying a simple interest approach, an alternative lookthrough rule (as provided in the proposed regulations), and an underlying assets approach. The simple interest approach looks solely to the holding period in the API, regardless of the length of time the partnership has engaged in substantive investment. This approach might allow taxpayers to avoid section 1061 characterization for long-term capital gains on assets that are not held for the more than three years by the partnership. This result would encourage distortive behavior in investment funds, which might look to create partnerships for different investors solely for tax purposes, relative to the approach adopted in the final regulations. That is, the partners of that investment partnership would not be subject to section 1061 if they had owned their APIs for more than three years, irrespective of how long the investment partnership had been active and attracting capital from outside investors.

Alternatively, the underlying asset, or full lookthrough, approach looks solely to the holding period in the underlying asset (or assets) of the partnership, regardless of whether the underlying asset is sold by the partnership or the API is sold by its owner. The underlying asset approach would be more difficult (and burdensome) for taxpayers to apply (relative to the provision provided in the final regulations) as it would require a determination of the unrealized gain for each asset held by the partnership, even in cases in which a relatively small share of assets by value have a holding period of three years or less.

The proposed regulations included an alternative lookthrough rule applied to the sale of an API if 80% or more of the value of the assets held by the partnership at the time of the API disposition were assets held for three years or less that would produce capital gain or loss subject to section 1061 if disposed of by the partnership. If the lookthrough rule in the proposed regulations applied, a portion of the capital gain on the disposition of the API attributable partnership assets held for three or fewer years would be re-

characterized as short-term capital gain. This alternative was rejected in the final regulations because the calculations required by the proposed lookthrough rule would impose unnecessary compliance burden on individual taxpayers selling an API without any accompanying general economic benefit. The rules requiring partnerships to furnish taxpayers with the relevant information to perform the calculations would also impose undue additional burden on the relevant partnerships. The lookthrough rule provided in the final regulations applies in more limited circumstances, narrowly targeting taxpayers that appear to be engaged in abusive practices to avoid section 1061(a) recharacterization. Therefore, the final regulations provide helpful guidance and certainty for taxpayers, while imposing minimal compliance burden relative to the no-action baseline or alternative regulatory approaches.

#### iii. Treatment of API transfers to Related Parties

Section 1061(d) recharacterizes certain long-term capital gain as short-term capital gain when a taxpayer transfers an API to a related person. While the statute provides a definition of a related person and a general description of the recharacterization amount, numerous commenters expressed uncertainty regarding the scope of transfers subject to section 1061(d), pointing out that although the statutory language of section 1061(d) refers to the transfer of an API, it refers to income inclusion associated with an API transfer that is related to the sale or exchange of partnership assets held for three years or less. Based on the statutory language, commenters expressed the view that section 1061(d) transfers should be limited to taxable transfers.

Although one read of the text of section 1061(d) suggests that the provision can be broadly applied to capture all API transfers, including gifts and other non-recognition transfer, the Treasury Department and the IRS considered and rejected applying section 1061(d) to nontaxable transfers. Applying section 1061(d) to nontaxable transfers would impose income recognition on gifts including an API, where no income recognition is im-

posed on otherwise similar gifts, creating a tax disadvantage for gifts including an API. Instead, the Treasury and the IRS have determined that the section 1061(d) statute is better read as a recharacterization provision that looks to how much of the taxpayer's long-term capital gain upon the sale of an API is attributable to the sale or exchange of any asset held for three years or less and that the provision's use of the word "transfer" does not supersede application of the sale or exchange requirement in the statute.

## II. Paperwork Reduction Act

A. Collection of information in §1.1061-6(a) on the Owner Taxpayer is on existing forms

The collection of information in §1.1061-6(a) requires an Owner Taxpayer to file such information with the IRS as the Commissioner may require in forms, instructions and other published guidance as is necessary for the IRS to determine that the taxpayer has properly complied with section 1061 and the Section 1061 Regulations. This information is necessary for the IRS to determine that the Owner Taxpayer has properly complied with section 1061. In general, the Owner Taxpayer is

an individual and the Owner Taxpayer's Recharacterization Amount and Section 1061(d) Recharacterization Amount will be required to be reported to the IRS as short-term capital gain on Schedule D, "Capital Gains and Losses," of the Form 1040, "U.S. Individual Income Tax Return." Less frequently, the Owner Taxpayer is a trust and the Owner Taxpayer's Recharacterization Amount and Section 1061(d) Recharacterization Amount will be required to be reported to the IRS as short-term capital gain on Schedule D, "Capital Gains and Losses," of the Form 1041, "U.S. Income Tax Return for Estates and Trusts."

The current status of the Paperwork Reduction Action submission related to §1.1061-6(a) is provided in the following table. The burdens associated with the collection of information from the Owner Taxpayer to comply with section 1061 are included in the aggregate burden estimates for Form 1040 under OMB control number 1545-0074 and Form 1041 under OMB control number 1545-0092. The overall burden estimates provided in OMB Control Number 1545-0074 represents a total estimated burden time, including all other related forms and schedules for individuals, of 1.784 billion hours and total estimated monetized costs of

\$31.74 billion (in 2017 dollars). The overall burden estimates provided in OMB Control Number 1545-0092 represents a total estimated burden time, including all other forms and schedules for trusts and estates of 307.8 million hours and total estimated monetized costs of \$9.95 billion (in 2016 dollars). These amounts are aggregate amounts that relate to all information collections associated with the applicable OMB control numbers, and will in the future include, but not isolate, the estimated burden of Owner Taxpayers as a result of the information collections in the regulations. No burden estimates specific to the final regulations are currently available. The Treasury Department and IRS have not estimated the burden, including that of any new information collections, related to the requirements under the final regulations. Those estimates would capture both changes made by the TCJA and those that arise out of discretionary authority exercised in the regulations. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the collection of information applicable to the Owner Taxpayer in these regulations. In addition, when available, drafts of IRS forms are posted for comment at [www.irs.gov/draftforms](http://www.irs.gov/draftforms).

| Form                                | Type of Filer                        | OMB Number(s) | Status  |
|-------------------------------------|--------------------------------------|---------------|---|
| Form 1040<br>(Including Schedule D) | Individual<br>(NEW Model)            | 1545-0074     | Published in the Federal Register on 9/30/19. Comment period closed on 11/29/19. 84 FR 51712. Thirty-day notice published on 12/18/19. 84 FR 69458. Approved by the Office of Information and Regulatory Affairs (OIRA) on 1/30/20. |
| Form 1041<br>(Including Schedule D) | Trusts and Estates<br>(Legacy Model) | 1545-0092     | Published in the Federal Register on 4/4/2018. 83 FR 14552. Public comment period closed 6/4/2018. Thirty-day notice published on 9/27/18. 83 FR 48894. Approved by OIRA on 5/8/19.   |

B. Collection of information on Passthrough Entities in §1.1061-6(b) and (c) on existing forms

### 1. Passthrough Entities

The collection of information in §1.1061-6(b) requires a Passthrough Entity that has issued an API to furnish

to the API Holder, including the Owner Taxpayer, such information at such time and in such manner as the Commissioner may require in forms, instructions, and other published guidance as is necessary to determine the One Year Gain amount and the Three Year Gain Amount with respect to an Owner Taxpayer. This includes: (i) the API One Year Distribu-

tive Share Amount and the API Three Year Distributive Share Amount (as determined under §1.1061-4); (ii) Capital gains and losses allocated to the API Holder that are excluded from section 1061 under §1.1061-4(b)(7); (iii) Capital Interest Gains and Losses allocated to the API Holder (as determined under §1.1061-3(c)); (iv) In the case of a dis-

position by the API Holder of an interest in the Passthrough Entity during the taxable year, any information required by the API Holder to properly take the disposition into account under section 1061, including information necessary to apply the Lookthrough Rule and to determine its Capital Interest Disposition Amount and any information necessary to determine an Owner Taxpayer's Section 1061(d) Recharacterization Amount. The regulations seek to minimize the information that a Passthrough Entity is required to automatically furnish annually. In some cases, an upper-tier Passthrough Entity may be an API Holder in a lower-tier Passthrough Entity, and the information furnished by the lower-tier Passthrough Entity to the upper-tier Passthrough Entity may not be sufficient for the upper-tier Passthrough Entity to meet its reporting obligations under the regulations. In this case, the regulations require the lower-tier Passthrough Entity to furnish information to the upper-tier Passthrough Entity if requested. Thus, if an upper-tier Passthrough Entity in a tiered entity structure holds an interest in a lower-tier Passthrough Entity and it needs information from the lower-tier Passthrough Entity to comply with its obligation to furnish information under the regulations, it must request information from the lower-tier entity and the lower-tier entity must furnish the requested information. This passing of information upon request between the tiers of entities is necessary to minimize the quantity of information required to be annually furnished by a Passthrough Entity and because each Passthrough Entity in a tiered entity arrangement is the only entity that has access to the information that is required to be furnished. The collection of information in the regulations is necessary to ensure that the Owner Taxpayer receives information sufficient to correctly calculate its Recharacterization Amount under section 1061.

## 2. RICs and REITs

Section 1.1061-6(c) permits a RIC or a REIT that reports or designates all or a part of a dividend as a capital gain dividend, to disclose additional information to their shareholders for purposes of section

1061. The furnishing of this information may allow a Passthrough Entity to include a portion of the capital gain dividend in the API Three Year Distributive Share amount furnished to API Holders and may ultimately enable an Owner Taxpayer to reduce its Recharacterization Amount under the regulations.

### 3. Table for collections of information in §1.1061-6(b) and (c)

The collection of information with respect to §1.1061-6(b) and (c) is provided in the following table. In the case of a Passthrough Entity that is a partnership, the information will be required to be furnished as an attachment to the Schedule K-1, "Partner's Share of Income, Deduction, Credit, Etc." of Form 1065, "U.S. Return of Partnership Income." In the case of a Passthrough Entity that is an S corporation, the information will be required to be furnished as an attachment to the Schedule K-1, "Shareholder's Share of Income, Deductions, Credit, Etc." of Form 1120-S, "U.S. Income Tax Return for an S Corporation." The burdens associated with the collection of information from the Passthrough Entities will be included in the aggregate burden estimates for the Form 1065 and the Form 1120S under OMB control number 1545-0123. The overall burden estimates provided in OMB Control Number 1545-0123 represents a total estimated burden time, including all others related forms and schedules, of 3.344 billion hours and total estimated monetized costs of \$61.558 billion (in 2019 dollars). The burden estimates provided in OMB Control Number 1545-0123 are aggregate amounts that relate to all information collections associated with the applicable OMB control number, and will in the future include, but not isolate, the Passthrough Entities' estimated burden as a result of the information collections in the proposed regulations.

In the case of a Passthrough Entity that is a trust or estate, the information will be required to be furnished as an attachment to the Schedule K-1, "Beneficiary's Share of Income, Deductions, Credit, Etc." of Form 1041, "U.S. Income Tax Return for Estates and Trusts." The burdens associated with the collection of information

from a Passthrough Entity that is a trust or estate will be included in the aggregate burden estimates for the Form 1041 OMB control number 1545-0092. The overall burden estimates provided in OMB Control Number 1545-0092 represents a total estimated burden time, including all other forms and schedules for trusts and estates of 307.8 million hours and total estimated monetized costs of \$9.95 billion (in 2016 dollars). The burden estimates provided in OMB Control Number 1545-0092 are aggregate amounts that relate to all information collections associated with the applicable OMB control number, and will in the future include, but not isolate, the Passthrough Entities' estimated burden as a result of the information collections in the regulations.

In the case of RICs and REITs the information will be furnished in connection with the Form 1099-DIV, "Dividends and Distributions." The burden estimates associated with the collection of information from RICs and REITs will be included in the aggregate burden estimated for the Form 1099-DIV under OMB Control Number 1545-0110. The overall burden estimates provided in OMB Control Number 1545-0110 represents a total estimated burden time of 32,119,195 hours and total estimated monetized costs of \$ 1.64 billion (in 2016 dollars). The burden estimates provided in OMB Control Number 1545-0110 relate to all information collections associated with the applicable OMB Control Number, and will in the future include, but not isolate, the RIC and REIT estimated burden as a result of the information collections in the regulations.

The Treasury Department and IRS have not estimated the burden, including that of any new information collections, related to the requirements under the regulations. Those estimates would capture both changes made by the TCJA and those that arise out of the discretionary authority exercised in the regulations. The Treasury Department and the IRS request comments on all aspects of information collection burdens related to the collection of information applicable to the Passthrough Entities in the regulations. In addition, when available, drafts of IRS Forms and the applicable instructions are posted for comment at <https://www.irs.gov/pub/irs-dft/>.

| Form  | Type of Filer                     | OMB Number(s) | Status  |
|---|-----------------------------------|---------------|---|
| Form 1041 (including Schedule K-1)  | Trusts and Estates (Legacy Model) | 1545-0092     | Published in the Federal Register on 4/4/2018. 83 FR 14552. Public comment period closed 6/4/2018. Thirty-day notice published on 9/27/18. 83 FR 48894. Approved by OIRA on 5/8/19.   |
| Form 1065 (including Schedule K-1)  | Business (NEW Model)              | 1545-0123     | Sixty-day notice published in the Federal Register on 9/30/19. Public Comment period closed on 11/29/19. 84 FR 51718. Thirty-day notice published in the Federal Register on 12/19/19. Public Comment period closed on 1/21/20. 84 FR 69825. Approved by OIRA on 1/30/20. |
| Form 1120S (Including Schedule K-1)   | Business (New Model)              | 1545-0123     | Sixty-day notice published in the Federal Register on 9/30/19. Public Comment period closed on 11/29/19. 84 FR 51718. Thirty-day notice published in the Federal Register on 12/19/19. Public Comment period closed on 1/21/20. 84 FR 69825. Approved by OIRA on 1/30/20. |
| Form 1099-DIV   | (Legacy Model)                    | 1545-0110     | Sixty-day notice published in the Federal Register on 9/19/19. Public comment period closed 11/18/19. 84 FR 49379. Thirty-day notice published in the Federal Register on 12/20/19. 84 FR 70269.  |
| Link: <a href="https://www.federalregister.gov/documents/2018/05/23/2018-10981/proposed-collection-comment-request-for-form-1099-div">https://www.federalregister.gov/documents/2018/05/23/2018-10981/proposed-collection-comment-request-for-form-1099-div</a> |                                   |               |   |

**C. Chart Showing Number of Respondents Regarding Existing Forms**

The following chart shows the estimated number of returns that are expected to have attachments providing additional in-

formation with respect to section 1061. As noted previously, Owner Taxpayers will be required to provide section 1061 information on an attachment to Schedules D for Forms 1040 and 1041. Passthrough Taxpayers will be required to report section

1061 on Forms 1041, 1065, and 1120S to the IRS and to furnish information to their API Holders on attachments to the respective K-1s. RICs and REITs may voluntarily report additional information at an attachment to Form 1099-DIV.

|                              |        |
|------------------------------|--------|
| Schedule D Form 1040         | 20,475 |
| Schedule D Form 1041         | 2,275  |
| Schedule K Form 1065         | 28,500 |
| Schedule K-1s Form 1065      | 57,000 |
| Schedule K Form 1120S        | 1,500  |
| Schedule K-1s Form 1120      | 1,000  |
| Form 1099-DIV filed by REITs | 836    |
| Form 1099-DIV filed by RICs  | 3,880  |

**D. Voluntary Collection of Information in §1.1061-6(d) on PFIC shareholder will be added to existing OMB Control Number for PFIC Information Retention**

Section 1.1061-6(d) permits a PFIC with respect to which the shareholder is

an API Holder who has a QEF election is in effect for the taxable year to provide additional information to the shareholder to determine the amount of the shareholder's inclusion that would be included in the API One Year Distributive Share Amount and the API Three Year Distributive Share

Amount. If the PFIC furnishes this information to the shareholder, the shareholder must retain a copy of this information along with the other information required to be retained under §1.1295-1(f)(2)(ii). The burden associated with retaining this additional information will be includ-

ed in the aggregate burden estimates for §1.1295-1(f) under OMB Control Number 1545-1555. 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 and records related to the 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 these final regulations will not have a significant economic impact on a substantial number of small entities within the meaning of section 601(6) of the Regulatory Flexibility Act. These regulations generally only impact investment funds that have capital gains and losses that derive from the disposition of assets that have a holding period of more than one year but not more than three years. Investment funds are considered small business if they have annual average receipts of \$41.5 million or less (13 CFR part 121). The rule may affect a substantial number of small entities, but data are not readily available to assess how many entities will be affected.

The Treasury Department and the IRS received no actionable comments on the impact that the proposed regulations would have on small entities. Although certain commenters requested that partnerships with an unspecified amount of limited assets be excepted from the application of the statutory rules of section 1061, these commenters did not provide any data to demonstrate that any burden would be significant. Similarly, a commenter requested an exception to the reporting requirements for passthrough entities in which a limited partner owns 5 percent or less of a fund but did not quantify the burden. In addition, the final regulations adopt other comments that limit the general burden of the regulations to all entities, including small entities.

Even if a substantial number of small entities are affected, the economic impact of these regulations on small entities is not significant. The regulations provide taxpayers with definitional and computational guidance regarding the application of section 1061. The impact of the regulations is to impose an additional reporting obligation that applies only with respect to the sale of assets held for more than one year but not more than three years. The Treasury Department and the IRS recognize that this reporting obligation may increase, at least to some extent, the tax preparation burden for affected taxpayers beyond that imposed by the statute. This reporting obligation generally will only apply to a minority of the asset dispositions by an entity. The entity will also have a reporting obligation in certain circumstances regarding the disposition of an API, but the extent of the reporting obligation depends on the number of assets disposed by the entity and their holding periods. The information reported is readily available to taxpayers and reported on forms already in use beginning with the 2019 taxable year such as Schedule D to IRS Form 1065. Finally, some taxpayers may find they need an initial investment of time to read and understand these regulations at an approximate cost of \$95/hour and an estimated time of ten hours. Accordingly, the Secretary certifies that these regulations will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f), the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comment on its impact on small businesses. No comments were received from the Chief Counsel for the Office of Advocacy of the Small Business Administration.

### IV. *Unfunded Mandates Reform Act*

Section 202 of the Unfunded Mandates Reform Act of 1995 requires that agencies assess anticipated costs and benefits and take certain other actions before issuing a final rule that includes any Federal mandate that may result in expenditures in any one year by a state, local, or tribal government, in the aggregate, or by the private

sector, of \$100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

### V. *Executive Order 13132: Federalism*

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

### VI. *Congressional Review Act*

The Administrator of the Office of Information and Regulatory Affairs of the Office of Management and Budget has determined that this Treasury decision is a major rule for purposes of the Congressional Review Act (5 U.S.C. 801 et seq.). Under 5 U.S.C. 801(a)(3), a major rule takes effect 60 days after the rule is published in the Federal Register.

Notwithstanding this requirement, 5 U.S.C. 808(2) allows agencies to dispense with the requirements of 5 U.S.C. 801 when the agency for good cause finds that such procedure would be impracticable, unnecessary, or contrary to the public interest and the rule shall take effect at such time as the agency promulgating the rule determines. Pursuant to 5 U.S.C. 808(2), the Treasury Department and the IRS find, for good cause, that a 60-day delay in the effective date is contrary to the public interest.

Following the enactment of section 1061 by the TCJA, the Treasury Department and the IRS published the proposed regulations to provide certainty to taxpayers. In particular, as demonstrated by the wide variety of public comments in response to the proposed regulations received, taxpayers continue to express un-

certainly regarding the proper application of the statutory rules under section 1061. This is especially the case for taxpayers in the trade or business of operating investment funds, which may be unwilling to engage in certain commercial transactions without the additional clarity provided by these final regulations. Additionally, various rules contained within these regulations attempt to curb certain abusive transactions designed to avoid the application of section 1061 and an earlier effective date is necessary to address these abusive transactions. Accordingly, the Treasury Department and the IRS have determined that the rules in this Treasury decision will take effect on the date of filing for public inspection in the Federal Register.

### Statement of Availability of IRS Documents

Notice 2018-18, 2018-2 I.R.B. 443 (in addition to any other revenue procedures or revenue rulings, etc. cited in this preamble) is published in the Internal Revenue Bulletin (or Cumulative Bulletin) and is available from the Superintendent of Documents, U.S. Government Publishing Office, Washington, DC 20402, or by visiting the IRS website at <http://www.irs.gov>.

### Drafting Information

The principal authors of these regulations are Kara K. Altman, Sonia K. Kothari, and Wendy L. Kribell of the Office of Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and record-keeping requirements.

### Amendment to the Regulations

Accordingly, 26 CFR Part 1 is amended as follows:

#### PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 is amended by adding entries for

§§1.1061-0, 1.1061-1, 1.1061-2, 1.1061-3, 1.1061-4, 1.1061-5, and 1.1061-6 in numerical order to read in part as follows:

- Authority: 26 U.S.C. 7805 \* \* \*
- Section 1.1061-0 added under 26 U.S.C. 1061(f).
- Section 1.1061-1 added under 26 U.S.C. 1061(f).
- Section 1.1061-2 added under 26 U.S.C. 1061(f).
- Section 1.1061-3 added under 26 U.S.C. 1(h)(9) and 1061(f).
- Section 1.1061-4 added under 26 U.S.C. 1061(f).
- Section 1.1061-5 added under 26 U.S.C. 1061(f).
- Section 1.1061-6 added under 26 U.S.C. 1061(f).
- \* \* \* \* \*

**Par. 2.** Section 1.702-1 is amended by adding a sentence at the end of paragraph (a)(2) and adding paragraph (g) to read as follows.

#### §1.702-1 Income and credits of partner.

- (a) \* \* \* \* \*
- (2) \* \* \* Each partner subject to section 1061 must take into account gains and losses from sales of capital assets held for more than one year as provided in section 1061 and §§1.1061-1 through 1.1061-6.
- \* \* \* \* \*

(g) *Applicability date.* The last sentence of paragraph (a)(2) of this section applies for the taxable years beginning on or after January 19, 2021.

**Par. 3.** Section 1.704-3 is amended by:

1. In paragraph (e)(3)(vi)(B), remove the word “and” at the end of the paragraph;
2. Redesignating paragraph (e)(3)(vi)(C) as paragraph (e)(3)(vi)(D);
3. Adding new paragraph (e)(3)(vi)(C); and
4. Revising the heading and first sentence of paragraph (f) and adding a sentence to the end of paragraph (f).

The additions and revisions read as follows:

#### §1.704-3 Contributed property.

- \* \* \* \* \*
- (e) \* \* \* \* \*
- (3) \* \* \* \* \*
- (vi) \* \* \* \* \*

(C) With respect to any person who directly or indirectly holds an Applicable Partnership Interest, as defined in §1.1061-1(a)(1), take into account the application of section 1061 with respect to such interest in an appropriate manner; and

\* \* \* \* \*

(f) *Applicability dates.* With the exception of paragraphs (a)(1), (a)(8)(ii) and (iii), (a)(10) and (11), and (e)(3)(vi)(C) of this section, and of the last sentence of paragraph (d)(2) of this section, this section applies to properties contributed to a partnership and to revaluations pursuant to §1.704-1(b)(2)(iv)(f) or (s) on or after December 21, 1993.

\* \* \* Paragraph (e)(3)(vi)(C) of this section applies to taxable years beginning on or after January 19, 2021.

\* \* \* \* \*

**Par. 4.** Sections 1.1061-0 through 1.1061-6 are added before the undesignated center heading “Changes to Effectuate F.C.C. Policy” to read as follows:

- Sec.
- \* \* \* \* \*
- 1.1061-0 Table of contents.
- 1.1061-1 Section 1061 definitions.
- 1.1061-2 Applicable partnership interests and applicable trades or businesses.
- 1.1061-3 Exceptions to the definition of an API.
- 1.1061-4 Section 1061 computations.
- 1.1061-5 Section 1061(d) transfers to related persons.
- 1.1061-6 Reporting rules.
- \* \* \* \* \*

#### §1.1061-0 Table of contents.

This section lists the captions that appear in §§1.1061-1 through 1.1061-6.

#### §1.1061-1 Section 1061 definitions.

- (a) Definitions.
- (b) Applicability date.

#### §1.1061-2 Applicable partnership interests and applicable trades or businesses.

- (a) API rules and examples.
- (1) Rules.
- (i) An API remains an API.
- (ii) Application of section 1061 to Unrealized API Gains and Losses.

(iii) API Gains and Losses retain their character.

(iv) Substantial services by the Owner Taxpayer, Passthrough Taxpayer or any Related Person.

(v) Grantor trusts and entities disregarded as separate from their owners.

(2) Examples.

(b) Application of the ATB Activity Test.

(1) In general.

(i) Rules for applying the ATB Activity Test.

(A) Aggregate Specified Actions taken into account.

(B) Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year.

(C) Combined conduct by multiple related entities taken into account.

(ii) Developing Specified Assets.

(iii) Partnerships.

(2) Examples.

(c) Applicability date.

#### *§1.1061-3 Exceptions to the definition of an API.*

(a) A partnership interest held by an employee of another entity not conducting an ATB.

(b) Partnership interest held by a corporation.

(1) In general.

(2) Treatment of interests held by an S corporation or a qualified electing fund.

(c) Capital Interest Gains and Losses.

(1) In general.

(2) Capital Interest Gains and Losses defined.

(3) General rules for determining Capital Interest Allocations.

(i) Commensurate with capital contributed.

(ii) In a similar manner.

(A) Relevant factors.

(B) Clear identification requirement.

(iii) Reinvestment of API Gain.

(iv) Unrelated Non-Service Partner requirement.

(v) Proceeds of certain loans not taken into account for Capital Interest Allocation purposes.

(A) General rule.

(B) Recourse liability.

(vi) Items that are not included in Capital Interest Allocations.

(4) Capital Interest Disposition Amounts.

(i) In general.

(ii) Determination of the Capital Interest Disposition Amount.

(5) Capital Interest Allocations made by a Passthrough Entity that is an API Holder.

(6) Examples.

(d) Partnership interest acquired by purchase by an unrelated person.

(1) Acquirer not a Related Person.

(2) Section 1061(d) not applicable.

(3) Acquirer not a service provider.

(e) [Reserved]

(f) Applicability date.

(1) General rule.

(2) Partnership interest held by an S corporation.

(3) Partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect.

#### *§1.1061-4 Section 1061 computations.*

(a) Computations.

(1) Recharacterization Amount.

(2) One Year Gain Amount and Three Year Gain Amount.

(i) One Year Gain Amount.

(ii) Three Year Gain Amount.

(3) API One Year Distributive Share Amount and API Three Year Distributive Share Amount.

(i) API One Year Distributive Share Amount.

(ii) API Three Year Distributive Share Amount.

(4) API One Year Disposition Amount and API Three Year Disposition Amount.

(i) API One Year Disposition Amount.

(ii) API Three Year Disposition Amount.

(b) Special rules for calculating the One Year Gain Amount and the Three Year Gain Amount.

(1) One Year Gain Amount equals zero or less.

(2) Three Year Gain Amount equals zero or less.

(3) One Year Gain Amount less than Three Year Gain Amount.

(4) Installment sale gain.

(5) Special rules for capital gain dividends from regulated investment companies (RICs) and real estate investment trusts (REITs).

(i) API One Year Distributive Share Amount.

(ii) API Three Year Distributive Share Amount.

(iii) Loss on sale or exchange of stock.

(6) Pro rata share of qualified electing fund (QEF) net capital gain.

(i) One year QEF net capital gain.

(ii) Three year QEF net capital gain adjustment.

(7) Items not taken into account for purposes of section 1061.

(8) Holding period determination.

(i) Determination of holding period for purposes of the Three Year Gain Amount.

(ii) Relevant holding period.

(9) Lookthrough Rule for certain API dispositions.

(i) Determination that the Lookthrough Rule applies.

(A) In general.

(B) Determination that the Lookthrough Rule applies to the disposition of a Passthrough Interest.

(ii) Application of the Lookthrough Rule.

(10) Section 83.

(c) Examples.

(1) Recharacterization rules.

(2) Special rules examples.

(d) Applicability date.

#### *§1.1061-5 Section 1061(d) transfers to related persons.*

(a) In general.

(b) Transfer.

(c) Section 1061(d) Recharacterization Amount.

(d) Special rules.

(e) Section 1061(d) Related Person.

(f) Examples.

(g) Applicability date.

#### *§1.1061-6 Reporting rules.*

(a) Owner Taxpayer filing requirements.

(1) In general.

(2) Failure to obtain information.

(b) Passthrough Entity filing requirements and reporting.

(1) Requirement to file information with the IRS and to furnish information to API Holder.

(2) Requirement to request, furnish, and file information in tiered structures.

(i) Requirement to request information.  
(ii) Requirement to furnish and file information.

(iii) Timing of requesting and furnishing information.

(A) Requesting information.

(B) Furnishing information.

(iv) Manner of requesting information.

(v) Recordkeeping requirement.

(vi) Passthrough Entity is not furnished information to meet its reporting obligations under paragraph (b)(1) of this section.

(vii) Filing requirements.

(viii) Penalties.

(c) Regulated investment company (RIC) and real estate investment trust (REIT) reporting.

(1) Section 1061 disclosures.

(i) One Year Amounts Disclosure.

(ii) Three Year Amounts Disclosure.

(2) Pro rata disclosures.

(3) Report to shareholders.

(d) Qualified electing fund (QEF) reporting.

(e) Applicability date.

#### *§1.1061-1 Section 1061 definitions.*

(a) *Definitions.* The following definitions apply solely for purposes of this section and §§1.1061-2 through 1.1061-6.

*API Gains and Losses* are any long-term capital gains and capital losses with respect to an API and include:

(i) The *API One Year Distributive Share Amount* as defined in §1.1061-4(a)(3)(i);

(ii) The *API Three Year Distributive Share Amount* as defined in §1.1061-4(a)(3)(ii);

(iii) The *API One Year Disposition Amount* as defined in §1.1061-4(a)(4)(i);

(iv) The *API Three Year Disposition Amount* as defined in §1.1061-4(a)(4)(ii); and

(v) Capital gains or losses from the disposition of Distributed API Property.

*API Holder* is a person who holds an API.

*Applicable Partnership Interest (API)* means any interest in a partnership which, directly or indirectly, is transferred to (or is held by) an Owner Taxpayer or Passthrough Taxpayer in connection with the performance of substantial services by the Owner Taxpayer or by a Passthrough

Taxpayer, or by any Related Person, including services performed as an employee, in any ATB unless an exception in §1.1061-3 applies. For purposes of defining an API under this section and section 1061 of the Internal Revenue Code (Code), an interest in a partnership also includes any financial instrument or contract, the value of which is determined in whole or in part by reference to the partnership (including the amount of partnership distributions, the value of partnership assets, or the results of partnership operations). An Owner Taxpayer and a Passthrough Taxpayer can hold an API directly or indirectly through one or more Passthrough Entities.

*Applicable Trade or Business (ATB)* means any activity for which the ATB Activity Test with respect to Specified Actions is met, and includes all Specified Actions taken by Related Persons, including combining activities occurring in separate partnership tiers or entities as one ATB.

*ATB Activity Test* has the meaning provided in §1.1061-2(b)(1).

*Capital account* means a capital account maintained under §1.704-1(b)(2)(iv) or similar principles.

*Capital Interest Allocations* means, with respect to a partnership, allocations of long-term capital gain or loss made under the partnership agreement to an API Holder and to Unrelated Non-Service Partners based on such partners' capital contributed with respect to the partnership to the extent such allocations otherwise meet the requirements of §1.1061-3(c). With respect to other Passthrough Entities, the principles of this definition apply.

*Capital Interest Disposition Amount* has the meaning provided in §1.1061-3(c)(4).

*Capital Interest Gains and Losses* has the meaning provided in §1.1061-3(c)(2).

*Distributed API Property* means property distributed by a Passthrough Entity to an API Holder with respect to an API if the holding period, as determined under sections 735 and 1223, in the API Holder's hands is three years or less at the time of disposition of the property by the API Holder.

*Indirect API* means an API that is held through one or more Passthrough Entities.

*Investing or Developing Actions* means actions involving either—

(i) Investing in (or disposing of) Specified Assets (or identifying Specified Assets for such investing or disposition); or

(ii) Developing Specified Assets (see §1.1061-2(b)(1)(ii)).

*Lookthrough Rule* means the recharacterization rule described in §1.1061-4(b)(9).

*One Year Gain Amount* has the meaning provided in §1.1061-4(a)(2)(i).

*Owner Taxpayer* means the person subject to Federal income tax on net gain with respect to an API or an Indirect API during the taxable year, including an owner of a Passthrough Taxpayer unless the owner of the Passthrough Taxpayer is a Passthrough Entity itself or is excepted under §1.1061-3(a), (b), or (d).

*Passthrough Entity* means a partnership, trust, estate, S corporation described in §1.1061-3(b)(2)(i), or passive foreign investment company described in §1.1061-3(b)(2)(ii).

*Passthrough Interest* means an interest in a Passthrough Entity that represents in whole or in part an API.

*Passthrough Taxpayer* means a Passthrough Entity that is treated as a taxpayer for the purpose of determining the existence of an API.

*Raising or Returning Capital Actions* means actions involving raising or returning capital but does not include Investing or Developing Actions.

*Recharacterization Amount* has the meaning provided in §1.1061-4(a)(1).

*Related Person* means a person or entity who is treated as related to another person or entity under sections 707(b) or 267(b).

*Relevant ATB* means the ATB in which services were provided and in connection with which an API is held or was transferred.

*Section 1061(d) Recharacterization Amount* has the meaning provided in §1.1061-5(c).

*Section 1061(d) Related Person* has the meaning provided in §1.1061-5(e).

*Section 1061 Regulations* means the provisions of this section and §§1.1061-2 through 1.1061-6.

*Specified Actions* means the combination of Raising or Returning Capital Actions and Investing or Developing Actions.

*Specified Assets* means—

(i) Securities, including interests in partnerships qualifying as securities (as defined in section 475(c)(2) without regard to the last sentence thereof);

(ii) Commodities (as defined in section 475(e)(2));

(iii) Real estate held for rental or investment;

(iv) Cash or cash equivalents; and

(v) An interest in a partnership to the extent that the partnership holds Specified Assets. See §1.1061-2(b)(1)(iii).

(vi) Specified Assets include options or derivative contracts with respect to any of the items provided in paragraphs (i) through (v) of this definition.

*Three Year Gain Amount* has the meaning provided in §1.1061-4(a)(2)(ii).

*Unrealized API Gains and Losses* means, with respect to a Passthrough Entity's assets, all unrealized capital gains and losses that would be:

(i) Realized if those assets were disposed of for fair market value in a taxable transaction on the relevant date; and

(ii) Allocated to an API Holder with respect to its API, taking into account the principles of section 704(c).

*Unrelated Non-Service Partners* means partners who do not (and did not) provide services in the Relevant ATB and who are not (and were not) Related Persons with respect to any API Holder in the partnership or any person who provides or has provided services in the Relevant ATB.

(b) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they consistently apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

*§1.1061-2 Applicable partnership interests and applicable trades or businesses.*

(a) *API rules and examples—(1) Rules—(i) An API remains an API.* Once a partnership interest qualifies as an API, the partnership interest remains an API unless and until the requirements of one of the exceptions to qualification of a partnership interest as an API, set forth in §1.1061-3, are satisfied.

(ii) *Application of section 1061 to Unrealized API Gains and Losses.* Unrealized API Gains and Losses are API Gains and Losses subject to section 1061 when the gains and losses are realized and recognized. Unrealized API Gains and Losses do not lose their character as such until they are recognized.

(iii) *API Gains and Losses retain their character.* API Gains and Losses retain their character as API Gains and Losses as they are allocated from one Passthrough Entity to another Passthrough Entity and then to the Owner Taxpayer.

(iv) *Substantial services by an Owner Taxpayer, Passthrough Taxpayer, or any Related Person.* If an interest in a partnership is transferred to or held by an Owner Taxpayer, Passthrough Taxpayer, or any Related Person in connection with the performance of services, the Owner Taxpayer, the Passthrough Taxpayer, or the Related Person is presumed to have provided substantial services for purposes of section 1061.

(v) *Grantor trusts and entities disregarded as separate from their owners.* A trust wholly described in subpart E, part I, subchapter J, chapter 1 of the Internal Revenue Code (that is, a grantor trust), a qualified subchapter S subsidiary described in section 1361(b)(3), and an entity with a single owner that is treated as disregarded as an entity separate from its owner under any provision of the Internal Revenue Code or any part of 26 CFR (including §301.7701-3 of this chapter) are disregarded for purposes of the Section 1061 Regulations.

(2) *Examples.* The following examples illustrate the provisions of this paragraph (a).

(i) *Example 1: API.* (A) A is the general partner of PRS, a partnership, and provides services to PRS. A is engaged in an ATB as defined in §1.1061-1(a). PRS transfers a PRS profits interest to A in connection with A's performance of substantial services with respect to PRS's ATB. A's interest in PRS is an API.

(B) After 6 years, A retires and is no longer engaged in an ATB and does not perform any services with respect to its ATB and with respect to PRS. However, A retains the API in PRS. PRS continues to acquire new capital assets and to allocate gain to A from the disposition of those assets. Under paragraph (a)(1)(i) of this section, A's interest in PRS remains an API after A retires.

(ii) *Example 2: Contribution of an API to a partnership.* Individuals A, B, and C each directly hold APIs in PRS, a partnership. A and B form

a new partnership, GP, and contribute their APIs in PRS to GP. Following the contribution, each of A and B holds an Indirect API because each of A and B now indirectly holds an API in PRS through GP, a Passthrough Entity. Each of A's and B's interests in GP is a Passthrough Interest because each of A's and B's interest in GP represents an Indirect API.

(iii) *Example 3: Passthrough Interest, Indirect API, Passthrough Taxpayer.* Each of A, B, and C provides services to, and is an equal partner in, GP. GP is engaged in an ATB as defined in §1.1061-1(a), is the general partner of PRS, and provides substantial management services to PRS. In connection with GP's performance of substantial services in an ATB, PRS issues a profits interest to GP. Because GP's PRS interest was received in connection with GP's providing services in an ATB, GP is a Passthrough Taxpayer and GP's interest in PRS is an API. Because A, B, and C are partners in GP, they each hold a Passthrough Interest in GP and an Indirect API in PRS. Each of A, B, and C is treated as an Owner Taxpayer because each is a partner in GP and because each holds an Indirect API in PRS in connection with the performance of its services to GP's ATB.

(iv) *Example 4: S corporation, Passthrough Interest, Indirect API, and Passthrough Taxpayer.* A owns all of the stock of S Corp, an S corporation. S Corp is engaged in an ATB, as defined in §1.1061-1(a). S Corp is the general partner of PRS, a partnership, and provides substantial management services to PRS. A provides substantial services in S Corp's ATB. In connection with S Corp providing substantial services to PRS, PRS issues a profits interest to S Corp. S Corp's interest in PRS is its only asset. Because S Corp's profits interest in PRS was issued to S Corp in connection with substantial services in an ATB, S Corp is a Passthrough Taxpayer and its interest in PRS is an API. Because A is a shareholder in S Corp, A holds a Passthrough Interest in S Corp and an Indirect API in PRS as a result of S Corp's API in PRS. A is treated as an Owner Taxpayer because A holds an interest in S Corp, a Passthrough Taxpayer, and also indirectly holds an API in PRS in connection with A's services in S Corp's ATB.

(v) *Example 5: Indirect API, Related Person, and Passthrough Taxpayer.* Each of A, B, and C is an equal partner in partnership GP, the general partner of PRS. GP's Specified Actions do not satisfy the ATB Activity Test under §1.1061-1(a) and as a result, GP's actions do not establish an ATB. Management Company is a Related Person with respect to GP within the meaning of sections 267(b) and 707(b), is engaged in an ATB, and provides substantial management services to PRS that are sufficient to satisfy the ATB Activity Test. Management Company's actions are attributed to GP under paragraphs (a)(1)(iv) and (b)(1)(i)(C) of this section because Management Company is a Related Person to GP. In connection with Management Company's services to PRS, PRS issues a profits interest to GP. Because its PRS profits interest is issued to GP in connection with services provided by Management Company, a Related Person, GP is a Passthrough Taxpayer and its interest in PRS is an API. Unless an exception described in §1.1061-3 applies, because A, B, and C are partners in GP, they each hold a Passthrough Interest in GP and an Indirect API in PRS. A, B, and C are treated as Owner Taxpayers because they hold an interest in GP, a Passthrough Taxpayer.

(b) *Application of the ATB Activity Test*—(1) *In general.* The ATB Activity Test is satisfied if both Raising and Returning Actions and Investing or Developing Actions are conducted by an Owner Taxpayer, Passthrough Taxpayer, or one or more Related Persons with respect to an Owner Taxpayer or Passthrough Taxpayer, and the total level of activity, including the combined activities of all Related Persons, satisfies the level of activity that would be required to establish a trade or business under section 162.

(i) *Rules for applying the ATB Activity Test*—(A) *Aggregate Specified Actions taken into account.* The determination of whether the ATB Activity Test is satisfied is based on the combined activities conducted that qualify as either Raising or Returning Capital Actions and Investing or Developing Actions. The fact that either Raising or Returning Capital Actions or Investing or Developing Actions are only infrequently taken does not preclude the test from being satisfied if the combined Specified Actions meet the test.

(B) *Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year.* Raising or Returning Capital Actions and Investing or Developing Actions are not both required to be taken in each taxable year in order to satisfy the ATB Activity Test. For example, the ATB Activity Test will be satisfied if Investing or Developing Actions are not taken in the current taxable year, but sufficient Raising or Returning Capital Actions are taken in anticipation of future Investing or Developing Actions. Additionally, the ATB Activity Test will be satisfied if no Raising or Returning Capital Actions are taken in the current taxable year, but have been taken in a prior taxable year (regardless of whether the ATB Activity Test was met in the prior year), and sufficient Investing or Developing Actions are undertaken by the taxpayer in the current taxable year.

(C) *Combined conduct by multiple related entities taken into account*—(1) *Related Entities.* If a Related Person(s) (within the meaning of §1.1061-1(a)) solely or primarily performs Raising or Returning Capital Actions and one or more other Related Person(s) solely or primarily performs Investing or Develop-

ing Actions, the combination of the activities performed by these Related Persons will be taken into account in determining whether the ATB Activity Test is satisfied.

(2) *Actions taken by an agent or delegate.* Specified Actions taken by an agent or a delegate in its capacity as an agent or a delegate of a principal will be taken into account by the principal in determining whether the ATB Activity Test is satisfied with respect to the principal. These Specified Actions are also taken into account in determining whether the ATB Activity Test is satisfied with respect to the agent or the delegate.

(ii) *Developing Specified Assets.* Developing Specified Assets takes place if it is represented to investors, lenders, regulators, or other interested parties that the value, price, or yield of a portfolio business may be enhanced or increased in connection with choices or actions of a service provider. Merely exercising voting rights with respect to shares owned or similar activities do not amount to developing Specified Assets.

(iii) *Partnerships.* Investing or Developing Actions directly conducted with respect to Specified Assets held by a partnership are counted towards the ATB Activity Test. Additionally, a portion of the Investing or Developing Actions conducted with respect to the interests in a partnership that holds Specified Assets is counted towards the ATB Activity Test. This portion is the value of the partnership's Specified Assets over the value of all of the partnership's assets. Actions taken to manage a partnership's working capital will not be taken into account in determining the portion of Investing or Developing Actions conducted with respect to the interests in the partnership.

(2) *Examples.* The following examples illustrate the application of the ATB Activity Test described in paragraph (b)(1) of this section.

(i) *Example 1: Combined activities of Raising or Returning Capital Actions and Investing or Developing Actions.* During the taxable year, B takes a small number of actions to raise capital for new investments. B takes numerous actions to develop Specified Assets. B's actions with respect to raising capital and B's actions with respect to developing Specified Assets are combined for the purpose of determining whether the ATB Activity Test is satisfied. These actions cumulatively rise to the level required to establish a trade or business under section 162. Thus, B satisfies the ATB Activity Test.

(ii) *Example 2: Combining Specified Actions in multiple entities.* GP, a partnership, conducts Raising or Returning Capital Actions. Management Company, a partnership that is a Related Person to GP, conducts Investing or Developing Actions. When GP's and Management Company's activities are combined, the ATB Activity Test is satisfied. Accordingly, both GP and Management Company are engaged in an ATB, and services performed by either GP or Management Company are performed in an ATB under paragraph (b)(1) of this section.

(iii) *Example 3: Investing or Developing Actions taken after Raising or Returning Capital Actions that do not meet the ATB Activity Test.* In year 1, PRS engaged in Raising or Returning Capital Actions to fund PRS's investment in Specified Assets. However, PRS' Specified Actions during year 1 did not satisfy the ATB Activity Test because they did not satisfy the level of activity required to establish a trade or business under section 162. Therefore, PRS was not engaged in an ATB in year 1. In year 2, PRS engaged in significant Investing or Developing Actions but did not engage in any Raising or Returning Capital Actions. In year 2, PRS's Investing or Developing Actions rise to the level required to establish a trade or business under section 162. Because PRS has cumulatively engaged in both Investing or Developing Actions and Raising or Returning Capital Actions and because the Specified Actions rise to the level of activity required to establish a trade or business under section 162, PRS is engaged in an ATB in year 2.

(iv) *Example 4: Raising or Returning Capital Actions taken in anticipation of Investing or Developing Actions.* In year 1, A only conducted Raising or Returning Capital Actions. A's Raising or Returning Capital Actions were undertaken to raise capital to invest in Specified Assets with the goal of increasing their value through Investing or Developing Actions and rise to the level of activity required to establish a trade or business under section 162. A did not take Investing or Developing Actions during the taxable year. A's Raising or Returning Capital Actions satisfy the ATB Activity Test because they were undertaken in anticipation of also engaging in Investing or Developing Actions. Therefore, the ATB Activity Test is satisfied, and A is engaged in an ATB in year 1.

(v) *Example 5: Attribution of delegate's actions.* GP is the general partner of PRS. GP is responsible for providing management services to PRS. GP contracts with Management Company to provide management services on GP's behalf to PRS. GP and Management Company are not Related Persons. The Specified Actions taken by Management Company on behalf of GP are attributed to GP for purposes of the ATB Activity Test because the Management Company is operating as a delegate of GP. Additionally, those Specified Actions are taken into account by Management Company for purposes of the ATB Activity Test and whether it is engaged in an ATB.

(vi) *Example 6: ATB Activity Test not satisfied.* A is the manager of a hardware store. Partnership owns the hardware store, including the building in which the hardware business is conducted. In connection with A's services as the manager of the hardware store, a profits interest in Partnership is transferred to A. Partnership's business involves buying hardware from wholesale suppliers and selling it to customers. The hardware is not a Specified Asset. Although real

estate is a Specified Asset if it is held for rental or investment purposes, Partnership holds the building for the purpose of conducting its hardware business and not for rental or investment purposes. Therefore, the building is not a Specified Asset as to Partnership. Partnership also maintains and manages a certain amount of working capital for its business, but actions with respect to working capital are not taken into account for the purpose of determining whether the ATB Activity Test is met. Partnership is not a Related Person with respect to any person who takes Specified Actions. Partnership is not engaged in an ATB because the ATB Activity Test is not satisfied. Although Partnership raises capital, its Raising or Returning Capital Actions alone do not satisfy the ATB Activity Test. Further, Partnership takes no Investing or Developing Actions because it holds no Specified Assets other than working capital. Partnership is not in an ATB and the profits interest transferred to A is not an API.

(c) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

#### *§1.1061-3 Exceptions to the definition of an API.*

(a) *A partnership interest held by an employee of another entity not conducting an ATB.* An API does not include any interest transferred to a person in connection with the performance of substantial services by that person as an employee of another entity that is conducting a trade or business (other than an ATB) and the person provides services only to such other entity.

(b) *Partnership interest held by a corporation—(1) In general.* An API does not include any interest directly or indirectly held by a corporation.

(2) *Treatment of interests held by an S corporation or a qualified electing fund.* For purposes of this section, a corporation does not include an entity for which an election was made to treat the entity as a Passthrough Entity. Thus, the following entities are not treated as corporations for purposes of section 1061—

(i) An S corporation for which an election under section 1362(a) is in effect; and

(ii) A passive foreign investment company (PFIC) with respect to which the

shareholder has a qualified electing fund (QEF) election under section 1295 in effect.

(c) *Capital Interest Gains and Losses—(1) In general.* Capital Interest Gains and Losses are not subject to section 1061 and, therefore, are not included in calculating an Owner Taxpayer's Recharacterization Amount.

(2) *Capital Interest Gains and Losses defined.* For purposes of paragraph (c)(1) of this section, Capital Interest Gains and Losses are Capital Interest Allocations that meet the requirements of paragraph (c)(3) of this section and Capital Interest Disposition Amounts that meet the requirements of paragraph (c)(4) of this section.

(3) *General rules for determining Capital Interest Allocations—(i) Commensurate with capital contributed.* An allocation will be considered a Capital Interest Allocation if the allocation to the API Holder with respect to its capital interest is determined and calculated in a similar manner as the allocations with respect to capital interests held by similarly situated Unrelated Non-Service Partners who have made significant aggregate capital contributions as described in paragraph (c)(3)(iv) of this section. For purposes of this paragraph (c)(3), a capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and the proceeds were then distributed in a complete liquidation of the partnership.

(ii) *In a similar manner.* For purposes of paragraph (c)(3)(i) of this section, a Capital Interest Allocation to an API Holder will be treated as made in a similar manner if allocations and distribution rights with respect to the capital contributed by an API Holder to which the API Holder's Capital Interest Allocation relates are reasonably consistent with allocation and distribution rights with respect to capital contributed by Unrelated Non-Service Partners where the Unrelated Non-Service Partner requirement is met. For purposes of this paragraph (c)(3)(ii), allocation and distribution rights for an API Holder that are limited to a particular class of partnership capital interests or that are determined with respect to capital contributions invested in a particular partnership investment will be considered

as made in a similar manner to allocations and distribution rights of Unrelated Non-Service Partners where the Unrelated Non-Service Partner requirement is met for the applicable interest class or partnership investment.

(A) *Relevant factors.* For purposes of this paragraph (c)(3)(ii), the following factors are not exclusive, but are relevant factors in determining whether allocation and distribution rights with respect to capital contributed by an API Holder are reasonably consistent with allocation and distribution rights of persons meeting the Unrelated Non-Service Partner requirement: the amount and timing of capital contributed, the rate of return on capital contributed, the terms, priority, type and level of risk associated with capital contributed, and the rights to cash or property distributions during the partnership's operations and on liquidation. Accordingly, an allocation to an API Holder will not fail to qualify solely because the allocation is subordinated to allocations made to Unrelated Non-Service Partners, because an allocation to an API Holder is not reduced by the cost of services provided by the API Holder or a Related Person to the partnership, where the cost of services provided includes management fees or API allocations, or because an API Holder has a right to receive tax distributions while Unrelated Non-Service Partners do not, where such distributions are treated as advances against future distributions.

(B) *Clear identification requirement.* For purposes of this paragraph (c)(3)(ii), allocations will be considered made in a similar manner only if the allocations to the API Holder and the Unrelated Non-Service Partners are allocations with respect to, and corresponding to, such partners' contributed capital that are separate and apart from allocations made to the API Holder with respect to its API and where both the partnership agreement and the partnership's contemporaneous books and records clearly demonstrate that the requirements of paragraph (c)(3) of this section have been met.

(iii) *Reinvestment of API Gain.* If an API Holder is allocated API Gain by a Passthrough Entity, to the extent that an amount equal to the API Gain is reinvested in the Passthrough Entity by the API Holder (either as the result of an actual

distribution and recontribution of the API Gain amount or the retention of the API Gain amount by the Passthrough Entity), the amount will be treated as a contribution to the Passthrough Entity for a capital interest that may produce Capital Interest Allocations for the API Holder, provided such allocations meet the requirements of this paragraph (c)(3).

(iv) *Unrelated Non-Service Partner requirement.* For purposes of paragraph (c)(3) of this section, the Unrelated Non-Service Partner requirement means that Unrelated Non-Service Partners must have made significant aggregate capital contributions in relation to total capital contributions of all partners. Unrelated Non-Service Partners will be treated as having made significant aggregate capital contributions provided such partners possess five percent or more of the aggregate capital contributed to the partnership at the time the allocations are made. With respect to an API Holder with allocation and distribution rights that are attributable to a particular interest class or partnership investment, the Unrelated Non-Service requirement must be met with respect to that particular interest class or partnership investment.

(v) *Proceeds of certain loans not taken into account for Capital Interest Allocation purposes—(A) General rule.* For purposes of the Section 1061 Regulations, an allocation is not a Capital Interest Allocation to the extent the allocation is attributable to the contribution of an amount of capital to a partnership that, directly or indirectly, results from, or is attributable to, any loan or other advance made or guaranteed, directly or indirectly, by the partnership, a partner in the partnership, or any Related Person with respect to such persons, except to the extent a loan or advance is described in paragraph (c)(3)(v)(B) of this section. However, the repayments on a loan described in the preceding sentence are taken into account as capital contributed (and may therefore generate Capital Interest Allocations) as those amounts are paid by the partner, provided that the loan is not repaid with the proceeds of another loan described in the preceding sentence.

(B) *Recourse liability.* Paragraph (c)(3)(v)(A) of this section does not apply with respect to an allocation attributable

to a contribution made by an individual service provider that, directly or indirectly, results from, or is attributable to, a loan or advance from another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other than the partnership) to such individual service provider if the individual service provider is personally liable for the repayment of such loan or advance. A contribution made by an individual service provider includes a contribution made by an entity that is wholly owned by, and disregarded as separate from, the individual service provider as described in §1.1061-2(a)(1)(v), including a contribution attributable to a loan or advance made to the disregarded entity by another partner in the partnership (or any Related Person with respect to such lending or advancing partner, other than the partnership) if the individual service provider is personally liable for the repayment of any and all borrowed amounts that are not repaid by the disregarded entity. For purposes of this paragraph (c)(3)(v)(B), an individual service provider is personally liable for the repayment of a loan or advance made by a partner (or any Related Person, other than the partnership) if—

(1) The loan or advance is fully recourse to the individual service provider;

(2) The individual service provider has no right to reimbursement from any other person; and

(3) The loan or advance is not guaranteed by any other person.

(vi) *Items that are not included in Capital Interest Allocations.* Capital Interest Allocations do not include—

(A) Amounts that are treated as API Gains and Losses and Unrealized API Gains and Losses; or

(B) Items that are not taken into account for purposes of section 1061 under §1.1061-4(b)(7).

(4) *Capital Interest Disposition Amounts—(i) In general.* The term *Capital Interest Disposition Amount* means the amount of long-term capital gain or loss recognized on the sale or disposition of all or a portion of a Passthrough Interest that is treated as Capital Interest Gain or Loss. In general, long-term capital gain or loss recognized on the sale or disposition of a Passthrough Interest is deemed to be API Gain or Loss unless it is determined under

paragraph (c)(4)(ii) of this section to be a Capital Interest Disposition Amount.

(ii) *Determination of the Capital Interest Disposition Amount.* If a Passthrough Interest that includes a right to allocations of Capital Interest Gains and Losses is disposed of, the amount of long-term capital gain or loss that is treated as a Capital Interest Disposition Amount is determined under the rules provided in this paragraph (c)(4)(ii).

(A) First, determine the amount of long-term capital gain or loss that would be allocated to the Passthrough Interest (or the portion of the Passthrough Interest sold) if all the assets of the Passthrough Entity (including gain or loss with respect to assets described in §1.1061-4(b)(7)) were sold for their fair market value in a fully taxable transaction immediately before the disposition of the Passthrough Interest (hypothetical asset sale). For purposes of this paragraph (c)(4)(ii), the assets of the Passthrough Entity include any assets held by a lower-tier Passthrough Entity in which the Passthrough Entity has a direct or indirect interest.

(B) Second, determine the amount from the hypothetical asset sale that would be allocated to the Passthrough Interest (or the portion of the Passthrough Interest sold) as Capital Interest Allocations under paragraph (c)(3) of this section.

(C) Third, if the transferor recognized long-term capital gain upon disposition of the Passthrough Interest and only net short-term capital losses, net long-term capital losses, or both, are allocated to the Passthrough Interest under paragraph (c)(4)(ii)(B) of this section from the hypothetical asset sale, all of the long-term capital gain is API Gain. If the transferor recognized long-term capital loss on the disposition of the Passthrough Interest and only net short-term capital gains, net long-term capital gains, or both, are allocated to the Passthrough Interest under paragraph (c)(4)(ii)(B) of this section, then all the long-term capital loss is API Loss.

(D) If paragraph (c)(4)(ii)(C) of this section does not apply and long-term capital gain is recognized on the disposition of the Passthrough Interest, the amount of long-term capital gain that the transferor of the Passthrough Interest recognizes that is treated as a Capital Interest Disposition Amount is determined by multiplying

long-term capital gain recognized on the disposition of the Passthrough Interest by a fraction, the numerator of which is the amount of long-term capital gain determined under paragraph (c)(4)(ii)(B) of this section, and the denominator of which is the amount of long-term capital gain determined under paragraph (c)(4)(ii)(A) of this section, with the percentage represented by the fraction limited to 100 percent. Alternatively, if paragraph (c)(4)(ii)(C) of this section does not apply and long-term capital loss is recognized on the disposition of the Passthrough Interest, the amount of long-term capital loss treated as a Capital Interest Disposition Amount is determined by multiplying the transferor's capital loss by a fraction, the numerator of which is the amount of long-term capital loss determined under paragraph (c)(4)(ii)(B) of this section, and the denominator of which is the amount of long-term capital loss determined under paragraph (c)(4)(ii)(A) of this section, with the percentage represented by the fraction limited to 100 percent.

(E) In applying this paragraph (c)(4)(ii), allocations of amounts that are not included in determining the amount of long-term capital gain or loss recognized on the sale or disposition of the Passthrough Interest are not included. See, for example, section 751(a).

(5) *Capital Interest Allocations made by a Passthrough Entity that is an API Holder.* An allocation made to a Passthrough Entity that holds an API in a lower-tier Passthrough Entity will be considered a Capital Interest Allocation if it meets the principles set forth in paragraphs (c)(3) and (4) of this section (other than paragraph (c)(3)(iv) of this section). For purposes of applying the Capital Interest Allocation rules in this paragraph (c)(5) to a tiered partnership structure, to the extent that a Capital Interest Allocation that is made by a lower-tier partnership to an upper-tier partnership is properly allocated to the upper-tier partnership's partners with respect to their capital interests in the upper-tier partnership in a manner that is respected under 704(b) (taking into account the principles of section 704(c)), such allocation is a Capital Interest Allocation.

(6) *Examples.* The rules of this paragraph (c) are illustrated by the following examples.

(i) *Example 1: Capital Interest Allocations—(A) Facts.* Each of A, B, and C contributes \$100 to GP and is an equal partner in GP, a partnership that is the general partner of PRS, a partnership. The contributions are not attributable to loans or advances described in paragraph (c)(3)(v)(A) of this section. PRS's other partners are Unrelated Non-Service Partners. Each of GP and PRS makes allocations to its partners in accordance with its partners' interests in that partnership, as described in §1.704-1(b)(3). GP holds a 20% profits interest in PRS that is an API that GP received in exchange for providing substantial services to PRS in an ATB. GP's API is an Indirect API to each of A, B, and C. GP contributes the \$300 of capital contributed by A, B and C to PRS. GP's \$300 contribution equals 2% of the contributed capital made by all of PRS's partners (\$15,000). PRS's partnership agreement describes its partners' economic distribution rights with respect to its liquidating proceeds as follows: first, liquidating proceeds are proportionately distributed to each of GP and the Unrelated Non-Service Partners equal to the amount necessary to return each of those partners' unreturned capital; second, liquidating proceeds are distributed to GP with respect to its API in PRS; and, finally, any residual liquidating proceeds are distributed, proportionately, 98% to the Unrelated Non-Service Partners and 2% to GP. During its initial taxable year, PRS has \$10,000 of net capital gain, causing an increase in PRS's distributable proceeds of \$10,000. In accordance with the partners' economic rights as described in PRS's partnership agreement, PRS allocates \$2,160 of net capital gain to GP (a \$2,000 API allocation plus \$160 (\$8,000 (\$10,000-\$2,000) x 2%), with respect to GP's contributed capital) and \$7,840 of net capital gain to the Unrelated Non-Service Partners with respect to their contributed capital. GP allocates \$720 (\$2,160/3) of this net capital gain to each of A, B, and C in accordance with their interests in GP.

(B) *PRS's Capital Interest Allocation Analysis.* Because PRS's partnership agreement provides for no differences as to the amount and timing of capital contributed, the rate of return on capital contributed, the type and level of risk associated with capital contributed, or the rights to cash or property distributions during the PRS's operations and on liquidation, the allocations and distribution rights with respect to the capital contributed by GP are reasonably consistent with the allocation and distribution rights with respect to capital contributed by Unrelated Non-Service Partners. Accordingly, GP's allocation of \$160 is a Capital Interest Allocation that is treated as made in a similar manner as the allocations made to the Unrelated Non-Service Partners.

(C) *GP Capital Interest Allocation Analysis.* GP is allocated \$2,160 from PRS, consisting of a \$2,000 API allocation and a \$160 Capital Interest Allocation. The \$160 Capital Interest Allocation is allocated equally to A, B, and C based on their capital contributions to GP. Therefore, they qualify as

Capital Interest Allocations by GP. See paragraph (c)(5) of this section. The \$2,000 of gain allocated by PRS's to GP with respect to GP's API cannot be treated as a Capital Interest Allocation by GP and therefore is subject to section 1061. In summary, A, B, and C are each allocated \$720 of capital gain from PRS (\$2,160/3). Of this amount, \$667 is API Gain (\$2,000/3) and \$53 is a Capital Interest Allocation (\$160/3).

(ii) *Example 2: Sale of a Passthrough Interest—(A) Facts.* In Year 1, A, B, and C form GP, a partnership. Each of A, B, and C contributes \$100 to GP and is an equal partner in GP. The contributions are not attributable to loans or advances described in paragraph (c)(3)(v)(A) of this section. GP invests the \$300 in Asset X in Year 1. GP is also the general partner of PRS, a partnership. PRS's other partners are Unrelated Non-Service Partners. GP holds a 20% profits interest in PRS that is an API that GP received in exchange for providing substantial services to PRS in an ATB. GP's API is an Indirect API to each of A, B, and C. Each of GP and PRS makes allocations to its partners in accordance with its partners' interests in that partnership, as described in §1.704-1(b)(3). In Year 3, A sells A's interest in GP to an unrelated third party for \$800 and recognizes \$700 of capital gain on the sale. If PRS had sold its assets in a hypothetical asset sale as required by paragraph (c)(4)(ii)(A) of this section and liquidated immediately before A sold its interest in GP, GP would have been allocated \$1,800 of long-term capital gain with respect to GP's API in PRS, and GP would have allocated \$600 of this \$1,800 to A. If GP sold Asset X for its fair market value and liquidated immediately before A sold its interest in GP, A would have been allocated \$100 of long-term capital gain.

(B) *Analysis.* GP does not have a capital interest in PRS. Therefore, its allocations from PRS are allocations with respect to its API which are subject to section 1061. The total gain allocable to A as a result of the hypothetical liquidations would be \$700. Under paragraph (c)(4)(ii)(D) of this section, \$100 of the \$700 of A's interest sale gain is A's Capital Interest Disposition Amount, and is not subject to section 1061.

(iii) *Example 3: Reinvestment of Realized API Gain.* A, B, and C are partners in PRS, a partnership. At the beginning of Year 1, A is issued an API in PRS in exchange for providing substantial services to PRS in an ATB. A has no capital interest in PRS. During Year 1, PRS's assets appreciate by \$100. At the end of Year 1, under the terms of its partnership agreement, if PRS were to sell all of its assets at their fair market value and distribute the proceeds in a complete liquidation, A would receive \$20 with respect to its API. Thus, at the end of Year 1, A has \$20 of Unrealized API Gain. In Year 2, PRS sells Asset X, an asset that PRS owned in Year 1, and allocates \$8 of the long-term capital gain to A as API Gain. As a result, \$8 of A's \$20 of Unrealized API Gain becomes API Gain that is subject to section 1061. A reinvests A's share of the proceeds from the Asset X sale in PRS. As a result, under paragraph (c)(3)(iii) of this section, A has an \$8 capital interest in PRS and, provided the requirements of paragraph (c)(3) of this section are met, A may receive future Capital Interest Allocations with respect to the capital interest.

(d) *Partnership interest acquired by purchase by an unrelated person.* If a

person (acquirer) acquires an interest in a partnership (target partnership) by taxable purchase for fair market value that, but for the exception set forth in this paragraph (d), would be an API, the transferor of the interest will be treated as selling an API but the acquirer will not be treated as acquiring an API if—

(1) *Acquirer not a Related Person.* Immediately before the purchase, the acquirer is not a Related Person with respect to—

(i) Any person who provides services in the Relevant ATB; or

(ii) Any service providers who provide services to, or for the benefit of, the target partnership or a lower-tier partnership in which the target partnership holds an interest, directly or indirectly.

(2) *Section 1061(d) not applicable.* Section 1061(d) does not apply to the transaction (as provided in §1.1061-5).

(3) *Acquirer not a service provider.* At the time of the purchase, the acquirer has not provided, does not provide, and does not anticipate providing, services in the future, to, or for the benefit of, the target partnership, directly or indirectly, or any lower-tier partnership in which the target partnership directly or indirectly holds an interest.

(e) [Reserved]

(f) *Applicability date—*(1) *General rule.* Except as provided in paragraphs (f)(2) and (3) of this section, the provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

(2) *Partnership interest held by an S corporation.* Paragraph (b)(2)(i) of this section, which provides that the exception under section 1061(c)(1) to the definition of an API does not apply to a partnership interest held by an S corporation with an election under section 1362(a) in effect, applies to taxable years beginning after December 31, 2017.

(3) *Partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect.* Paragraph (b)(2)

(ii) of this section, which provides that the exception under section 1061(c)(1) to the definition of an API does not apply to a partnership interest held by a PFIC with respect to which the shareholder has a QEF election in effect under section 1295, applies to taxable years of an Owner Taxpayer and Passthrough Entity beginning after August 14, 2020.

#### *§1.1061-4 Section 1061 computations.*

(a) *Computations—*(1) *Recharacterization Amount.* The Recharacterization Amount is the amount that an Owner Taxpayer must treat as short-term capital gain under section 1061(a). The Recharacterization Amount equals—

(i) The Owner Taxpayer's One Year Gain Amount; less

(ii) The Owner Taxpayer's Three Year Gain Amount.

(2) *One Year Gain Amount and Three Year Gain Amount—*(i) *One Year Gain Amount.* The Owner Taxpayer's One Year Gain Amount is the sum of—

(A) The Owner Taxpayer's combined net API One Year Distributive Share Amount from all APIs held during the taxable year; and

(B) The Owner Taxpayer's API One Year Disposition Amount.

(ii) *Three Year Gain Amount.* The Owner Taxpayer's Three Year Gain Amount is the sum of—

(A) The Owner Taxpayer's combined net API Three Year Distributive Share Amount from all APIs held during the taxable year; and

(B) The Owner Taxpayer's API Three Year Disposition Amount.

(3) *API One Year Distributive Share Amount and API Three Year Distributive Share Amount—*(i) *API One Year Distributive Share Amount.* The API One Year Distributive Share Amount equals—

(A) The API Holder's distributive share of net long-term capital gain or loss from the partnership for the taxable year (including capital gain or loss on the disposition of Distributed API Property by an API Holder that is a Passthrough Entity or the disposition of all or a part of an API by an API Holder that is a Passthrough Entity), with respect to the partnership interest held by the API Holder calculated without the application of section 1061; less

(B) To the extent included in the amount determined under paragraph (a)(3)(i)(A) of this section, the aggregate of—

(1) Amounts that are not taken into account for purposes of section 1061 under paragraph (b)(7) of this section; and

(2) Capital Interest Gains and Losses as determined under §1.1061-3(c)(2).

(ii) *API Three Year Distributive Share Amount.* The API Three Year Distributive Share Amount equals the API One Year Distributive Share Amount, less—

(A) Items included in the API One Year Distributive Share Amount that would not be treated as a long-term gain or loss if three years is substituted for one year in paragraphs (3) and (4) of section 1222; and

(B) Any adjustments resulting from the application of the Lookthrough Rule under paragraph (b)(9)(ii) of this section when an API is disposed of by an API Holder that is a Passthrough Entity.

(4) *API One Year Disposition Amount and API Three Year Disposition Amount—*(i) *API One Year Disposition Amount.* The API One Year Disposition Amount is the combined net amount of—

(A) Long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer, including long-term capital gain computed under the installment method that is taken into account for the taxable year, on the disposition of all or a portion of an API that has been held for more than one year, including a disposition to which the Lookthrough Rule applies;

(B) Long-term capital gain and loss recognized by an Owner Taxpayer due to a distribution with respect to an API during the taxable year that is treated under section 731(a) as gain or loss from the sale or exchange of a partnership interest held for more than one year; and,

(C) Long-term capital gains and losses recognized by an Owner Taxpayer on the disposition of Distributed API Property (taking into account deemed exchanges under section 751(b)) during the taxable year that has a holding period of more than one year but not more than three years to the distributee Owner Taxpayer on the date of disposition, excluding items described in paragraph (b)(7) of this section.

(ii) *API Three Year Disposition Amount.* The API Three Year Disposition Amount is the combined net amount of—

(A) Long-term capital gains and losses recognized during the taxable year by an Owner Taxpayer, including long-term capital gain computed under the installment method that is taken into account for the taxable year, on the disposition of all or a portion of an API that has been held for more than three years and to which the Lookthrough Rule does not apply;

(B) Long-term capital gains and losses recognized by an Owner Taxpayer on the disposition during the taxable year of all or a portion of an API that has been held for more than three years in a transaction to which the Lookthrough Rule in paragraph (b)(9) of this section applies, less any adjustments required under the Lookthrough Rule in paragraph (b)(9)(ii) of this section; and

(C) Long-term capital gains and losses recognized on a distribution with respect to an API during the taxable year that is treated under sections 731(a) as gain or loss from the sale or exchange of a partnership interest held for more than three years.

(b) *Special rules for calculating the One Year Gain Amount and the Three Year Gain Amount*—(1) *One Year Gain Amount equals zero or less.* If an Owner Taxpayer's One Year Gain Amount is zero or results in a loss, the Recharacterization Amount for the taxable year is zero and section 1061(a) does not apply.

(2) *Three Year Gain Amount equals zero or less.* If an Owner Taxpayer's Three Year Gain Amount is less than or equal to \$0, the Three Year Gain Amount is zero for purposes of calculating the Recharacterization Amount.

(3) *One Year Gain Amount less than Three Year Gain Amount.* If the One Year Gain Amount and the Three Year Gain Amount are both greater than zero but the One Year Gain Amount is less than the Three Year Gain Amount, none of the One Year Gain Amount is included in the Recharacterization Amount for the taxable year.

(4) *Installment sale gain.* The One Year Gain Amount under paragraph (a)(2)(i) of this section and the Three Year Gain Amount, as determined under paragraph (a)(2)(ii) of this section include long-term capital gains from installment sales. This includes long-term capital gain or loss recognized with respect to an API after

December 31, 2017, with respect to an installment sale that occurred on or before December 31, 2017. The holding period of the asset upon the date of disposition is used for purposes of determining whether capital gain is included in the taxpayer's One Year Gain Amount or the Three Year Gain Amount.

(5) *Special rules for capital gain dividends from regulated investment companies (RICs) and real estate investment trusts (REITs)*—(i) *API One Year Distributive Share Amount.* If a RIC or REIT reports or designates a dividend as a capital gain dividend and provides the One Year Amounts Disclosure as defined in §1.1061-6(c)(1)(i), the amount provided in the One Year Amounts Disclosure is included in the calculation of an API One Year Distributive Share Amount. If the RIC or REIT does not provide the One Year Amounts Disclosure, the full amount of the RIC's or REIT's capital gain dividend must be included in the calculation of an API One Year Distributive Share Amount.

(ii) *API Three Year Distributive Share Amount.* If a RIC or REIT reports or designates a dividend as a capital gain dividend and provides the Three Year Amounts Disclosure as defined in §1.1061-6(c)(1)(ii), the amount provided in the Three Year Amounts Disclosure is used for the calculation of an API Three Year Distributive Share amount. If the RIC or REIT does not provide the Three Year Amounts Disclosure, no amount of the RIC's or REIT's capital gain dividend may be used for the calculation of an API Three Year Distributive Share Amount.

(iii) *Loss on sale or exchange of stock.* If a RIC or REIT provides the Three Year Amounts Disclosure as provided in paragraph (b)(5)(ii) of this section, any loss on the sale or exchange of shares of a RIC or REIT held for six months or less is treated as a capital loss on an asset held for more than three years, to the extent of the amount of the Three Year Amounts Disclosure from that RIC or REIT.

(6) *Pro rata share of qualified electing fund (QEF) net capital gain*—(i) *One year QEF net capital gain.* The calculation of an API One Year Distributive Share Amount includes an Owner Taxpayer's inclusion under section 1293(a)(1)(B) as limited by section 1293(e)(2) with respect to a passive foreign investment company

(as defined in section 1297(a)) for which a QEF election (as described in section 1295(a)) is in effect for the taxable year. The amount of the inclusion may be reduced by the amount of long-term capital gain that is not taken into account for purposes of section 1061 as provided in paragraph (b)(7) of this section and may be reduced by the Owner Taxpayer's share of the excess, if any, of the Capital Interest Gain over Capital Interest Loss with respect to the QEF, provided in each case that the relevant information is provided by the QEF. See §1.1061-6 for reporting rules.

(ii) *Three year QEF net capital gain adjustment.* For purposes of calculating an Owner Taxpayer's API Three Year Distributive Share Amount, the entire amount determined under paragraph (b)(6)(i) of this section, after any allowed reduction, is included as an item in paragraph (a)(3)(ii)(A) of this section unless the QEF provides information to determine the amount of the inclusion that would constitute net capital gain (as defined in §1.1293-1(a)(2), as limited by section 1293(e)(2)) if the QEF's net capital gain for the taxable year were calculated under section 1222(11) applying paragraphs (3) and (4) of section 1222 by substituting three years for one year. If such information is provided, the amount included as an item in paragraph (a)(3)(ii)(A) of this section is the amount determined under paragraph (b)(6)(i) of this section that would not be treated as long-term gain if three years were substituted for one year in paragraphs (3) and (4) of section 1222. See §1.1061-6 for reporting rules.

(7) *Items not taken into account for purposes of section 1061.* The following items of long-term capital gain and loss are excluded from the calculation of the API One Year Distributive Share Amount in paragraph (a)(3)(i) of this section and the API Three Year Distributive Share Amount in paragraph (a)(3)(ii) of this section—

(i) Long-term capital gain and long-term capital loss determined under section 1231;

(ii) Long-term capital gain and long-term capital loss determined under section 1256;

(iii) Qualified dividends included in net capital gain for purposes of section 1(h)(11)(B); and

(iv) Capital gains and losses that are characterized as long-term or short-term without regard to the holding period rules in section 1222, such as certain capital gains and losses characterized under the mixed straddle rules described in section 1092(b) and §§1.1092(b)-3T, 1.1092(b)-4T, and 1.1092(b)-6.

(8) *Holding period determination*—(i) *Determination of holding period for purposes of the Three Year Gain Amount.* For purposes of computing the Three Year Gain Amount, the relevant holding period of either an asset or an API is determined under all provisions of the Code or regulations that are relevant to determining whether the asset or the API has been held for the long-term capital gain holding period by applying those provisions as if the holding period were three years instead of one year.

(ii) *Relevant holding period.* The relevant holding period is the direct owner's holding period in the asset sold. Accordingly, for purposes of determining an API Holder's Taxpayer's API One Year Distributive Share Amount and API Three Year Distributive Share Amount for the taxable year under paragraph (a)(3) of this section, the partnership's holding period in the asset being sold or disposed of (whether a directly held asset or a partnership interest) is the relevant holding period for purposes of section 1061.

(9) *Lookthrough Rule for certain API dispositions*—(i) *Determination that the Lookthrough Rule applies*—(A) *In general.* The Lookthrough Rule will apply if, at the time of disposition of an API held for more than three years—

(1) The API would have a holding period of three years or less if the holding period of such API were determined by not including any period before the date that an Unrelated Non-Service Partner is legally obligated to contribute substantial money or property directly or indirectly to the Passthrough Entity to which the API relates. This paragraph (b)(9)(i)(A) does not apply to the disposition of an API to the extent that the gain recognized upon the disposition of the API is attributable to any asset not held for portfolio investment on behalf of third party investors (as defined in section 1061(c)(5)). Solely for the purpose of this paragraph (b)(9)(i)(A), a substantial legal obligation to contrib-

ute money or property is an obligation to contribute a value that is at least 5 percent of the partnership's total capital contributions as of the time of the API disposition; or

(2) A transaction or series of transactions has taken place with a principal purpose of avoiding potential gain recharacterization under section 1061(a).

(B) *Determination that the Lookthrough Rule applies to the disposition of a Passthrough Interest.* Paragraph (b)(9)(i)(A) of this section similarly applies with respect to a Passthrough Interest issued by an S corporation or a PFIC to the extent the Passthrough Interest is treated as an API.

(ii) *Application of the Lookthrough Rule.* If the Lookthrough Rule applies, for purposes of applying an Owner Taxpayer's Recharacterization Amount, as described in paragraph (a) of this section—

(A) The Owner Taxpayer must include the entire amount of capital gain recognized on the disposition of an API by the Owner Taxpayer in the Owner Taxpayer's API One Year Disposition Amount; and

(B) The Owner Taxpayer must include in its Three Year Disposition Amount an amount equal its One Year Disposition Amount (determined under paragraph (b)(9)(ii)(A) of this section) reduced by the Owner Taxpayer's share of the amount of any gain, directly or indirectly, from assets held for three years or less that would have been allocated to the Owner Taxpayer (to the extent attributable to the transferred API) by the partnership if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the Owner Taxpayer's transfer of the API.

(C) In the case of an API disposition by an API Holder that is a Passthrough Entity and not an Owner Taxpayer, the principles set forth in paragraph (b)(9)(ii)(A) of this section must be applied to determine the amount to include in the Owner Taxpayer's One Year Distributive Amount and in paragraph (b)(9)(ii)(B) of this section to determine the amounts included in the Owner Taxpayer's Three Year Distributive Share Amount.

(10) *Section 83.* Except with respect to any portion of the interest that is a capital

interest under §1.1061-3(c), this section applies regardless of whether an Owner Taxpayer or Passthrough Entity has made an election under section 83(b) or included amounts in gross income under section 83.

(c) *Examples*—(1) *Recharacterization rules.* The rules of paragraph (a) of this section are illustrated by the following examples. Unless otherwise stated, all gains and losses are long-term capital gains and losses, none of the long-term capital gain or loss in this section is capital gain or loss not taken into account for purposes of section 1061 under paragraph (b)(7) of this section, and neither the Lookthrough Rule nor section 751 is applicable.

(i) *Example 1: Determination of API One Year and Three Year Distributive Share Amounts*—(A) *Facts.* A holds an API in PRS but has no capital interest in PRS and is not entitled to a Capital Interest Allocation with respect to PRS. During the taxable year, PRS allocates to A \$20 of long-term capital gain from the sale of capital asset X (which had been held by PRS for two years) and \$40 of long-term capital gain from the sale of capital asset Y (which had held by PRS for five years). A has no other items of long-term capital gain or loss with respect to its interest in PRS during the taxable year. A has no other long-term capital gains or losses with respect to any other API during the taxable year.

(B) *Determination of A's API One Year Distributive Share Amount.* Under paragraph (a)(3)(i) of this section, A has an API One Year Distributive Share Amount of \$60. This amount is the sum of the \$20 of the long-term capital gain allocated to A from PRS's sale of capital asset X and the \$40 of long-term capital gain allocated to A from PRS's sale of capital asset Y.

(C) *Determination of A's API Three Year Distributive Share Amount.* (1) Under paragraph (a)(3)(ii) of this section, A's API Three Year Distributive Share Amount is equal to A's API One Year Distributive Amount, \$60, less the sum of:

(i) The items included in the API One Year Distributive Share Amount that would not be treated as a long-term gain or loss if three years is substituted for one year in paragraphs (3) and (4) of section 1222, \$20; and

(ii) Adjustments resulting from the application of the Lookthrough Rule under paragraph (b)(9)(ii) of this section, which under the facts in paragraph (c)(1)(i)(A) of this section, is inapplicable.

(2) Thus, A's Three Year API Distributive Share Amount is \$40.

(D) *Determination of A's Recharacterization Amount.* Under paragraph (a)(2)(i) of this section, A's One Year Gain amount is equal to A's API One Year Distributive Share Amount, \$60. A's Three Year Gain Amount is equal to A's API Three Year Distributive Share Amount, \$40. Under paragraph (a)(1) of this section, A's Recharacterization Amount is A's One Year Gain Amount, minus A's Three Year Gain Amount, or \$20.

(ii) *Example 2: API One Year and Three Year Disposition Amounts*—(A) *Facts.* During the taxable

year, A disposes of an API that A has held for four years for a \$100 gain. Additionally, A sells Distributed API Property for a \$300 gain at a time when A has a two-year holding period in such property. A has no other items of long-term capital gain or loss with respect to any API in the year.

(B) *Determination of A's API One Year and Three Year Disposition Amounts.* Under paragraph (a)(4)(i) of this section, A's API One Year Disposition Amount is \$400. This amount is the sum of A's \$300 of long-term capital gain on A's disposition of the Distributed API Property and A's \$100 of long-term capital gain on the disposition of the API. Under paragraph (a)(4)(ii) of this section, A's Three Year Disposition Amount is \$100, which is the amount of long-term capital gain that A recognized upon disposition of the API held for more than three years. Under paragraph (a)(2) of this section, A's One Year Gain Amount is \$400 and A's Three Year Gain Amount is \$100.

(C) *Determination of A's Recharacterization Amount.* Under paragraph (a)(1) of this section, A's Recharacterization Amount is \$300, which is the difference between A's One Year Gain Amount and Three Year Gain Amount.

(iii) *Example 3: Determination of One Year Gain Amount, Three Year Gain Amount, and Recharacterization Amount—(A) Facts.* A holds an API in each of PRS1 and PRS2. With respect to PRS1, A's API One Year Distributive Share Amount is \$100 and A's API Three Year Distributive Share Amount is (\$200). With respect to PRS2, A's API One Year Distributive Share Amount is \$600 and A's API Three Year Distributive Share Amount is \$300. During the taxable year, A also has an API One Year Disposition Amount of \$200 of gain. A has no other items of long-term capital gain or loss with respect to an API for the taxable year.

(B) *Determination of A's One Year Gain Amount.* Under paragraph (a)(2) of this section, A's One Year Gain Amount is \$900, which is an amount equal to A's \$100 API One Year Distributive Share Gain from PRS1 and A's \$600 API One Year Distributive Share from PRS2 (a combined net API One Year Distributive Share Amount of \$700) plus A's \$200 API One Year Disposition Amount.

(C) *Determination of A's Three Year Gain Amount.* Under paragraph (a)(2) of this section, A's Three Year Gain Amount is \$100, which is equal to A's combined net API Three Year Distributive Share Amount for the taxable year (A's \$200 API Three Year Distributive Share Amount loss from PRS1 plus A's API Three Year Distributive Share Amount Gain of \$300 from PRS2). A does not have an API Three Year Disposition Amount.

(D) *Determination of A's Recharacterization Amount.* Under paragraph (a)(1) of this section, A's Recharacterization Amount is \$800. (A's One Year Gain Amount of \$900 less A's Three Year Gain Amount of \$100).

(2) *Special rules examples.* The principles of paragraph (b) of this section are illustrated by the following examples.

(i) *Example 1: Lookthrough Rule.* On July 1, 2021, A and B form partnership PRS. At the time of PRS's formation, A agrees to provide substantial services to PRS in exchange for a 20% profits interest in PRS, and B, a partner that is an Unrelated Non-Service Partner, contributes \$1 million in exchange for

an interest in PRS and PRS immediately uses the capital to purchase marketable securities. On July 1, 2023, C, another Unrelated Non-Service Partner becomes legally obligated to contribute capital to PRS (\$75 million) for the purposes of investing in and developing Specified Assets and is admitted into PRS. On July 3, 2023, and after C makes a contribution of \$75 million, PRS uses this capital to acquire stock in portfolio company Z. On July 1, 2025, when Z has a value of \$500 million and the value of the marketable securities is \$2 million, A sells its API in PRS for \$85.2 million. As a result of this sale, the Lookthrough Rule applies because B's contribution was non-substantial under paragraph (b)(9)(i)(A)(I) of this section. Therefore, A includes \$85.2 million in its API One Year Disposition Amount and under paragraph (b)(9)(ii)(B) of this section, \$200,000 (20% share of \$1 million gain in marketable securities) in its API Three Year Disposition Amount. Accordingly, under paragraph (a)(1) of this section, A's Recharacterization Amount is \$85 million.

(ii) *Example 2: Installment sale gain.* On December 22, 2021, A disposed of A's API in an installment sale. At the time of the disposition, A had held its API for two years. A received a payment with respect to the installment sale during A's 2022 taxable year causing A to recognize \$200 of long-term capital gain. The \$200 long-term capital gain recognized in 2022 is subject to section 1061 because it is recognized after December 31, 2017. Accordingly, the \$200 of long-term capital gain recognized by A in 2022 is included in A's API One Year Disposition Amount. The \$200 of long-term capital gain is not in A's API Three Year Disposition Amount because the API was not held for more than three years at the time of its disposition.

(iii) *Example 3: REIT capital gain dividend.* During the taxable year, A holds an API in PRS. PRS holds an interest in REIT. During the taxable year, REIT distributes a \$1,000 capital gain dividend to PRS of which 50% is allocable to A's API. Part of the capital gain dividend for the year results from section 1231 gain. In accordance with §1.1061-6(c)(1)(i), REIT discloses to PRS the One Year Amounts Disclosure of \$400, which is the \$1000 capital gain dividend reduced by the \$600 of section 1231 capital gain dividend included in that amount. Part of the One Year Amounts Disclosure for the year results from gain from property held for three years or less. In accordance with §1.1061-6(c)(1)(ii), REIT also discloses the Three Year Amounts Disclosure of \$150, which is the \$400 One Year Amounts Disclosure reduced by the \$250 of gain attributable to property held for three years or less. PRS includes a \$200 gain in determining A's API One Year Distributive Share Amount and a \$75 gain in determining A's API Three Year Distributive Share Amount. See paragraphs (b)(5)(i) and (ii) of this section.

(d) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the

Section 1061 Regulations in their entirety to that year and all subsequent years.

### §1.1061-5 Section 1061(d) transfers to related persons.

(a) *In general.* If an Owner Taxpayer transfers any API or Distributed API Property, directly or indirectly, to a Section 1061(d) Related Person (as defined in paragraph (e) of this section), the Owner Taxpayer must include in gross income as short-term capital gain, an amount equal to—

(1) The short-term capital gain recognized upon the API transfer without regard to this paragraph (a); and  
(2) The lesser of—

(i) The amount of net long-term capital gain recognized by the Owner Taxpayer upon the transfer of such interest; or

(ii) The amount treated as short-term capital gain under paragraph (c) of this section (Section 1061(d) Recharacterization Amount).

(b) *Transfer.* For purposes of this section, the term *transfer* means a sale or exchange in which gain is recognized by the Owner Taxpayer under chapter 1 of the Internal Revenue Code.

(c) *Section 1061(d) Recharacterization Amount.* To the extent an Owner Taxpayer recognizes long-term capital gain upon a transfer of an API to a Section 1061(d) Related Person, the Owner Taxpayer's Section 1061(d) Recharacterization Amount is the amount of net long-term capital gain (excluding amounts not taken into account for purposes of section 1061 under §1.1061-4(b)(7)) from assets held for three years or less that would have been allocated to the Owner Taxpayer (to the extent attributable to the transferred API) by the partnership if the partnership had sold all of its property in a fully taxable transaction for cash in an amount equal to the fair market value of such property (taking into account section 7701(g)) immediately prior to the Owner Taxpayer's transfer of the API. If only a portion of an Owner Taxpayer's API is transferred, this paragraph (c) shall apply with respect to the portion of gain attributable to the transferred interest.

(d) *Special rules.* For purposes of this section, the following rules are applicable.

(1) An Owner Taxpayer will be treated as transferring the Owner Taxpayer's share of any Indirect API or Distributed API Property if the Indirect API or Distributed API Property is transferred by the API Holder to a person that is a Section 1061(d) Related Person with respect to the Owner Taxpayer.

(2) The rules set forth in paragraphs (a), (b), and (c) of this section apply upon the transfer of a Passthrough Interest issued by an S corporation or PFIC to the extent the Passthrough Interest is treated as an API.

(e) *Section 1061(d) Related Person.* For purposes of this section, the term Section 1061(d) Related Person means—

(1) A person that is a member of the taxpayer's family within the meaning of section 318(a)(1);

(2) A person that performed a service within the current calendar year or the preceding three calendar years in a Relevant ATB to the API transferred by taxpayer; or

(3) A Passthrough Entity to the extent that a person described in paragraph (e) (1) or (2) of this section owns an interest, directly or indirectly.

(f) *Examples.* The following examples illustrate the rules of this section.

(1) *Example 1: Transfer to child by gift.* A, an individual, performs services in an ATB and has held an API in connection with those services for 10 years. The API has a fair market value of \$1,000 and a tax basis of \$0, and no debt is associated with the API. A transfers all of the API to A's daughter as a gift. A's daughter is a section 1061(d) Related Person but A's gift is not a transfer as described in paragraph (b) of this section thus section 1061(d) does not apply to A's gift. However, the API remains an API in the hands of A's daughter under §1.1061-2(a)(1)(i).

(2) *Example 2: Transfer of an API to a partnership owned by Section 1061(d) Related Persons—(i) Facts.* A, B, and C are equal partners in GP, a partnership. GP holds only one asset, an API in PRS1 which is an Indirect API as to each A, B, and C. A, B, and C each provides services in the ATB in connection with which GP was transferred its API in PRS1. A and B contribute their interests in GP to PRS2 in a Section 721(a) exchange for interests in PRS2.

(ii) *Application of section 1061(d).* Because the contribution by A and B of their interest in GP to PRS2 is an exchange in which no gain is recognized by either A or B, the contribution is not a transfer as described in paragraph (b) of this section thus section 1061(d) does not apply to A and B's contribution. However, the API remains an API in the hands of PRS2 under §1.1061-2(a)(1)(i).

(3) *Example 3: Transfer of an API to a Section 1061(d) Related Person.* A holds an API in GP, a partnership which A has owned for four years. A transfers the API to a Section 1061(d) Related Per-

son described in paragraph (e) of this section in exchange for \$100 of cash, resulting in A recognizing long-term capital gain of \$100. Because this is a transfer described in paragraph (b) of this section, section 1061(d) applies to the transfer of A's API and A must determine its Section 1061(d) Recharacterization Amount under paragraph (c) of this section. If, immediately prior to A's transfer of the API, the partnership had sold all of its assets in a fully taxable transaction for cash equal of the fair market value of the assets, A's share of the net long-term capital gain (excluding amounts not taken into account for purposes of section 1061 under §1.1061-4(b)(7)) from assets held for three years or less would have been \$120. Thus, A's Section 1061(d) Recharacterization Amount is \$120. As a result, A's \$100 long-term capital gain is recharacterized as short-term capital gain under paragraph (a) of this section. The API remains an API in the hands of the Section 1061(d) Related Person under §1.1061-2(a)(1)(i).

(g) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December 31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

#### §1.1061-6 Reporting rules.

(a) *Owner Taxpayer filing requirements—(1) In general.* An Owner Taxpayer must file such information with the IRS as the Commissioner of Internal Revenue or the Commissioner's delegate (Commissioner) may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that the Owner Taxpayer has properly complied with section 1061 and the Section 1061 Regulations. If an Owner Taxpayer requires information from a Passthrough Entity to determine the Capital Interest Disposition Amount or the Section 1061(d) Recharacterization Amount, the Owner Taxpayer must request such information from that entity.

(2) *Failure to obtain information.* Paragraph (b)(1) of this section requires certain Passthrough Entities to furnish an Owner Taxpayer with certain amounts necessary to determine its Recharacterization Amount and meet its reporting requirements under paragraph (a)(1) of this section. To the extent that an Owner Taxpayer is not furnished the information required to be furnished under paragraph (b)

(1) of this section in such time and in such manner as required by the Commissioner and the Owner Taxpayer is not otherwise able to substantiate all or a part of these amounts to the satisfaction of the Commissioner, then if the information with respect to the determination of the—

(i) API One Year Distributive Share Amount under §1.1061-4(a)(3)(i) is not furnished, the API One Year Distributive Share Amount will not be reduced by—

(A) Amounts not taken into account for purposes of section 1061 under §1.1061-4(b)(7); or

(B) Capital Interest Gains and Losses as determined under §1.1061-3(c)(2).

(ii) API Three Year Distributive Share Amount determined under §1.1061-4(a)(3)(ii) is not furnished, all items included in the API One Year Distributive Share Amount are treated as items that would not be treated as long-term capital gain or loss, if three years is substituted for one year in paragraphs (3) and (4) of section 1222.

(b) *Passthrough Entity filing requirements and reporting—(1) Requirement to file information with the IRS and to furnish information to API Holder.* A Passthrough Entity must file such information with the IRS as the Commissioner may require in forms, instructions, or other guidance as is necessary for the Commissioner to determine that it and its partners have complied with section 1061 and the Section 1061 Regulations. A Passthrough Entity that has issued an API must furnish to the API Holder, including an Owner Taxpayer, such information at such time and in such manner as the Commissioner may require in forms, instructions, or other guidance as is necessary to determine the One Year Gain Amount and the Three Year Gain Amount with respect to an Owner Taxpayer that directly or indirectly holds the API. A Passthrough Entity that has furnished information to the API Holder must file such information with the IRS, at such time and in such manner as the Commissioner may require in forms, instructions, or other guidance. This information includes:

(i) The API One Year Distributive Share Amount and the API Three Year Distributive Share Amount (as determined under §1.1061-4);

(ii) Capital gains and losses allocated to the API Holder that are excluded from section 1061 under §1.1061-4(b)(7);

(iii) Capital Interest Gains and Losses allocated to the API Holder (as determined under §1.1061-3(c)); and

(iv) In the case of a disposition by an API Holder of an interest in the Passthrough Entity during the taxable year, upon the request of an API Holder, any information required by the API Holder to properly take the disposition into account under section 1061, including—

(A) Information necessary to apply the Lookthrough Rule and to determine the API Holder's Capital Interest Disposition Amount; and

(B) Information necessary to determine an Owner Taxpayer's Section 1061(d) Re-characterization Amount.

(2) *Requirement to request, furnish, and file information in tiered structures—*  
(i) *Requirement to request information.* If a Passthrough Entity requires information to meet its reporting and filing requirements under this section (in addition to any information required to be furnished to the Passthrough Entity under paragraph (b)(1) of this section) from a lower-tier entity in which it holds an interest, the Passthrough Entity must request such information from that entity.

(ii) *Requirement to furnish and file information.* If information is requested of a Passthrough Entity under paragraph (b)(2) (i) of this section, the Passthrough Entity must furnish the requested information to the person making the request but only to the extent the information is necessary for the requesting Passthrough Entity to meet its reporting and filing requirements under this section or is required by the Commissioner in forms, instructions, or other guidance. If the person requesting the information is an API Holder in the Passthrough Entity, the information is furnished under paragraph (b)(1) of this section. If the Passthrough Entity requesting the information is not an API Holder, the Passthrough Entity must furnish the information to the requesting Passthrough Entity as required by the Commissioner in forms, instructions, or other guidance.

(iii) *Timing of requesting and furnishing information—*(A) *Requesting information.* A Passthrough Entity described in paragraph (b)(2)(i) of this section must re-

quest information under paragraph (b)(2) (i) of this section by the later of the 30th day after the close of the taxable year to which the information request relates or 14 days after the date of a request for information from an upper-tier Passthrough Entity.

(B) *Furnishing information—*(1) *In general.* Except as provided in paragraph (b)(2)(iii)(B)(2) of this section, requested information must be furnished by the date on which the entity is required to furnish information under section 6031(b) or under section 6037(b), as applicable.

(2) *Late requests.* Information with respect to a taxable year that is requested by an upper-tier Passthrough Entity after the date that is 14 days prior to the due date for a lower-tier Passthrough Entity to furnish and file information under section 6031(b) or section 6037(b), as applicable, must be furnished and filed in the time and manner prescribed by forms, instructions and other guidance.

(iv) *Manner of requesting information.* Information may be requested electronically or in any manner that is agreed to by the parties.

(v) *Recordkeeping requirement.* Any Passthrough Entity receiving a request for information must retain a copy of the request and the date received in its books and records.

(vi) *Passthrough Entity is not furnished information to meet its reporting obligations under paragraph (b)(1) of this section.* If an upper-tier Passthrough Entity holds an interest in a lower-tier Passthrough Entity and it is not furnished the information described in paragraph (b)(1) of this section, or, alternatively, if it has not been furnished information after having properly requested the information under this paragraph (b)(2), the upper-tier Passthrough Entity must take actions to otherwise determine and substantiate the missing information. To the extent that the upper-tier Passthrough Entity is not able to otherwise substantiate and determine the missing information to the satisfaction of the Commissioner, the upper-tier Passthrough Entity must treat these amounts as provided under paragraph (a)(2) of this section. The upper-tier Passthrough Entity must provide notice to the API Holder and the IRS regarding the application of this paragraph (b)(2) to the

information being reported as required in forms, instructions, and other guidance.

(vii) *Filing requirements.* Both the Passthrough Entity requesting the information and the Passthrough Entity furnishing the information must file all information with the IRS as the Commissioner may require in forms, instructions, or other guidance.

(viii) *Penalties.* In addition to the requirement in section 1061(e) that the Secretary shall require reporting (at the time and in the manner prescribed by the Secretary) as is necessary to carry out the purposes of this section, the information required to be furnished under this paragraph (b) is also required to be furnished under sections 6031(b) and 6037(b). Failure to report as required under this paragraph (b) will be subject to penalties under section 6722.

(c) *Regulated investment company (RIC) and real estate investment trust (REIT) reporting—*(1) *Section 1061 disclosures.* A RIC or REIT that reports or designates a dividend, or part thereof, as a capital gain dividend, may, in addition to the information otherwise required to be furnished to a shareholder, disclose two amounts for purposes of section 1061—

(i) *One Year Amounts Disclosure.* The *One Year Amounts Disclosure* of a RIC or REIT is a disclosure by the RIC or REIT of an amount that is attributable to a computation of the RIC's or REIT's net capital gain excluding capital gain and capital loss not taken into account for purposes of section 1061 under §1.1061-4(b)(7). The aggregate amounts provided in the One Year Amounts Disclosures with respect to a taxable year of a RIC or REIT must equal the lesser of the RIC's or REIT's net capital gain, excluding any capital gains and capital losses not taken into account for purposes of section 1061 under §1.1061-4(b)(7), for the taxable year or the RIC's or REIT's aggregate capital gain dividends for the taxable year.

(ii) *Three Year Amounts Disclosure.* The *Three Year Amounts Disclosure* of a RIC or REIT is a disclosure by the RIC or REIT of an amount that is attributable to a computation of the RIC's or REIT's One Year Amounts Disclosure substituting "three years" for "one year" in applying section 1222. The aggregate amounts provided in the Three Year Amounts Dis-

closures with respect to a taxable year of a RIC or REIT must equal the lesser of the aggregate amounts provided in the RIC's or REIT's One Year Amounts Disclosures substituting "three years" for "one year" in applying section 1222 for the taxable year or the RIC's or REIT's aggregate capital gain dividends for the taxable year.

(2) *Pro rata disclosures.* The One Year Amounts Disclosure and Three Year Amounts Disclosure made to each shareholder of a RIC or REIT must be proportionate to the share of capital gain dividends reported or designated to that shareholder for the taxable year.

(3) *Report to shareholders.* A RIC or REIT that provides the section 1061 disclosures described in paragraphs (c)(1)(i) and (ii) of this section must provide those section 1061 disclosures in writing to its shareholders with the statement described in section 852(b)(3)(C)(i) or the notice described in section 857(b)(3)(B) in which the capital gain dividend is reported or designated.

(d) *Qualified electing fund (QEF) reporting.* A passive foreign investment company with respect to which the shareholder has a QEF election (as described in section 1295(a)) in effect for the taxable year that determines net capital gain as provided in §1.1293-1(a)(2)(i)(A), as limited by section 1293(e)(2), may provide some or all of the information listed in paragraph (b)(1) of this section (and any other relevant information) to its shareholders to enable API Holders to determine the amount of their inclusion under section 1293(a)(1) that would be included in the API One Year Distributive Share Amounts and API Three Year Distributive Share Amounts. To the extent that such information is not provided, paragraph (a)(2) of this section will apply except that Owner Taxpayers are not permitted to separately substantiate the information. An API Holder who receives the additional information described in this paragraph (d) must retain such information as required by §1.1295-1(f)(2)(ii).

(e) *Applicability date.* The provisions of this section apply to taxable years of Owner Taxpayers and Passthrough Entities beginning on or after January 19, 2021. An Owner Taxpayer or Passthrough Entity may choose to apply this section to a taxable year beginning after December

31, 2017, provided that they apply the Section 1061 Regulations in their entirety to that year and all subsequent years.

**Par. 5.** Section 1.1223-3 is amended by:

1. Redesignating paragraph (b)(5) as paragraph (b)(6);
2. Adding a new paragraph (b)(5);
3. Designating *Examples 1* through 8 of paragraph (f) as paragraphs (f)(1) through (8);
4. Adding paragraphs (f)(9) and (10); and
5. Revising the heading and adding a sentence at the end of paragraph (g).

The additions and revision read as follows:

*§1.1223-3 Rules relating to the holding periods of partnership interests.*

\* \* \* \* \*

(b) \* \* \*

(5) *Divided holding period if partnership interest comprises in whole or in part one or more profits interests—(i) In general.* If a partnership interest is comprised in whole or in part of one or more profits interests (as defined in paragraph (b)(5)(ii) of this section), then, for purposes of applying paragraph (b)(1) of this section, the portion of the holding period to which a profits interest relates is determined based on the fair market value of the profits interest upon the disposition of all, or part, of the interest (and not at the time that the profits interest is acquired). Paragraph (b)(1) of this section continues to apply to the extent that a partner acquires portions of a partnership interest that are not comprised of a profits interest and the value of the profits interest is not included for purposes of determining the value of the entire partnership interest under paragraph (b)(1).

(ii) *Definition of capital interest and profits interest.* For purposes of this paragraph (b)(5), a profits interest is a partnership interest other than a capital interest. A capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value at the time the interest was received and then the proceeds were distributed in a complete liquidation of the partnership. A profits interest, for purposes of this paragraph (b)(5), is received in

connection with the performance of services to or for the benefit of a partnership in a partner capacity or in anticipation of being a partner, and the receipt of the interest is not treated as a taxable event for the partner or the partnership under applicable Federal income tax guidance.

\* \* \* \* \*

(f) \* \* \*

(9) *Example 9.* On June 1, 2020, GP contributes \$10,000 to PRS for a partnership interest in PRS. On June 30, 2023, GP receives a 20% interest in the profits of PRS that is an Applicable Partnership Interest (API) as defined in §1.1061-1(a). On June 30, 2025, GP sells its interest in PRS for \$30,000. At the time of GP's sale of its interest, the API has a fair market value of \$15,000. GP has a divided holding period in its interest in PRS; 50% of the partnership interest has a holding period beginning on June 1, 2020, and 50% has a holding period that begins on June 30, 2023.

(10) *Example 10.* Assume the same facts as in paragraph (f)(9) of this section (*Example 9*), except that on June 30, 2024, GP contributes an additional \$5,000 cash to GP prior to GP's sale of its interest in 2025. Immediately after the contribution of the \$5,000 on June 30, 2024, GP's interest in PRS has a value of \$15,000, not taking into account the value of GP's profits interest in PRS. GP calculates its holding period in the portions not comprised by the profits interest and two-thirds of its holding period runs from June 30, 2020, and one-third runs from June 30, 2024. On June 30, 2025, GP sells its interest for \$30,000 and the API has a fair market value of \$15,000. Accordingly, on the date of disposition, one-third of GP's interest has a five year holding period from its interest received in 2020 for its \$10,000 contribution, one-half of GP's interest has a two year holding period from the profits interest issued on June 30, 2023, and one-sixth of GP's interest has a one year holding period from the contribution of the \$5,000.

(g) *Applicability dates.* \* \* \* Paragraphs (b)(5) and (f)(9) and (10) of this section apply to taxable years beginning on or after January 19, 2021.

Sunita Lough,  
*Deputy Commissioner for Services  
and Enforcement.*

Approved: January 5, 2021.

David J. Kautter,  
*Assistant Secretary of the Treasury  
(Tax Policy).*

(Filed by the Office of the Federal Register on January 13, 2021, 4:15 p.m., and published in the issue of the Federal Register for January 19, 2021, 85 F.R. 5452)

## Section 401. —Qualified Pension, Profit-Sharing, and Stock Bonus Plans

26 CFR 1.401(l)-1: Permitted disparity in employer-provided contributions or benefits.

### Rev. Rul. 2021-3

This revenue ruling provides tables of covered compensation under § 401(l)(5)(E) of the Internal Revenue Code and the Income Tax Regulations thereunder, for the 2021 plan year.

Section 401(l)(5)(E)(i) defines covered compensation with respect to an employee as the average of the contribution and benefit bases in effect under section 230 of the Social Security Act (“Act”) for each year in the 35-year period ending with the year in which the employee attains Social Security retirement age.

Section 401(l)(5)(E)(ii) states that the determination for any year preceding the

year in which the employee attains Social Security retirement age shall be made by assuming that there is no increase in covered compensation after the determination year and before the employee attains Social Security retirement age.

Section 1.401(l)-1(c)(34) of the Income Tax Regulations defines the taxable wage base as the contribution and benefit base under section 230 of the Act.

Section 1.401(l)-1(c)(7)(i) defines covered compensation for an employee as the average (without indexing) of the taxable wage bases in effect for each calendar year during the 35-year period ending with the last day of the calendar year in which the employee attains (or will attain) Social Security retirement age. A 35-year period is used for all individuals regardless of the year of birth of the individual. In determining an employee’s covered compensation for a plan year, the taxable wage base for all calendar years beginning after the first day of the plan year is assumed to be the same as the taxable wage base in

effect as of the beginning of the plan year. An employee’s covered compensation for a plan year beginning after the 35-year period applicable under § 1.401(l)-1(c)(7)(i) is the employee’s covered compensation for a plan year during which the 35-year period ends. An employee’s covered compensation for a plan year beginning before the 35-year period applicable under § 1.401(l)-1(c)(7)(i) is the taxable wage base in effect as of the beginning of the plan year.

Section 1.401(l)-1(c)(7)(ii) provides that, for purposes of determining the amount of an employee’s covered compensation under § 1.401(l)-1(c)(7)(i), a plan may use tables, provided by the Commissioner, that are developed by rounding the actual amounts of covered compensation for different years of birth.

For purposes of determining covered compensation for the 2021 year, the taxable wage base is \$142,800.

The following tables provide covered compensation for 2021.

| ATTACHMENT I                    |   |                                    |
|---------------------------------|---|------------------------------------|
| 2021 COVERED COMPENSATION TABLE |   |                                    |
| CALENDAR YEAR OF BIRTH          | CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE | 2021 COVERED COMPENSATION TABLE II |
| 1907                            | 1972  | \$ 4,488                           |
| 1908                            | 1973  | 4,704                              |
| 1909                            | 1974  | 5,004                              |
| 1910                            | 1975  | 5,316                              |
| 1911                            | 1976  | 5,664                              |
| 1912                            | 1977  | 6,060                              |
| 1913                            | 1978  | 6,480                              |
| 1914                            | 1979  | 7,044                              |
| 1915                            | 1980  | 7,692                              |
| 1916                            | 1981  | 8,460                              |
| 1917                            | 1982  | 9,300                              |
| 1918                            | 1983  | 10,236                             |
| 1919                            | 1984  | 11,232                             |
| 1920                            | 1985  | 12,276                             |
| 1921                            | 1986  | 13,368                             |
| 1922                            | 1987  | 14,520                             |
| 1923                            | 1988  | 15,708                             |
| 1924                            | 1989  | 16,968                             |
| 1925                            | 1990  | 18,312                             |

## ATTACHMENT I

## 2021 COVERED COMPENSATION TABLE

| CALENDAR YEAR OF BIRTH | CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE | 2021 COVERED COMPENSATION TABLE II |
|------------------------|---|------------------------------------|
| 1926                   | 1991  | 19,728                             |
| 1927                   | 1992  | 21,192                             |
| 1928                   | 1993  | 22,716                             |
| 1929                   | 1994  | 24,312                             |
| 1930                   | 1995  | 25,920                             |
| 1931                   | 1996  | 27,576                             |
| 1932                   | 1997  | 29,304                             |
| 1933                   | 1998  | 31,128                             |
| 1934                   | 1999  | 33,060                             |
| 1935                   | 2000  | 35,100                             |
| 1936                   | 2001  | 37,212                             |
| 1937                   | 2002  | 39,444                             |
| 1938                   | 2004  | 43,992                             |
| 1939                   | 2005  | 46,344                             |
| 1940                   | 2006  | 48,816                             |
| 1941                   | 2007  | 51,348                             |
| 1942                   | 2008  | 53,952                             |
| 1943                   | 2009  | 56,628                             |
| 1944                   | 2010  | 59,268                             |
| 1945                   | 2011  | 61,884                             |
| 1946                   | 2012  | 64,560                             |
| 1947                   | 2013  | 67,308                             |
| 1948                   | 2014  | 69,996                             |
| 1949                   | 2015  | 72,636                             |
| 1950                   | 2016  | 75,180                             |
| 1951                   | 2017  | 77,880                             |
| 1952                   | 2018  | 80,532                             |
| 1953                   | 2019  | 83,244                             |
| 1954                   | 2020  | 86,052                             |
| 1955                   | 2022  | 91,764                             |
| 1956                   | 2023  | 94,560                             |
| 1957                   | 2024  | 97,260                             |
| 1958                   | 2025  | 99,876                             |
| 1959                   | 2026  | 102,432                            |
| 1960                   | 2027  | 104,928                            |
| 1961                   | 2028  | 107,364                            |
| 1962                   | 2029  | 109,704                            |
| 1963                   | 2030  | 112,044                            |
| 1964                   | 2031  | 114,324                            |
| 1965                   | 2032  | 116,544                            |
| 1966                   | 2033  | 118,668                            |

ATTACHMENT I

2021 COVERED COMPENSATION TABLE

| CALENDAR YEAR OF BIRTH | CALENDAR YEAR OF SOCIAL SECURITY RETIREMENT AGE | 2021 COVERED COMPENSATION TABLE II |
|------------------------|---|------------------------------------|
| 1967                   | 2034  | 120,672                            |
| 1968                   | 2035  | 122,580                            |
| 1969                   | 2036  | 124,356                            |
| 1970                   | 2037  | 126,012                            |
| 1971                   | 2038  | 127,608                            |
| 1972                   | 2039  | 129,180                            |
| 1973                   | 2040  | 130,680                            |
| 1974                   | 2041  | 132,072                            |
| 1975                   | 2042  | 133,368                            |
| 1976                   | 2043  | 134,532                            |
| 1977                   | 2044  | 135,564                            |
| 1978                   | 2045  | 136,584                            |
| 1979                   | 2046  | 137,616                            |
| 1980                   | 2047  | 138,552                            |
| 1981                   | 2048  | 139,380                            |
| 1982                   | 2049  | 140,124                            |
| 1983                   | 2050  | 140,820                            |
| 1984                   | 2051  | 141,504                            |
| 1985                   | 2052  | 141,960                            |
| 1986                   | 2053  | 142,368                            |
| 1987                   | 2054  | 142,644                            |
| 1988 and Later         | 2055 and Later                                  | 142,800                            |

ATTACHMENT II

2021 ROUNDED COVERED COMPENSATION TABLE

| CALENDAR YEAR OF BIRTH | 2021 COVERED COMPENSATION ROUNDED |
|------------------------|-----------------------------------|
| 1937                   | \$ 39,000                         |
| 1938 – 1939            | 45,000                            |
| 1940                   | 48,000                            |
| 1941                   | 51,000                            |
| 1942                   | 54,000                            |
| 1943                   | 57,000                            |
| 1944                   | 60,000                            |
| 1945                   | 63,000                            |
| 1946 – 1947            | 66,000                            |
| 1948                   | 69,000                            |
| 1949                   | 72,000                            |
| 1950                   | 75,000                            |
| 1951                   | 78,000                            |
| 1952                   | 81,000                            |
| 1953                   | 84,000                            |
| 1954                   | 87,000                            |
| 1955                   | 93,000                            |
| 1956 – 1957            | 96,000                            |
| 1958                   | 99,000                            |
| 1959                   | 102,000                           |
| 1960                   | 105,000                           |
| 1961                   | 108,000                           |
| 1962 – 1963            | 111,000                           |
| 1964                   | 114,000                           |
| 1965                   | 117,000                           |
| 1966 – 1967            | 120,000                           |
| 1968 – 1969            | 123,000                           |
| 1970                   | 126,000                           |
| 1971 – 1972            | 129,000                           |
| 1973 – 1975            | 132,000                           |
| 1976 – 1977            | 135,000                           |
| 1978 – 1981            | 138,000                           |
| 1982 – 1984            | 141,000                           |
| 1985 and Later         | 142,800                           |

DRAFTING INFORMATION

The principal author of this notice is Tom Morgan of the Office of the Asso-

ciate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the IRS participated in the development

of this guidance. For further information regarding this notice, contact Mr. Morgan at 202-317-6700 or Christopher Denning at 202-317-8698 (not toll-free numbers).

# Part III

## Update for Weighted Average Interest Rates, Yield Curves, and Segment Rates

### Notice 2021-9

This notice provides guidance on the corporate bond monthly yield curve, the corresponding spot segment rates used under § 417(e)(3), and the 24-month average segment rates under § 430(h)(2) of the Internal Revenue Code. In addition, this notice provides guidance as to the interest rate on 30-year Treasury securities under § 417(e)(3)(A)(ii)(II) as in effect for plan years beginning before 2008 and the 30-year Treasury weighted average rate under § 431(c)(6)(E)(ii)(I).

#### YIELD CURVE AND SEGMENT RATES

Section 430 specifies the minimum funding requirements that apply to single-employer plans (except for CSEC

plans under § 414(y)) pursuant to § 412. Section 430(h)(2) specifies the interest rates that must be used to determine a plan's target normal cost and funding target. Under this provision, present value is generally determined using three 24-month average interest rates ("segment rates"), each of which applies to cash flows during specified periods. To the extent provided under § 430(h)(2)(C)(iv), these segment rates are adjusted by the applicable percentage of the 25-year average segment rates for the period ending September 30 of the year preceding the calendar year in which the plan year begins.<sup>1</sup> However, an election may be made under § 430(h)(2)(D)(ii) to use the monthly yield curve in place of the segment rates.

Notice 2007-81, 2007-44 I.R.B. 899, provides guidelines for determining the monthly corporate bond yield curve, and the 24-month average corporate bond segment rates used to compute the target normal cost and the funding target. Consistent with the methodology specified in Notice 2007-81, the monthly corporate bond yield curve derived from December 2020 data is in Table 2020-12 at the end of this notice. The spot first, second, and third segment

rates for the month of December 2020 are, respectively, 0.51, 2.26, and 3.01.

The 24-month average segment rates determined under § 430(h)(2)(C)(i) through (iii) must be adjusted pursuant to § 430(h)(2)(C)(iv) to be within the applicable minimum and maximum percentages of the corresponding 25-year average segment rates. For plan years beginning before 2021, the applicable minimum percentage is 90% and the applicable maximum percentage is 110%. For plan years beginning in 2021, the applicable minimum percentage is 85% and the applicable maximum percentage is 115%. The 25-year average segment rates for plan years beginning in 2019, 2020, and 2021 were published in Notice 2018-73, 2018-40 I.R.B. 526, Notice 2019-51, 2019-41 I.R.B. 866, and Notice 2020-72, 2020-40 I.R.B. 789, respectively.

#### 24-MONTH AVERAGE CORPORATE BOND SEGMENT RATES

The three 24-month average corporate bond segment rates applicable for January 2021 without adjustment for the 25-year average segment rate limits are as follows:

*24-Month Average Segment Rates Without 25-Year Average Adjustment*

| Applicable Month | First Segment | Second Segment | Third Segment |
|------------------|---------------|----------------|---------------|
| January 2021     | 1.75          | 3.04           | 3.65          |

Based on § 430(h)(2)(C)(iv), the 24-month averages applicable for January

2021, adjusted to be within the applicable minimum and maximum percentages of

the corresponding 25-year average segment rates, are as follows:

*Adjusted 24-Month Average Segment Rates*

| For Plan Years Beginning In | Applicable Month | First Segment | Second Segment | Third Segment |
|-----------------------------|------------------|---------------|----------------|---------------|
| 2019                        | January 2021     | 3.74          | 5.35           | 6.11          |
| 2020                        | January 2021     | 3.64          | 5.21           | 5.94          |
| 2021                        | January 2021     | 3.32          | 4.79           | 5.47          |

#### 30-YEAR TREASURY SECURITIES INTEREST RATES

Section 431 specifies the minimum

funding requirements that apply to multi-employer plans pursuant to § 412. Section 431(c)(6)(B) specifies a minimum amount for the full-funding limitation described in

§ 431(c)(6)(A), based on the plan's current liability. Section 431(c)(6)(E)(ii)(I) provides that the interest rate used to calculate current liability for this purpose must be

<sup>1</sup> Pursuant to § 433(h)(3)(A), the 3<sup>rd</sup> segment rate determined under § 430(h)(2)(C) is used to determine the current liability of a CSEC plan (which is used to calculate the minimum amount of the full funding limitation under § 433(c)(7)(C)).

no more than 5 percent above and no more than 10 percent below the weighted average of the rates of interest on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year. Notice 88-73, 1988-2 C.B.

383, provides guidelines for determining the weighted average interest rate. The rate of interest on 30-year Treasury securities for December 2020 is 1.67 percent. The Service determined this rate as the average of the daily determinations of yield on the

30-year Treasury bond maturing in November 2050. For plan years beginning in January 2021, the weighted average of the rates of interest on 30-year Treasury securities and the permissible range of rates used to calculate current liability are as follows:

| <b>For Plan Years<br/>Beginning In</b> | <i>Treasury Weighted Average Rates</i>       |  |
|--|--|--|
|  | <b>30-Year Treasury<br/>Weighted Average</b> | <b>Permissible Range<br/>90% to 105%</b> |
| January 2021                           | 2.31   | 2.08 to 2.43                             |

**MINIMUM PRESENT VALUE  
SEGMENT RATES**

In general, the applicable interest rates

under § 417(e)(3)(D) are segment rates computed without regard to a 24-month average. Notice 2007-81 provides guidelines for determining the minimum pres-

ent value segment rates. Pursuant to that notice, the minimum present value segment rates determined for December 2020 are as follows:

| <b>Month</b>  | <i>Minimum Present Value Segment Rates</i> |                       |                      |
|---------------|--|-----------------------|----------------------|
|               | <b>First Segment</b>                       | <b>Second Segment</b> | <b>Third Segment</b> |
| December 2020 | 0.51                                       | 2.26                  | 3.01                 |

**DRAFTING INFORMATION**

The principal author of this notice is Tom Morgan of the Office of the Asso-

ciate Chief Counsel (Employee Benefits, Exempt Organizations, and Employment Taxes). However, other personnel from the IRS participated in the development

of this guidance. For further information regarding this notice, contact Mr. Morgan at 202-317-6700 or Paul Stern at 202-317-8702 (not toll-free numbers).

**Table 2020-12**  
 Monthly Yield Curve for December 2020  
 Derived from December 2020 Data

| <i>Maturity</i> | <i>Yield</i> | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| 0.5             | 0.16         | 20.5            | 2.85         | 40.5            | 3.03         | 60.5            | 3.09         | 80.5            | 3.13         |
| 1.0             | 0.26         | 21.0            | 2.86         | 41.0            | 3.03         | 61.0            | 3.09         | 81.0            | 3.13         |
| 1.5             | 0.35         | 21.5            | 2.87         | 41.5            | 3.03         | 61.5            | 3.09         | 81.5            | 3.13         |
| 2.0             | 0.42         | 22.0            | 2.87         | 42.0            | 3.03         | 62.0            | 3.10         | 82.0            | 3.13         |
| 2.5             | 0.48         | 22.5            | 2.88         | 42.5            | 3.03         | 62.5            | 3.10         | 82.5            | 3.13         |
| 3.0             | 0.53         | 23.0            | 2.88         | 43.0            | 3.04         | 63.0            | 3.10         | 83.0            | 3.13         |
| 3.5             | 0.59         | 23.5            | 2.89         | 43.5            | 3.04         | 63.5            | 3.10         | 83.5            | 3.13         |
| 4.0             | 0.66         | 24.0            | 2.89         | 44.0            | 3.04         | 64.0            | 3.10         | 84.0            | 3.13         |
| 4.5             | 0.75         | 24.5            | 2.90         | 44.5            | 3.04         | 64.5            | 3.10         | 84.5            | 3.13         |
| 5.0             | 0.85         | 25.0            | 2.90         | 45.0            | 3.05         | 65.0            | 3.10         | 85.0            | 3.13         |
| 5.5             | 0.96         | 25.5            | 2.91         | 45.5            | 3.05         | 65.5            | 3.10         | 85.5            | 3.13         |
| 6.0             | 1.08         | 26.0            | 2.91         | 46.0            | 3.05         | 66.0            | 3.10         | 86.0            | 3.13         |
| 6.5             | 1.21         | 26.5            | 2.92         | 46.5            | 3.05         | 66.5            | 3.10         | 86.5            | 3.13         |
| 7.0             | 1.34         | 27.0            | 2.92         | 47.0            | 3.05         | 67.0            | 3.11         | 87.0            | 3.13         |
| 7.5             | 1.47         | 27.5            | 2.93         | 47.5            | 3.06         | 67.5            | 3.11         | 87.5            | 3.13         |
| 8.0             | 1.60         | 28.0            | 2.93         | 48.0            | 3.06         | 68.0            | 3.11         | 88.0            | 3.14         |
| 8.5             | 1.73         | 28.5            | 2.94         | 48.5            | 3.06         | 68.5            | 3.11         | 88.5            | 3.14         |
| 9.0             | 1.85         | 29.0            | 2.94         | 49.0            | 3.06         | 69.0            | 3.11         | 89.0            | 3.14         |
| 9.5             | 1.96         | 29.5            | 2.95         | 49.5            | 3.06         | 69.5            | 3.11         | 89.5            | 3.14         |
| 10.0            | 2.06         | 30.0            | 2.95         | 50.0            | 3.06         | 70.0            | 3.11         | 90.0            | 3.14         |
| 10.5            | 2.16         | 30.5            | 2.96         | 50.5            | 3.07         | 70.5            | 3.11         | 90.5            | 3.14         |
| 11.0            | 2.25         | 31.0            | 2.96         | 51.0            | 3.07         | 71.0            | 3.11         | 91.0            | 3.14         |
| 11.5            | 2.33         | 31.5            | 2.97         | 51.5            | 3.07         | 71.5            | 3.11         | 91.5            | 3.14         |
| 12.0            | 2.40         | 32.0            | 2.97         | 52.0            | 3.07         | 72.0            | 3.11         | 92.0            | 3.14         |
| 12.5            | 2.46         | 32.5            | 2.98         | 52.5            | 3.07         | 72.5            | 3.12         | 92.5            | 3.14         |
| 13.0            | 2.52         | 33.0            | 2.98         | 53.0            | 3.07         | 73.0            | 3.12         | 93.0            | 3.14         |
| 13.5            | 2.57         | 33.5            | 2.98         | 53.5            | 3.07         | 73.5            | 3.12         | 93.5            | 3.14         |
| 14.0            | 2.61         | 34.0            | 2.99         | 54.0            | 3.08         | 74.0            | 3.12         | 94.0            | 3.14         |
| 14.5            | 2.65         | 34.5            | 2.99         | 54.5            | 3.08         | 74.5            | 3.12         | 94.5            | 3.14         |
| 15.0            | 2.68         | 35.0            | 2.99         | 55.0            | 3.08         | 75.0            | 3.12         | 95.0            | 3.14         |
| 15.5            | 2.71         | 35.5            | 3.00         | 55.5            | 3.08         | 75.5            | 3.12         | 95.5            | 3.14         |
| 16.0            | 2.73         | 36.0            | 3.00         | 56.0            | 3.08         | 76.0            | 3.12         | 96.0            | 3.14         |
| 16.5            | 2.75         | 36.5            | 3.00         | 56.5            | 3.08         | 76.5            | 3.12         | 96.5            | 3.14         |
| 17.0            | 2.77         | 37.0            | 3.01         | 57.0            | 3.08         | 77.0            | 3.12         | 97.0            | 3.14         |
| 17.5            | 2.79         | 37.5            | 3.01         | 57.5            | 3.09         | 77.5            | 3.12         | 97.5            | 3.14         |
| 18.0            | 2.80         | 38.0            | 3.01         | 58.0            | 3.09         | 78.0            | 3.12         | 98.0            | 3.14         |
| 18.5            | 2.81         | 38.5            | 3.01         | 58.5            | 3.09         | 78.5            | 3.12         | 98.5            | 3.15         |
| 19.0            | 2.83         | 39.0            | 3.02         | 59.0            | 3.09         | 79.0            | 3.12         | 99.0            | 3.15         |
| 19.5            | 2.83         | 39.5            | 3.02         | 59.5            | 3.09         | 79.5            | 3.13         | 99.5            | 3.15         |
| 20.0            | 2.84         | 40.0            | 3.02         | 60.0            | 3.09         | 80.0            | 3.13         | 100.0           | 3.15         |

26 CFR 601.105: Examination of returns and claims for refund, credit or abatement; determination of correct tax liability.  
(Also: Part I, §§ 860D, 860F, 860G, 1001; 1.856-6, 1.860G-2, 1.1001-3, 301.7701-2, 301.7701-3, 301.7701-4.)

## Rev. Proc. 2021-12

### SECTION 1. PURPOSE

In light of the continuing Coronavirus Disease 2019 (COVID-19) pandemic, this revenue procedure extends the expiration dates relevant to the application of the safe harbors in Rev. Proc. 2020-26, 2020-18 I.R.B. 753. These safe harbors protect the Federal income tax status of real estate mortgage investment conduits (REMICs) and investment trusts that provide certain forbearances of mortgage loans they hold or that acquire mortgage loans that have received certain forbearances. Additionally, this revenue procedure extends the expiration dates relevant to the application of the safe harbors in Rev. Proc. 2020-34, 2020-26 I.R.B. 990. These safe harbors protect the Federal income tax status of certain investment trusts whose trustees request or agree to certain forbearances of mortgage loans, make certain modifications of real property leases, or accept certain cash contributions.

### SECTION 2. BACKGROUND — COVID-19 and the CARES ACT

On March 27, 2020, the President signed into law the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 134 Stat. 281 (CARES Act). The CARES Act provides, among other things, that borrowers with Federally backed mortgage loans and multifamily borrowers with Federally backed multifamily mortgage loans experiencing a financial hardship due, directly or indirectly, to the COVID-19 emergency may request and obtain forbearance on their loans. See sections 4022 and 4023 of the CARES Act.

### SECTION 3. BACKGROUND — REVENUE PROCEDURE 2020-26

.01 On April 13, 2020, the Department of the Treasury (Treasury Department)

and the Internal Revenue Service (IRS) issued Rev. Proc. 2020-26. Rev. Proc. 2020-26 provided safe harbors for determining the Federal income tax status of REMICs and investment trusts that hold mortgage loans. Under the safe harbors, certain modifications of mortgage loans in connection with forbearances described in Rev. Proc. 2020-26 are not treated as replacing the unmodified obligation with a newly issued obligation, as giving rise to prohibited transactions, as resulting in a deemed reissuance of the REMIC regular interests, or as manifesting a power to vary. In addition, under another safe harbor in the revenue procedure, REMICs are not treated as having improper knowledge of an anticipated default on the grounds that they acquired a mortgage loan with respect to which the borrower had requested or agreed to a forbearance described in Rev. Proc. 2020-26.

.02 The forbearances described in Rev. Proc. 2020-26 are—

(1) Forbearances of any Federally backed mortgage loans or Federally backed multifamily mortgage loans provided under sections 4022 or 4023 of the CARES Act, respectively, and all related modifications [(CARES Act Forbearances)], and

(2) Forbearances (and all related modifications) that are not [CARES Act Forbearances], that are provided by a holder or servicer, that are agreed to by the borrower of any Federally backed or non-Federally backed mortgage loan, and that are made under forbearance programs for borrowers experiencing a financial hardship due, directly or indirectly, to the COVID-19 emergency. For this purpose, forbearance programs are programs that are identical or similar to those described in section 2.07 of [Rev. Proc. 2020-26] pursuant to which, between March 27, 2020, and December 31, 2020, inclusive, the borrower requests or agrees to the forbearance (and all related modifications).

2020-18 I.R.B. 755.

.03 In light of the continuing COVID-19 pandemic, the Treasury Department and the IRS have decided to extend the expiration dates relevant to the application of the safe harbors in Rev. Proc. 2020-26.

### SECTION 4. BACKGROUND — REVENUE PROCEDURE 2020-34

.01 On June 4, 2020, the Treasury Department and the IRS issued Rev. Proc. 2020-34. Rev. Proc. 2020-34 provided safe harbors for determining the Federal income tax status of certain investment trusts that hold real property. Under the safe harbors, certain modifications of mortgage loans in connection with forbearance programs described in Rev. Proc. 2020-26 are not treated as manifesting a power to vary. Additionally, certain modifications of real property leases and the acceptance of additional cash contributions related to the COVID-19 emergency are not treated as manifesting a power to vary.

.02 The SCOPE section of Rev. Proc. 2020-34 provides—

.01 [Rev. Proc. 2020-34] applies to arrangements that are trusts under § 301.7701-4(c) and Rev. Rul. 2004-86 and that hold real property and engage in one or more of the actions described in sections 6.02, 6.03, or 6.04 of [Rev. Proc. 2020-34]. Although Rev. Rul. 2004-86 describes a trust that had been formed under a specific Delaware statute, [Rev. Proc. 2020-34] applies to trusts formed under the equivalent law (if any) of other States or the District of Columbia.

.02 Modification of one or more mortgage loans that secure the trust's real property in—

(1) A CARES Act Forbearance (and all related modifications); or

(2) A forbearance (and all related modifications)—

(a) That are described in section 2.07 of Rev. Proc. 2020-26;

(b) That the trust requested, or agreed to, between March 27, 2020, and December 31, 2020; and

(c) That were granted as a result of the trust experiencing a financial hardship due to the COVID-19 emergency.

.03 Modifications of one or more real property leases (including modifications to the specific allocations of fixed rent in the lease agreements as described in § 467 of the Code and the regulations under § 467; see section 9.01 of [Rev. Proc. 2020-34]). The lease must have been entered

into by the trust on or before March 13, 2020, and the modifications must have been requested and agreed to on or after March 27, 2020, and on or before December 31, 2020. The reason for the modifications must be—

(1) To coordinate the lease cash flows with the cash flows that result from [the forbearances described in section 6.02 of Rev. Proc. 2020–34]; or

(2) To defer or waive one or more tenants’ rental payments for any period between March 27, 2020, and December 31, 2020 (and all related modifications), because the tenants are experiencing a financial hardship due to the COVID-19 emergency.

.04 Acceptance of cash contributions that are made between March 27, 2020, and December 31, 2020, as a result of the trust experiencing financial hardship due to the COVID-19 emergency, provided the contribution must be needed to increase permitted trust reserves, to maintain trust property, to fulfill obligations under mortgage loans, or to

fulfill obligations under real property leases. See section 10 of [Rev. Proc. 2020–34] regarding the tax treatment of non-pro rata contributions or contributions from new investors for an interest in the trust.

2020–26 I.R.B. 992.

.03 In light of the continuing COVID-19 pandemic, the Treasury Department and the IRS have decided to extend the expiration dates relevant to the application of the safe harbors in Rev. Proc. 2020-34.

#### **SECTION 5. EXTENSION OF TIME PERIODS**

.01 The time periods described in sections 5.01(2), 5.02(2), and 6.02(2) of Rev. Proc. 2020-26 are extended until September 30, 2021. Accordingly, in sections 5.01(2), 5.02(2), and 6.02(2) of Rev. Proc. 2020-26, “September 30, 2021” is substituted for “December 31, 2020” in each place it appears.

.02 The time periods described in sections 6.02(2)(b), 6.03, 6.03(2), and 6.04 of Rev. Proc. 2020-34 are extended until September 30, 2021. Accordingly, in sec-

tions 6.02(2)(b), 6.03, 6.03(2) and 6.04 of Rev. Proc. 2020-34, “September 30, 2021” is substituted for “December 31, 2020” each place it appears.

#### **SECTION 6. EFFECT ON OTHER DOCUMENTS**

This revenue procedure amplifies Rev. Proc. 2020-26 and Rev. Proc. 2020-34.

#### **SECTION 7. DRAFTING INFORMATION**

The principal authors of this revenue procedure are Diana Imholtz and Michael Chin of the Office of Associate Chief Counsel (Financial Institutions & Products), with respect to the amplification of Rev. Proc. 2020–26, and Christiaan Cleary of the Office of Associate Chief Counsel (Passthroughs and Special Industries), with respect to the amplification of Rev. Proc. 2020–34. For further information regarding this revenue procedure, contact Mr. Chin at (202) 317-6842 (not a toll-free number) or Mr. Cleary at (202) 317-6850 (not a toll-free number).

# Part IV

## Notice of Proposed Rulemaking

### 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)

#### REG-111950-20

**AGENCY:** Internal Revenue Service (IRS), Treasury.

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

**SUMMARY:** This document contains proposed regulations regarding the determination of whether a foreign corporation is treated as a passive foreign investment company (“PFIC”) for purposes of the Internal Revenue Code (“Code”). The proposed regulations also provide guidance regarding the treatment of income and assets of a qualifying insurance corporation (“QIC”) that is engaged in the active conduct of an insurance business (“PFIC insurance exception”). This document also contains proposed regulations addressing the treatment of qualified improvement property (“QIP”) under the alternative depreciation system (“ADS”) for purposes of calculating qualified business asset investment (“QBAI”) for purposes of the global intangible low-taxed income (“GILTI”) and the foreign-derived intangible income (“FDII”) provisions, which were added to the Code in the Tax Cuts and Jobs Act. The proposed regulations affect United States persons with direct or indirect ownership interests in certain foreign corporations, United States shareholders of controlled foreign corporations, and domestic corporations eligible for the deduction for FDII.

**DATES:** Written or electronic comments and requests for a public hearing must be received by April 14, 2021. Requests for a public hearing must be submitted as prescribed in the “Comments and Requests for a Public Hearing” section.

**ADDRESSES:** Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-111950-20) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

Send paper submissions to: CC:PA:LPD:PR (REG-111950-20), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

#### FOR FURTHER INFORMATION

**CONTACT:** Concerning proposed regulations §§1.250(b)-1(b)(2) and 1.250(b)-2(e)(2), Lorraine Rodriguez, (202) 317-6726; concerning proposed regulations §1.951A-3(e)(2), Jorge M. Oben and Larry R. Pounders, (202) 317-6934; concerning proposed regulations §§1.1297-0 through 1.1297-2, 1.1298-0 and 1.1298-4, Christina G. Daniels at (202) 317-6934; concerning proposed regulations §§1.1297-4 through 1.1297-6 (the PFIC insurance exception), Josephine Firehock at (202) 317-4932; concerning submissions of comments and requests for a public hearing, Regina L. Johnson at (202) 317-6901 (not toll-free numbers) or by sending an email to [publichearings@irs.gov](mailto:publichearings@irs.gov) (preferred).

#### SUPPLEMENTARY INFORMATION:

##### Background

##### I. *Passive Foreign Investment Companies*

##### A. *In general*

This document contains proposed amendments to 26 CFR part 1 under sections 1297 and 1298. 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. 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)(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.

##### B. *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 cor-

poration 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 re-insurance business a company must do to qualify under the exception, which made the exception difficult to enforce. H.R. Report 115-409 at 409-10. 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.

### C. Prior proposed regulations

On April 24, 2015, the **Federal Register** published a notice of proposed rulemaking (REG-108214-15) 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.

On July 11, 2019, the **Federal Register** published a notice of proposed rulemaking (REG-105474-18) at 84 FR 33120 (the "2019 proposed regulations") under sections 1291, 1297, and 1298. The 2019

proposed regulations provided guidance with respect to the application of the Income Test and the Asset Test under section 1297(a), the look-through rule under section 1297(c), and indirect ownership rules under section 1291. The 2019 proposed regulations also addressed the PFIC insurance exception under section 1297(b)(2) (B), including the definition of a QIC under section 1297(f) and the requirements for a foreign corporation to be engaged in the active conduct of an insurance business.

A public hearing on the 2019 proposed regulations was scheduled for December 9, 2019, but it was not held because there were no requests to speak. The Treasury Department and the IRS received written comments with respect to the 2019 proposed regulations. Concurrently with the publication of these proposed regulations, the Treasury Department and the IRS are publishing in the Rules and Regulations section of this edition of the **Federal Register** (RIN 1545-BO59) final regulations under sections 1291, 1297, and 1298 (the "final regulations"). In response to certain comments, the Treasury Department and the IRS are publishing this notice of proposed rulemaking to provide additional proposed regulations under sections 1297 and 1298.

## II. QBAI Rules for GILTI and FDII

### A. GILTI and FDII — In general

Section 951A(a) requires a United States shareholder (as defined in section 951(b)) ("U.S. shareholder") of any controlled foreign corporation (as defined in section 957) ("CFC") for any taxable year to include in gross income the U.S. shareholder's GILTI for such taxable year ("GILTI inclusion amount"). The U.S. shareholder's GILTI inclusion amount is calculated based on its pro rata share of certain items — such as tested income, tested loss, and QBAI — of each CFC owned by the U.S. shareholder. *See* §1.951A-1(c). Section 951A(d)(3)<sup>1</sup> requires a taxpayer to calculate QBAI by determining the adjusted basis of property using the ADS under section 168(g) "notwithstanding any pro-

vision of this title (or any other provision of law) which is enacted after the date of the enactment of [section 951A]." Section 1.951A-3(e)(2) states that "[t]he adjusted basis in specified tangible property is determined without regard to any provision of law enacted after December 22, 2017, unless such later enacted law specifically and directly amends the definition of qualified business asset investment under section 951A." The GILTI provisions in section 951A apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. *See* section 14201(d) of the Act.

The definition of QBAI in section 951A(d) also applies for purposes of determining deemed tangible income return under section 250. *See* section 250(b)(2) (B) and §1.250(b)-2(b). Section 250 generally allows a domestic corporation a deduction equal to 37.5 percent (21.875 percent for taxable years after 2025) of its FDII (as defined in section 250(b)(1) and §1.250(b)-1(b)). For purposes of FDII, QBAI is used to determine the deemed tangible income return of a corporation, which in turn reduces the amount of FDII of a corporation. *See* section 250(b)(1) and (2). Section 250(b)(2)(B) and §1.250(b)-2 incorporate the definition of QBAI in section 951A(d)(3), with some modifications. Similar to the GILTI rule provided in §1.951A-3(e)(2), §1.250(b)-2(e)(2) provides that "[t]he adjusted basis in specified tangible property is determined without regard to any provision of law enacted after December 22, 2017, unless such later enacted law specifically and directly amends the definition of QBAI under section 250 or section 951A." The FDII provisions in section 250 apply to taxable years beginning after December 31, 2017. *See* section 14202(a) of the Act.

### B. ADS depreciation

ADS depreciation under section 168(g) is determined by using the straight-line method (without regard to salvage value), the applicable convention determined under section 168(d), and the applicable re-

<sup>1</sup> As enacted, section 951A(d) contains two paragraphs designated as paragraph (3). The section 951A(d)(3) discussed in this preamble relates to the determination of the adjusted basis in property for purposes of calculating QBAI.

covery period as determined under section 168(g)(2)(C).<sup>2</sup> On December 22, 2017, the date the Act was enacted, section 168(g)(2)(C)(iv) provided that the recovery period for purposes of ADS depreciation for nonresidential real property under section 168(e)(2)(B) was 40 years. Nonresidential real property is defined under section 168(e)(2)(B) as section 1250 property (that is, real property not described in section 1245) that is not residential rental property or property with a class life of less than 27.5 years.

Section 168(g)(2)(C)(i) provided that the recovery period for property not described in section 168(g)(2)(C)(ii) or (iii)<sup>3</sup> is the property's class life. Class life is generally determined under section 168 or Rev. Proc. 87-56; 1987-42 I.R.B. 4; however, section 168(g)(3) specifies class lives for certain types of property for ADS purposes.

### C. *Qualified improvement property*

#### 1. *The Act*

Effective for property placed in service after December 31, 2017, section 13204 of the Act amended section 168(e) by removing references to qualified leasehold improvement property, qualified restaurant improvement property, and qualified retail improvement property, and instead referring only to QIP. Under section 168(e)(6), QIP includes certain improvements made by a taxpayer<sup>4</sup> to the interior of a nonresidential building that are placed in service after the building was first placed in service. The conference report under the Act states that Congress intended QIP to be classified as 15-year property under the general depreciation system and be assigned a 20-year ADS recovery period. See Conference Report to Accompany H.R. 1 at 366-367.

#### 2. *The CARES Act*

The Coronavirus Aid, Relief, and Economic Security Act, P.L. 116-136 (the

“CARES Act”) was enacted on March 27, 2020. According to the Description of the Tax Provisions of Public Law 116-136, the Coronavirus Aid, Relief, and Economic Security (“CARES”) Act, prepared by the Staff of the Joint Committee on Taxation, when Congress added the definition of QIP in section 168(e)(6) of the Code, it intended for QIP to be classified as 15-year property under section 168(e)(3)(E) of the Code, with a 15-year recovery period under the general depreciation system in section 168(a) of the Code and a 20-year ADS recovery period but inadvertently omitted from the statute such language. See Joint Committee on Taxation, Description of the Tax Provisions of Public Law 116-136, The Coronavirus, Relief, and Economic Security (“CARES”) Act (JCX-12R-20) at 69-70 (Apr. 23, 2020) (“JCT CARES Act Report”). Section 2307(a)(2) of the CARES Act amended section 168(e) by adding clause (vii) to paragraph (E)(3), providing that QIP is classified as 15-year property, and amending the table in section 168(g)(3)(B) to provide a recovery period of 20 years for QIP for purposes of the ADS (the “technical amendment”). The technical amendment is effective as if it had been included in the Act.<sup>5</sup>

#### D. *Notice 2020-69*

Notice 2020-69, 2020-30 I.R.B. 604, announced that the Treasury Department and the IRS intend to issue regulations addressing the treatment of QIP under the ADS depreciation provisions in section 168(g) for purposes of calculating QBAI under the FDII and GILTI provisions. The notice provided that the Treasury Department and the IRS expect the regulations under sections 250 and 951A to clarify that the technical amendment to section 168 enacted in section 2307(a) of the CARES Act applies to determine the adjusted basis of property under section 951A(d)(3) as if it had originally been part of section 13204 of the Act.

## Explanation of Provisions

The proposed regulations provide guidance on the valuation of assets and on the treatment of working capital for purposes of the Asset Test. They modify the treatment of dividends paid out of earnings and profits not previously taken into account, such as dividends paid out of pre-acquisition earnings, and provide safe harbors for application of the principal purpose anti-abuse test that may prohibit the use of the qualified stock rules of section 1298(b)(7). The proposed regulations also 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 I.A of this Explanation of Provisions describes rules for income derived in the active conduct of a banking business, asset valuation, and working capital in proposed §1.1297-1; the special dividend rules in proposed §1.1297-2; and the proposed safe harbors for the qualified stock principal purpose anti-abuse test in proposed §1.1298-4(e). Part I.B of this Explanation of Provisions describes the rules in proposed §1.1297-4 for determining whether a foreign corporation is a QIC. Part I.C of this Explanation of Provisions describes the rules in proposed §1.1297-5 for determining whether a foreign corporation is engaged in the active conduct of an insurance business. Part I.D of this Explanation of Provisions describes the rules in proposed §1.1297-6 regarding the treatment of income and assets of a qualifying domestic insurance company.

The proposed regulations also provide guidance on the treatment of QIP under the ADS for purposes of calculating QBAI under the GILTI and FDII provisions. See Part II of this Explanation of Provisions.

<sup>2</sup>Although the applicable convention for nonresidential real property under section 168(d)(2)(A) is the mid-month convention, §1.951A-3(e)(1) provides that for the purpose of determining QBAI, the period in the CFC inclusion year to which such depreciation relates is determined without regard to the applicable convention under section 168(d).

<sup>3</sup>Section 168(g)(2)(C)(ii) and (iii) refer to personal property with no class life and residential rental property, respectively.

<sup>4</sup>The phrase “made by a taxpayer” was added by section 2307(a)(2) of P.L. 116-136, discussed below.

<sup>5</sup>Rev. Proc. 2020-25, 2020-19 I.R.B. 785, generally allows a taxpayer to change its depreciation method under section 168 for QIP placed in service by the taxpayer after December 31, 2017, by amending the applicable tax returns or requesting an accounting method change. The determination of a taxpayer's adjusted basis for purposes of determining QBAI is not addressed in the revenue procedure and is not treated as a method of accounting. T.D. 9866, 84 FR 29288, 29304 (2019).

## I. Passive Foreign Investment Companies

### A. General PFIC rules

#### 1. Income Derived in the Active Conduct of a Banking Business

##### a. Active banking business exception

Section 1297(b)(1) generally defines the term passive income to mean any income which is of a kind which would be FPHCI as defined in section 954(c). Section 1297(b)(2) provides exceptions to this general definition. Section 1297(b)(2)(A) provides that passive income does not include any income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in regulations, by any other corporation) (the “section 1297(b)(2)(A) banking exception”), and section 1297(b)(2)(B) provides a similar exception for income derived in the active conduct of an insurance business. The Treasury Department and the IRS have determined that in light of this statutory framework, qualifying banking income should be treated as non-passive under the section 1297(b)(2)(A) banking exception (and qualifying insurance income should be treated as non-passive under the similar rule in section 1297(b)(2)(B)) and not under the general rule of section 1297(b)(1). Otherwise, an exception for active banking and insurance income of a tested foreign corporation would apply indirectly under section 1297(b)(1) and also directly under sections 1297(b)(2)(A) and (B), which would be duplicative and would effectively narrow the scope of the statutory exceptions in section 1297(b)(2). Accordingly, the Treasury Department and the IRS have determined that section 954(h)(1), which provides that for purposes of section 954(c)(1) FPHCI does not include qualified banking or financing income of an eligible controlled foreign corporation, does not apply for purposes of section 1297(b)(1). See Part III.B.1 of the preamble to the final regulations.

Notice 88-22, 1988-1 C.B. 489, states that assets held by foreign corporations described in section 1297(b)(2)(A) (then section 1296(b)(2)(A)) that are utilized to produce income in the active conduct of a banking business will be treated as non-passive assets. Notice 89-81, 1989-2 C.B. 399, provides guidance addressing the characterization of income derived in a banking business by a foreign corporation that is not licensed to do business as a bank in the United States for purposes of the definitional tests of the PFIC provisions, and states that the rules contained in Notice 89-81 will be incorporated into future regulations. In 1995, regulations were proposed to implement the section 1297(b)(2)(A) banking exception. See proposed §1.1296-4, 60 FR 20922, April 28, 1995. In light of the fact that the 1995 proposed regulations have not been finalized, the Treasury Department and the IRS are aware that taxpayers need guidance on how to properly apply section 1297(b)(2)(A).

Section 1297(b)(2)(A) requires that income be derived in the active conduct of a banking business, and grants authority for regulations to expand the scope of entities that are eligible for the section 1297(b)(2)(A) exception beyond U.S.-licensed banks. The preamble to the 1995 proposed regulations states that the Treasury Department and the IRS believe that Congress intended to grant the banking exception only to corporations that conform to a traditional U.S. banking model. 1995-1 C.B. 978. The Treasury Department and IRS continue to believe that the section 1297(b)(2)(A) banking exception should apply to foreign banks and not to other types of financial institutions, based on both the statutory framework and the history of section 1297(b).<sup>6</sup>

In the Tax Reform Act of 1986, Congress repealed broad FPHCI exceptions under section 954, including an exception for active banks, while simultaneously enacting PFIC rules, including current section 1297(b)(2)(A) (as subsequently renumbered in 1997). Thus, when the PFIC rules were enacted, section 1297(b)(2)

(A) was the exclusive means by which an active bank could avail itself of a passive income exception to the PFIC rules.

Since 1986, Congress has repeatedly amended section 1297(b) to add, repeal, and modify the exceptions therein as they apply to financial institutions. For example, in 1993 a new paragraph (3) was added to section 1297(b) (then section 1296(b)) providing that income earned in the active conduct of a securities business by a CFC was not treated as passive for PFIC purposes for a United States shareholder (“U.S. shareholder”) as defined in section 951(b). Pub. L. No. 103-66, Omnibus Budget Reconciliation Act of 1993, section 13231(d)(3). In 1997, that paragraph was repealed, in connection with the enactment of section 1297(d) (then section 1297(e)), which eliminated the need for rules relating to CFCs in section 1297 with respect to US shareholders. Pub. L. No. 105-34, Taxpayer Relief Act of 1997, section 1122(d)(4). In 2017, TCJA amended section 1297(b)(2)(B), relating to income earned in the active conduct of an insurance business, and added section 1297(f). Congress has thus expressly addressed when income of a kind earned by various active financial institutions should be treated as non-passive. Because section 1297(b)(2)(A) applies to income derived in the active conduct of a banking business, the relevant class of foreign financial institutions is foreign banks.

The Treasury Department and the IRS have considered alternatives to the analysis set forth above. In particular, because the PFIC rules when enacted in 1986 provided broader exclusions for income of active foreign financial institutions than the subpart F rules did, and because broader exclusions for active financial businesses for PFIC purposes may be appropriate in light of the fact that U.S. investors in a PFIC do not control the PFIC, the Treasury Department and the IRS have considered whether a wholesale incorporation of section 954(h) into either section 1297(b)(1) or section 1297(b)(2)(A) would be appropriate as an exercise of regulatory discretion. A broader approach of that kind

<sup>6</sup> See Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986*, at 1025 (JCS-10-87) (May 4, 1987) (“The Act provides regulatory authority to expand the exception to passive income for income derived by a foreign bank licensed to do business in the United States to any other foreign corporation engaged in the active conduct of a banking business, as well.”) (emphasis added); cf. H.R. REP. NO. 99-841, at II-644 (1986) (Conf. Rep.) (providing that “the Secretary has regulatory authority to apply the PFIC provisions to any ‘bank’ where necessary to prevent U.S. individuals from earning what is essentially portfolio investment income in a tax deferred entity”) (emphasis added).

could be of particular relevance to finance companies whose income is eligible for the section 954(h) exception.

The Treasury Department and the IRS concluded that such a broader approach is not warranted by the statutory language or history, as described in Part I.A.1.a of this Explanation of Provisions. Furthermore, the 1993 legislative history to the expansion of section 1297(b)'s passive income exceptions makes clear that the PFIC rules as in effect at that time did not apply to finance companies, that is, entities that did not engage in the deposit-taking activities characteristic of banks.<sup>7</sup> Consequently, if all of section 954(h) were permitted to apply for purposes of section 1297(b)(2)(A), finance companies, which can qualify for the section 954(h) exception, would obtain a privileged treatment for PFIC purposes that Congress intended to deny in 1993 and has not expressly approved in the interim.

However, section 954(h) provides some useful guideposts that can be applied to interpret section 1297(b)(2)(A) in the absence of final regulations, because the two provisions have similar and complementary purposes. Sections 954(h)(2)(B)(ii) and 1297(b)(2)(A) construe the same statutory phrase: income "derived in the active conduct of a banking business." And they both are limited to banks licensed to do business as a bank in the United States or any other corporation as prescribed by the Secretary. Moreover, the legislative history to section 954(h) explicitly states that the phrase "active conduct of a banking business" under section 954(h) is intended to have the same meaning as under the 1995 proposed regulations issued under section 1297(b)(2)(A).<sup>8</sup> Finally, section 954(h) is a more recent expression of Congressional intent as to the conditions under which banking income of a foreign entity should be treated as non-passive than section 1297(b)(2)(A).

Accordingly, in order to provide guidance to foreign banks and in light of the

close connection between section 1297(b)(2)(A) and section 954(h)(2)(B)(ii), the Treasury Department and the IRS propose to apply certain principles of section 954(h) for purposes of section 1297(b)(2)(A), under section 1297(b)(2)(A)'s specific grant of regulatory authority. *See* proposed §1.1297-1(c)(2). Alternatively, taxpayers also may rely upon Notice 89-81 or proposed §1.1296-4 (relating to banking income of active banks) to determine whether income of a foreign entity may be treated as non-passive under section 1297(b)(2)(A).

#### b. Proposed exception for active banking income of foreign banks

Proposed §1.1297-1(c)(2) provides that income of a tested foreign corporation will not be treated as passive if the income would be eligible for section 954(h) if the tested foreign corporation were a CFC, and the income is derived in the active conduct of a banking business by a foreign bank. The term active conduct of a banking business has the meaning given to it by section 954(h)(2)(B)(ii). *See* proposed §1.1297-1(c)(2)(i)(B). The term foreign bank is defined in a manner similar to the definition of active bank under proposed §1.1296-4, and is intended to have the same meaning, except where the proposed regulations provide a different rule. For example, a foreign bank must engage in one or more of the list of relevant banking activities provided by section 954(h)(4) rather than being required to make loans. *See* proposed §1.1297-1(c)(2)(ii). Some clarifying changes have been made to the definition to ensure that it applies only to entities that are banks as that term is ordinarily understood, and not, for example, to payment service providers or money transmitters. As is the case under section 954(h), the exception is intended to apply to the income of qualified business units of a foreign bank.

As proposed, the exception does not apply to affiliates of a foreign bank that do not independently qualify for the exception, in light of the fact that section 954(h) takes affiliates into account only for purposes of treating the activities of same-country related persons that are CFCs as activities that are conducted directly by an eligible CFC if certain conditions are satisfied. *See* section 954(h)(3)(E). Proposed §1.1297-1(c)(2)(i)(A) permits such related persons to be treated as if they were CFCs so that section 954(h)(3)(E) may apply for purposes of proposed §1.1297-1(c)(2).

A comment on the 2019 proposed regulations suggested that the attribution of activities of look-through subsidiaries to other affiliates that is permitted by §1.1297-2(e) for purposes of specified provisions of section 954(c) be extended to apply for purposes of section 954(h). The comment indicated that such treatment would be proper because financial businesses generally segregate assets and operations that are part of an integrated business into different entities for non-tax reasons. Because section 954(h)(3)(E) operates to attribute activities among entities for purposes of determining whether income constitutes qualified banking income, the Treasury Department and the IRS have determined that it would be inappropriate to adopt additional rules for attribution of activities for purposes of the incorporation of section 954(h) into section 1297(b)(2)(A) and did not adopt this comment in the final regulations. However, as an alternative to proposed §1.1297-1(c)(2), taxpayers may rely upon Notice 89-81 or proposed §1.1296-4, which provide rules treating banking income of qualified bank affiliates as non-passive. If a foreign bank is a look-through subsidiary of a tested foreign corporation, then under section 1297(c) and §1.1297-2(b)(2) the income and assets of the foreign bank are treated as passive or non-passive at the level of the tested foreign corporation to the extent

<sup>7</sup> *See* H.R. CONF. REP. NO. 103-213, *Omnibus Budget Reconciliation Act of 1993*, at 641 (Aug. 4, 1993) ("These rules [the banking exception and the securities dealer exception], however, do not apply to income derived in the conduct of financing and credit services businesses").

<sup>8</sup> H.R. REP. NO. 817, 105th Cong. 2d Sess. 37 (Oct. 12, 1988) ("It generally is intended that these requirements for the active conduct of a banking or securities business be interpreted in the same manner provided in the regulations proposed under prior law section 1296(b) . . . *See* Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6. Specifically, it is intended that these requirements include the requirements for foreign banks under Prop. Treas. Reg. sec. 1.1296-4 as currently drafted."); *see also* H.R. REP. NO. 220, 105th Cong. 1st Sess. 642 (July 30, 1997) (similar language); Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in 1997*, at 330 (JCS-23-97) (Dec. 17, 1997) ("The Congress generally intended that the income of a corporation engaged in the active conduct of a banking or securities business that would have been eligible for this exception would have been the income that is treated as nonpassive under the regulations proposed under prior law section 1296(b). *See* Prop. Treas. Reg. secs. 1.1296-4 and 1.1296-6.").

they are treated as passive or non-passive at the level of the foreign bank. If that foreign bank itself owns a look-through subsidiary, then under section 1297(c) and §1.1297-2(b)(2) the income and assets of the look-through subsidiary are treated as passive or non-passive at the level of the foreign bank to the extent they are treated as passive or non-passive at the level of the look-through subsidiary.

Another comment noted that, in the case of tested foreign corporations with look-through subsidiaries that are domestic corporations, section 954(h)(3)(A)(ii)(I) would result in the section 954(h) exception being inapplicable to active financing income earned by these subsidiaries from transactions with local customers, even though it would otherwise be of a type that would not be passive. The comment suggested that section 954(h) should be applied in the PFIC context by treating income as qualified banking or financing income even if the income is derived from transactions with customers in the United States.

Section 1298(b)(7) provides an exception for income derived from certain 25-percent owned domestic subsidiaries that treats such income as non-passive. The Treasury Department and the IRS do not agree that an additional rule should be provided to treat income of a domestic subsidiary that is not eligible for section 1298(b)(7) as non-passive, and accordingly these proposed regulations do not adopt this recommendation.<sup>9</sup>

The preamble to the 2019 proposed regulations requested comments addressing the question of whether the section 954(h) exception, if adopted as proposed in the 2019 proposed regulations, should continue to apply if final regulations implementing section 1297(b)(2)(A), for example final regulations similar to proposed §1.1296-4, are adopted. Several comments recommended that the section 954(h) exception continue to apply in the PFIC context under section 1297(b)(1) in such a case. In light of the different approach taken by these proposed regulations compared to the 2019 proposed regulations, the Treasury Department and the IRS request comments on whether

proposed §1.1297-1(c)(2) provides sufficient guidance to foreign banks, such that Notice 89-81 and proposed §1.1296-4 can be withdrawn, whether alternatively proposed §1.1296-4 should be finalized rather than proposed §1.1297-1(c)(2), whether both proposed §1.1296-4 and proposed §1.1297-1(c)(2) should be finalized, or whether a single harmonized set of rules should be provided. Until Notice 89-81 and proposed §1.1296-4 are withdrawn, taxpayers may rely upon them as alternatives to proposed §1.1297-1(c)(2).

The Treasury Department and the IRS also request comments on the general approach taken by proposed §1.1297-1(c)(2), on whether further guidance is needed to address when income is derived in the active conduct of a banking business, on whether the definition of foreign bank is drafted in a manner that does not exclude *bona fide* foreign banks and does not include other types of financial institutions, and on how income of affiliates of foreign banks should be taken into account.

## 2. Valuation of Assets for Purposes of the Asset Test

Under section 1297(e), the determination of whether a tested foreign corporation satisfies the Asset Test either must or may be made on the basis of the value of the assets of the tested foreign corporation, unless the tested foreign corporation is a controlled foreign corporation the shares of which are not publicly traded. Accordingly, it is typically necessary to determine the relative value of a tested foreign corporation's passive and non-passive assets in order to determine whether the tested foreign corporation satisfies the Asset Test.

The value of individual assets of an operating company may not be readily determinable. However, financial accounting standards generally provide rules that are intended to provide stakeholders with an economically realistic understanding of a company's financial position, including the cost or value of its assets. Financial statement information also often is accessible by tested foreign corporations and their shareholders, and is prepared

for non-tax purposes. The Treasury Department and the IRS understand that, for these reasons, taxpayers often utilize financial statements in order to determine the value of a tested foreign corporation's assets. Section 1297(f)(4) specifically requires the use of information from financial statements prepared under U.S. generally accepted accounting principles ("GAAP") or international financial reporting standards ("IFRS") for purposes of the QIC rules, indicating that Congress believes that such information is appropriate in some circumstances as a basis for determining whether a tested foreign corporation qualifies as a PFIC.

Accordingly, proposed §1.1297-1(d)(1)(v)(D) generally permits a taxpayer to rely upon the information in a tested foreign corporation's financial statements in order to determine the value of the corporation's assets. The Treasury Department and the IRS request comments on whether ordering rules similar to those of section 1297(f)(4) and proposed §1.1297-4(f)(1) should apply, and whether other safeguards such as requiring that financial statements be audited should be required.

The Treasury Department and the IRS are aware that financial statements do not include values for some types of assets that are important to companies in certain industries, for example self-created intangibles. Accordingly, proposed §1.1297-1(d)(1)(v)(D) provides that if a shareholder has reliable information about the value of an asset that differs from its financial statement valuation, that information must be used to determine the value of the asset. Whether valuation information is more reliable than financial statement valuation is based on the facts and circumstances, including the experience and knowledge of the source of the information, whether the information is recent and whether there have been intervening developments that would affect the accuracy of the information, and whether the information specifically addresses the value of the asset in question. Another fact pattern that may raise questions as to whether divergence from a financial statement valuation is warranted is when a tested foreign corpo-

<sup>9</sup>The legislative history of section 954(h) states that the active banking test is not intended to apply to affiliates that do not independently satisfy the test. H.R. Rep. No. 817, 105<sup>th</sup> Cong. 2d Sess. 37 (Oct. 12, 1988) ("[I]t is not intended that these requirements be considered to be satisfied by a CFC merely because it is a qualified bank affiliate ... within the meaning of the proposed regulations under former section 1296(b).")

ration or look-through entity owns property that is subject to a lease or license that is disregarded under the rules for intercompany obligations between a tested foreign corporation and a look-through entity, and similar fact patterns. See §1.1297-2(c)(1)(ii). The Treasury Department and the IRS request comments on whether the Asset Test should take into account the value of the property subject to the lease or license and the value of the lease or license, or whether instead the Asset Test should take into account the value of the property disregarding the lease or license. The Treasury Department and the IRS request comments on additional considerations that may be relevant to determining when shareholders may use information other than financial statement valuations for purposes of the Asset Test.

### 3. Treatment of Working Capital and Goodwill for Purposes of the Asset Test, and Other Asset Test Rules Provided by Notice 88-22

Notice 88-22, 1988-1 C.B. 489 (“Notice 88-22”), provides guidance on the application of the Asset Test pending the issuance of regulations. The Treasury Department and the IRS propose to adopt final regulations that will address the portions of Notice 88-22 that have not already been addressed by regulations, for example the guidance relating to depreciable property used in a trade or business, trade or service receivables, intangible property, working capital, and tax-exempt assets. After the issuance of those regulations Notice 88-22 would be obsoleted. Except as described in the remainder of this Part I.A.3 of this Explanation of Provisions section, the rules provided in Notice 88-22 are proposed to be adopted in final form as set forth in Notice 88-22. The Treasury Department and the IRS request comments on whether any changes should be made to those rules when they are adopted in final regulations.

Notice 88-22 provides that cash and other current assets readily convertible into cash, including assets that may be characterized as the working capital of an active business, are treated as passive assets for purposes of the Asset Test. Notice 88-22 indicated that passive treatment is warranted because working capital pro-

duces passive income (that is, interest income).

Comments have noted that the approach taken in Notice 88-22 with respect to working capital may be inconsistent with the intent of the PFIC regime to distinguish between investments in passive assets and investments in active businesses. It has been asserted that the working capital rule in Notice 88-22 causes many foreign corporations otherwise engaged in active operating businesses to be classified as PFICs because Notice 88-22 treats working capital as a passive asset even though it is an asset used in the active conduct of business operations. Critics of Notice 88-22’s working capital rule have also noted that, for some purposes of the Code, cash is treated as a business (non-passive) asset to the extent it is held as working capital for use in a trade or business. See generally section 1202(e)(6) and §§1.864-4(c)(2) and 1.897-1(f)(1)(iii).

The Treasury Department and the IRS recognize that, because any active operating company must have some cash or cash equivalents on hand to pay operating expenses, Notice 88-22’s working capital rule, which treats all working capital as a passive asset, does not reflect the manner in which *bona fide* businesses operate. The Treasury Department and the IRS also are aware that some foreign companies engaged in active businesses hold cash or liquid securities in amounts that substantially exceed the present needs of the business for extended periods. Therefore, the proposed regulations provide a limited exception to the treatment of working capital as passive. Under proposed §1.1297-1(d)(2), an amount of cash held in a non-interest bearing account that is held for the present needs of an active trade or business and is no greater than the amount reasonably expected to cover 90 days of operating expenses incurred in the ordinary course of the trade or business of the tested foreign corporation (for example, accounts payable for ordinary operating expenses or employee compensation) is not treated as a passive asset.

The Treasury Department and the IRS understand that this definition is narrower than the ordinary business meaning of working capital and the definitions used in some other Treasury regulations. Because the PFIC rules are based on numeric for-

mulas, it is important that taxpayers and the IRS can determine what the amount treated as working capital is for purposes of the PFIC asset test with some level of precision. Moreover, because the statutory PFIC rules (and FPHCI rules) generally treat an asset held to produce interest as passive, it may not be appropriate to treat an interest-bearing instrument held by an operating company as working capital other than as an asset that produces passive income. Those rules permit interest-bearing assets to be treated as active assets for limited classes of taxpayers like banks, insurance companies and securities dealers, and also permit interest from related persons to be treated in whole or part as active, but in those cases there are specific statutory exceptions from passive treatment. See sections 1297(b)(2)(A) (banks), 1297(b)(2)(B) and (f) (insurance companies), 1297(b)(2)(C) (interest from related persons) and 954(c)(2)(C) (securities dealers). The Treasury Department and the IRS request comments on this exception to the general rule of Notice 88-22 that cash is a passive asset, including the scope of statutory authority to treat interest-bearing accounts or instruments held as working capital as an active asset and the ways in which the exception might be broadened while maintaining appropriate safeguards to avoid uncertainty as to how to determine the amounts and types of instruments properly treated as held for the present needs of a business and to ensure that a business’s investments and capital held for future needs continue to be characterized as passive assets.

Like working capital, goodwill was not addressed by the 2019 proposed regulations. Notice 88-22 provides that, for purposes of the Asset Test, goodwill or going concern value must be identified with a specific income-producing activity of the corporation and characterized as a passive or non-passive asset based on the income derived from the activity. The Treasury Department and the IRS understand that some taxpayers believe that Notice 88-22 takes an improper approach with respect to the treatment and characterization of goodwill for purposes of the Asset Test and argue that goodwill related to an active trade or business should be treated in its entirety as a non-passive asset or, in the alternative, that the dual-character asset

rule in the proposed regulations should be read to apply to goodwill.

The Treasury Department and the IRS agree that goodwill should be allocated to business activities but do not agree that goodwill should always be treated entirely as a non-passive asset because the PFIC rules may treat certain business assets as passive and it is therefore possible that goodwill would be associated with those assets. Because companies in different lines of business may be valued as an economic matter under different valuation models, some of which may give more weight to income and others to assets or to other aspects of a business like customer relationships, there is no single basis for allocating goodwill that is likely to be best suited to every company as an economic matter. The Treasury Department and the IRS believe that the approach provided by Notice 88-22 for determining the character of goodwill for purposes of the Asset Test is a reasonable approach although other approaches may be more economically accurate for a particular tested foreign corporation. In light of the complex nature of goodwill as an economic and accounting matter, and developments in tax law since 1988 with respect to the treatment of goodwill and similar assets, the Treasury Department and the IRS request comments on alternative approaches to addressing the treatment of goodwill for purposes of the Asset Test.

#### 4. Elimination of Intercompany Dividends for Purposes of the Income Test and Related Adjustments

Proposed §1.1297-2(c)(2) provided that, for purposes of applying the Income Test, intercompany payments of dividends between a look-through subsidiary and a tested foreign corporation are eliminated to the extent the payment is attributable to income of a look-through subsidiary that was included in gross income by the tested foreign corporation for purposes of determining its PFIC status. The preamble to the proposed regulations indicated that the Treasury Department and the IRS intended for the elimination of such items to prevent double counting of intercompany income and assets.

A comment expressed concern that the proposed regulation did not eliminate a

payment of a dividend by a look-through subsidiary to a tested foreign corporation that is made out of earnings and profits not attributable to income of the subsidiary previously included in the gross income of the tested foreign corporation for purposes of determining its PFIC status (“dividends from non-accounted-for earnings”), for example a dividend paid out of earnings and profits accumulated before the tested foreign corporation’s acquisition of the look-through subsidiary. The comment recommended that final regulations provide for the elimination of all dividends from look-through subsidiaries and made a number of alternative suggestions intended to reduce or eliminate the likelihood that a dividend from a look-through subsidiary would be treated as a dividend from non-accounted-for earnings. The final regulations did not adopt these recommendations, because treating a distribution from a look-through subsidiary as not giving rise to gross income to the tested foreign corporation for purposes of the Income Test could reduce gain on a future sale of the stock of the look-through subsidiary unless a basis or other adjustment were made to the stock or gain.

The final regulations indicate that for purposes of applying the Income Test, a tested foreign corporation must take into account its gain on the disposition of stock in a look-through subsidiary. *See* §1.1297-2(f)(2). In the final regulations, 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. *See* §1.1297-2(f)(2). The residual gain equals the total gain recognized by the tested foreign corporation from the disposition of the stock of the look-through subsidiary reduced (but not below zero) by unremitted earnings. *Id.* Unremitted earnings are the excess of the aggregate income taken into account by the tested foreign corporation pursuant to section 1297(c) with respect to the stock of the disposed-of look-through subsidiary over the aggregate dividends received

by the tested foreign corporation from the disposed-of look-through subsidiary with respect to the stock. *Id.*

Reducing unremitted earnings to take dividends into account as provided by the final regulations does not fully account for the effect of dividends from non-accounted-for earnings, for example where there are no unremitted earnings after taking into account distributions of earnings and profits previously included in the gross income of the tested foreign corporation for purposes of determining its PFIC status but the stock of the look-through subsidiary is sold at a gain. Consequently, either such dividends should be treated as giving rise to income to the recipient, as provided by the final regulations, or some other adjustment such as to basis should be made in order to prevent the disappearance of potential gain. *See* Part IV.D.1 of the Summary of Comments and Explanation of Revisions for the final regulations.

The PFIC regulations do not provide rules for determining or adjusting the basis of the stock of a look-through subsidiary. In addition to the fact pattern described above, many other fact patterns could raise questions about how the basis of stock of a look-through subsidiary should be adjusted. Examples of such transactions include unremitted earnings, certain reorganizations the parties to which are look-through subsidiaries, in-kind dividend distributions that could give rise to gain at the level of the distributing subsidiary but the elimination of dividends from the income of the dividend recipient, and other transactions governed by subchapter C. Additional questions arise if a subsidiary becomes, or ceases to be, a look-through subsidiary while its shares continue to be held by the same shareholder, and with respect to transactions that shift property between a look-through entity and a tested foreign corporation that owns the look-through entity (or between two look-through entities) in light of the fact that the transaction may give rise to gain or loss if it is regarded but the tested foreign corporation is treated as owning the asset for Asset Test purposes both before and after the transaction.

Rules addressing similar issues exist for members of a consolidated group, which might provide a possible model for rules addressing “corporate” transac-

tions between a look-through subsidiary and its owner(s). However, the consolidated return regulations are highly complex and may not be suitable for foreign corporations that do not follow U.S. tax principles. The consolidated return regulations are also based on a single-entity paradigm that may not be relevant for section 1297(c) given that the stock ownership threshold for treating a subsidiary as a look-through subsidiary is 25 percent rather than 80 percent. Accordingly, those rules may not be an appropriate model for basis and related rules for look-through subsidiaries.

Proposed §1.1297-2(c)(2) and (f) provide rules that would—for purposes of determining a tested foreign corporation's PFIC status—eliminate from the gross income of the corporation a dividend it receives from a look-through subsidiary that is made out of earnings and profits not attributable to income of the subsidiary previously included in the gross income of the tested foreign corporation. The rules also would make corresponding adjustments to the basis of a look-through subsidiary's stock for purposes of determining gain upon the disposition of such stock in applying the Income Test. For the reasons already described, these rules may or may not be a desirable approach to addressing the issues with respect to earnings and distributions of look-through subsidiaries. For example, the basis reduction rule could apply if a subsidiary paid a dividend when it was not a look-through subsidiary but later became one. The Treasury Department and the IRS invite comments addressing these issues—in particular, comments are requested on the treatment of pre-acquisition earnings and profits.

#### 5. Safe Harbors for the Domestic Subsidiary Anti-Abuse Rule

Section 1298(b)(7) provides a special characterization rule that applies when (i) a tested foreign corporation owns at least 25 percent of the value of the stock of a domestic corporation (“25-percent-owned domestic corporation”), (ii) the 25-percent-owned domestic corporation owns stock in another domestic corporation (“the second-tier domestic corporation”), and (iii) the tested foreign corporation is

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

The 2019 proposed regulations provided that section 1298(b)(7) did not apply if, among other matters, a principal purpose for the tested foreign corporation's formation or acquisition of the 25-percent-owned domestic corporation was to avoid classification of the tested foreign corporation as a PFIC (“principal purpose anti-abuse rule”). See proposed §1.1298-4(f)(2). A modified version of the principal purpose anti-abuse rule is adopted in the final regulations. See §1.1298-4(e)(1).

The proposed regulations provide two safe harbors from the principal purpose anti-abuse rule in §1.1298-4(e)(1). The Treasury Department and the IRS request comments on the application of the safe harbors discussed in this Part I.A.5 of the Explanation of Provisions.

Under the first safe harbor, the anti-abuse rule will not apply if more than 80 percent of the assets of the second-tier domestic corporation are used in an active U.S. trade or business, as determined under modified section 367 rules. See proposed §1.1298-4(e)(2)(i). For purposes of the safe harbor, the assets of the domestic subsidiary qualified affiliates (as defined in proposed §1.1298-4(e)(2)(i)(B)) are also taken into account in determining whether the assets of the second-tier domestic corporation are used in a U.S. trade or business. See proposed §1.1298-4(e)(2)(i)(A).

The proposed regulations provide a second safe harbor for active companies undergoing transition and start-up companies. See proposed §1.1298-4(e)(2)(ii). Under this safe harbor, the anti-abuse rule will not apply if the second-tier domestic corporation engages in an active U.S. trade or business that satisfies the first safe harbor by the end of the transition period following the testing date. See proposed §1.1298-4(e)(2)(ii). Proposed §1.1298-4(e)(2)(ii)(B) defines testing date as the last day of the month in which either (i)

the second-tier domestic corporation is created, organized, or acquired (“start-up testing date”) or (ii) a second-tier domestic corporation that previously satisfied the first safe harbor disposes of substantially all its active U.S. trade or business (“change-of-business testing date”). Proposed §1.1298-4(e)(2)(ii)(C) provides that the transition period is thirty-six months after a testing date. If the requirements of the business transition and start-up safe harbor are not satisfied within the transition period, the benefit of the safe harbor is lost retroactively for the entire period in which the safe harbor was claimed. See proposed §1.1298-4(e)(2)(ii)(D). In these instances, the general anti-abuse rule in §1.1298-4(e)(1) will be applied to the tested foreign corporation to determine whether a principal purpose to avoid PFIC classification existed for the preceding years, which would be within the normal statute of limitations on assessments under section 6501.

#### B. Proposed revisions to §1.1297-4 – qualifying insurance corporation

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) either (A) has applicable insurance liabilities (“AIL”) constituting more than 25 percent of its total assets on its applicable financial statement (“AFS”) (“the 25 percent test”), or (B) meets an elective alternative facts and circumstances test which lowers the required AIL-to-total assets ratio to 10 percent (“alternative facts and circumstances test”).

Most of the rules for determining whether a foreign corporation is a QIC under section 1297(f) are provided in the final regulations under §1.1297-4. Proposed §1.1297-4 contains additional rules relating to the definition of an applicable financial statement, the definition of applicable insurance liabilities, and an optional adjustment to total assets.

#### 1. Definition of Applicable Financial Statement

Proposed §1.1297-4(f)(1) defines the term applicable financial statement (“AFS”) in a manner that provides order-

ing rules for how to prioritize between multiple financial statements prepared at the same level of priority, for example multiple financial statements prepared on the basis of GAAP or multiple financial statements prepared on the basis of IFRS, and between multiple financial statements prepared taking into account the assets and liabilities of different legal entities. The definition is modeled on similar definitions elsewhere in the Code and Treasury regulations, such as regulations under section 451, but has been adapted to the QIC context.

The term financial statement is defined to mean a complete balance sheet, income statement, and cash flow statement, or the equivalent statements under the relevant accounting standard, and ancillary documents typically provided together with such statements. As regards an AFS, in addition to the general levels of priority set forth in section 1297(f)(4)(A) (GAAP, IFRS, and insurance regulatory (statutory) statements), ordering rules provide sub-priority levels (based on the purpose for which the statement is prepared), with higher priority being accorded to accounting statements viewed as more reliable. Since the AFS is the financial statement of a non-U.S. entity, financial statements provided to foreign regulatory bodies generally are treated as having the same priority as if provided to an equivalent U.S. regulatory body. The requirement that a non-U.S. regulatory agency have standards not less stringent than those of the U.S. Securities & Exchange Commission is intended to provide a standard similar to the definition of a qualified exchange or other market for purposes of section 1296, with respect to reporting standards. Because audited financial statements have been reviewed by independent auditors, and it is anticipated that insurance regulators will require audited financial statements, only audited statements can qualify as AFS.

If a tested foreign corporation has multiple financial statements, the order of priority described above is determinative. However, if there are multiple financial statements within a single level of priority and sub-priority (for example, multiple GAAP financial statements provided to creditors), additional ordering rules are provided to assign priority first to a finan-

cial statement that is not prepared on a consolidated basis (and that accounts for investments in the tested foreign corporation's subsidiaries (if any) on a cost or equity basis), and then to a consolidated financial statement that has the tested foreign corporation as the parent of the consolidated group. These rules are intended to make it more likely that the AFS reflects the same or similar assets and liabilities as the financial statement used to determine whether the section 1297(f)(3)(B) limitation on the amount of applicable insurance liabilities applies.

A financial statement prepared on a consolidated basis that takes into account affiliates that are not owned by the tested foreign corporation (for example, sister companies) is not treated as the AFS unless it is the only financial statement of the tested foreign corporation and is provided to an insurance regulator. It is anticipated that the only financial statement likely to fall within that category is a financial statement that includes the tested foreign corporation and subsidiaries if any, and a parent corporation.

Accordingly, if there are multiple financial statements with the same level of priority, non-consolidated financial statements take priority over consolidated financial statements. However, a consolidated financial statement prepared on the basis of GAAP that has the tested foreign corporation as the parent of the consolidated group has priority over a non-consolidated statement prepared on the basis of statutory accounting standards, because financial statements prepared on the basis of GAAP are higher priority than financial statements prepared on the basis of statutory accounting standards. Similarly, a consolidated statement prepared on the basis of IFRS would have priority over a non-consolidated statement prepared on the basis of statutory accounting standards.

The Treasury Department and IRS request comments on the expanded definition of an AFS and the priority rules provided, including whether special rules are needed to properly apply the limitation under §1.1297-4(e)(2) if the statutory accounting statement covers a different period than the AFS, and whether other more detailed rules are necessary in order to identify the AFS when a foreign corpora-

tion operates in multiple jurisdictions and is subject to the authority of more than one insurance regulatory body.

## 2. Definition of Applicable Insurance Liabilities

As described in Part V.A.2 of the Summary of Comments and Explanation of Revisions to the final regulations, section 1297(f)(4) contemplates that a foreign corporation can use GAAP, IFRS, or the accounting standard used for the annual statement required to be filed with the local regulator (if a statement prepared for financial reporting purposes using GAAP or IFRS is not available) as the starting point to determine AIL. The preamble to the final regulations notes, however, that AIL is defined more specifically so that only those liabilities that meet the requirements of section 1297(f)(3) and the related regulatory definitions in §1.1297-4(f)(2) are included in AIL, irrespective of differences in nomenclature and methods that may be used by different financial reporting standards.

Proposed §1.1297-4(f)(2)(i)(D)(3) clarifies that, in determining AIL, liabilities are reduced by an amount equal to the assets reported on the corporation's financial statement that represent amounts relating to those liabilities that may be recoverable from other parties through reinsurance. The rule is necessary because GAAP and the newest IFRS accounting standard for insurance contracts, IFRS 17, (and possibly local statutory accounting depending on the laws of the foreign jurisdiction) record amounts recoverable from other parties as reinsurance with respect to unpaid insurance losses and other reserves on the asset side of the balance sheet, rather than reducing balance sheet liabilities. In contrast, insurance regulatory accounting rules (including those in the United States) often reduce a ceding company's insurance liabilities by those amounts instead of including them as assets on the balance sheet. Both methods result in the same amount of shareholder equity for a foreign corporation but create different ratios of AIL to total assets and, thus, can potentially produce a difference in a foreign corporation's QIC status.

The Treasury Department and IRS have determined that AIL should ex-

clude amounts that have been reinsured because the ratio test would otherwise be subject to manipulation, and because the Treasury Department and IRS believe that a uniform approach is appropriate for the treatment of reinsured risk regardless of the particular accounting standard that may apply. In addition, proposed §1.1297-4(f)(2)(i)(D)(3) clarifies that, if a tested foreign corporation's financial statement is prepared on a consolidated basis, liabilities of the tested corporation must be reduced (to the extent not reduced under other provisions) by an amount equal to the assets relating to those liabilities that may be recoverable through reinsurance from another entity included in the consolidated financial statement, regardless of whether the reinsurance transaction is eliminated in the preparation of the consolidated financial statement. This proposed rule is consistent with the rules of §1.1297-4(f)(2)(i)(D)(1) and (2), which provide that no item may be taken into account more than once and that AIL include only the liabilities of the foreign corporation whose QIC status is being tested, and not liabilities of other entities within a consolidated group.

The Treasury Department and IRS are aware that certain arrangements permit a ceding company to continue to hold the reserves and assets required to support the insurance liabilities for the reinsured contracts during the policy term (so-called modified coinsurance or modco). It has been held that life insurance reserves on policies reinsured under a modco arrangement are attributed to the ceding company, and not the assuming company. *See* Rev. Rul. 70-508, 1970-2 C.B. 136 (1970). *See generally Colonial Am. Life Ins. v. United States*, 491 U.S. 244, 248, n.2 (1989); *Anchor National Life Ins. v. Commissioner*, 93 T.C. 382, 423 (1989). Proposed §1.1297-4(f)(2)(i)(D)(3) is not intended to apply to modco arrangements where the ceding company retains the assets supporting the insured risks (because they do not create an amount recoverable from another party), but the Treasury Department and IRS request comments as to whether the rule appropriately addresses modco arrangements and whether additional rules may be necessary in the final regulations.

The Treasury Department and IRS also request comments as to whether to more specifically define amounts recoverable from another party through reinsurance and whether there are other special circumstances in which modification of the definition of AIL is appropriate.

### 3. Optional Asset Adjustment

Due to the manner in which AIL are defined under §1.1297-4(f)(2), it may be necessary to adjust the amount of a foreign corporation's total assets to avoid distortions in applying the 25 percent test and the 10 percent test. First, if a foreign corporation's AFS is prepared on a consolidated basis, total assets may be reduced by the amount equal to the amount of insurance liabilities of affiliated entities that are reported on the AFS and would be included in AIL if its definition did not limit AIL to the AIL of the subject foreign corporation. *See* proposed §1.1297-4(e)(4)(i). This adjustment is appropriate because insurance liabilities of an affiliate, though excluded from the definition of AIL, can have the effect of reducing the assets available to satisfy the foreign corporation's insurance liabilities.

Second, if a foreign corporation reports amounts recoverable from other parties through reinsurance as assets on its AFS, proposed §1.1297-4(e)(4)(ii) provides that total assets may be reduced by the amount by which AIL are reduced under proposed §1.1297-4(f)(2)(i)(D)(3). As explained in Part I.B.2 of this Explanation of Provisions, proposed §1.1297-4(f)(2)(i)(D)(3) requires a foreign corporation's AIL to be reduced to reflect those amounts. Without a corresponding adjustment to total assets, the same reinsurance contract could have the effect of reducing a foreign corporation's AIL while also increasing its total assets. The Treasury Department and IRS request comments as to whether there are other situations that warrant an adjustment to total assets.

### C. Proposed §1.1297-5: active conduct of an insurance business

Section 1297(b)(2)(B) provides an exclusion from the definition of passive income for income derived in the ac-

tive conduct of an insurance business by a QIC. As described in Part VI.A of the Summary of Comments and Explanation of Revisions to the final regulations, proposed §1.1297-5 revises previously proposed rules for determining whether a QIC is engaged in the active conduct of an insurance business.

#### 1. Overview

As explained in Part VI.A of the Summary of Comments and Explanation of Revisions to the final regulations, the Treasury Department and the IRS have determined that the active conduct of an insurance business is a requirement mandated by the statute in addition to (and separate from) the requirements of subchapter L and section 1297(f), but that in response to comments, the active conduct test should be amended to provide more flexibility in determining whether a QIC is engaged in the active conduct of an insurance business. Proposed §1.1297-5(b)(1) provides that a QIC is treated as engaged in the active conduct of an insurance business if it satisfies either the factual requirements test under proposed §1.1297-5(c) or the active conduct percentage test under proposed §1.1297-5(d). The Treasury Department and IRS request comments on the active conduct test, including the addition of the new factual requirements test and revisions to the active conduct percentage test.

#### 2. Exclusions from Active Conduct

Under §1.1297-5(b)(2), two categories of insurance companies are precluded from meeting the active conduct test. First, a QIC is not engaged in the active conduct of an insurance business if it has no employees (or a nominal number of employees) and relies exclusively (or almost exclusively) on independent contractors to perform its core functions. Second, the active conduct test excludes securitization vehicles (such as vehicles used to issue catastrophe bonds, sidecars, or collateralized reinsurance vehicles) and insurance linked securities funds that invest in securitization vehicles. These vehicles are excluded because they are designed to provide a passive investment return tied to insurance risk rather than participation in

the earnings of an active insurance business.

### 3. Factual Requirements Test

As noted in Part VI.A of the Summary of Comments and Explanation of Revisions to the final regulations, several comments requested the addition of a facts and circumstances test; other comments recommended that the active conduct test focus on the assumption of insurance risk; and a comment specifically identified underwriting as a core insurance function that must be performed by an insurance company's officers and employees. The factual requirements test has been added in response to these comments. The active conduct percentage test has been retained (in modified form) as an alternative means of satisfying the active conduct requirement.

Proposed §1.1297-5(c) provides that the factual requirements test is satisfied if the QIC's officers and employees carry out substantial managerial and operational activities on a regular and continuous basis with respect to all of its core functions and perform virtually all of the active decision-making functions relevant to underwriting. A QIC's core functions are generally defined to include underwriting, investment, contract and claim management, and sales activities. *See* proposed § 1.1297-5(f) for definitions of these terms. *See* Part I.C.5 of this Explanation of Provisions for rules concerning officers and employees of related entities.

A QIC's officers and employees are considered to carry out substantial managerial and operational activities relevant to its core functions only if they are involved in all levels of planning and implementation related to the QIC's core functions as described in proposed §1.1297-5(c) (2). The required activities must be conducted by officers or senior employees with appropriate experience who devote all (or virtually all) of their work to those activities and similar activities for related entities.

The active decision-making functions relevant to a QIC's underwriting activities are those underwriting activities most important to decisions of the QIC relating to the assumption of specific insurance risks. *See* proposed §1.1297-5(c)(3). To meet

this requirement, officers and employees of the QIC must carry out virtually all of the activities related to a QIC's decision to assume an insurance risk and must conduct virtually all of the decision-making with respect to the execution of an insurance contract on a contract-by-contract basis. Development of underwriting policies and parameters that are changed infrequently is not an active decision-making function in the absence of further ongoing involvement by the QIC's officers and employees. *See* proposed §1.1297-5(c)(3)(iii)(A).

### 4. Active Conduct Percentage Test

The active conduct percentage test is provided in proposed §1.1297-5(d). To meet this test, two requirements must be satisfied. First, the total costs incurred by a QIC with respect to its officers and employees for services rendered with respect to its core functions (other than investment activities) must equal at least 50 percent of the total costs incurred for all services rendered with respect to the QIC's core functions (other than investment activities). In response to comments to the 2019 proposed regulations, investment activities have been excluded from both the numerator and denominator of the percentage calculation. Second, if any part of a QIC's core functions (including investment management) is outsourced to an unrelated entity, the QIC's officers and employees must conduct robust oversight with respect to the outsourced activities. *See* proposed §1.1297-5(d)(2).

The proposed regulations provide a definition of total costs that is used to apply the active conduct percentage test. *See* §1.1297-5(f)(8). With respect to a QIC's own officers and employees, total costs are defined as compensation costs plus other expenses reasonably allocable to the services provided (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 §1.482-9(k)(2)). With respect to services performed by employees of another entity (whether related or unrelated), total costs are equal to the amount paid or accrued by the QIC to the other entity for the relevant services. Ceding commissions paid with respect to reinsurance contracts and commissions paid to brokers or sales agents to

procure reinsurance contracts are excluded from the definition of total costs.

### 5. Officers and Employees of Related Entities

For purposes of applying the factual requirements test and the active conduct percentage test, a QIC's officers and employees are considered to include the officers and employees of related entities, where such entities are qualified affiliates of the QIC within the meaning of §1.1297-2(e)(2), except that the 50 percent ownership standard is based on both value and voting power. *See* proposed §1.1297-5(e). A qualified affiliate is a corporation or a partnership that is included in an affiliated group that includes the QIC. Affiliated group has the meaning provided in section 1504(a), determined without regard to section 1504(b)(2) and (3) (which would otherwise exclude foreign corporations and life insurance companies from membership) and substituting "more than 50 percent" ownership for "at least 80 percent". In addition, consistent with the rules of §1.1297-2(e)(2), the common parent of the group must be a foreign corporation or foreign partnership, and a corporation or a partnership is included in the affiliated group only if it is a look-through subsidiary or look-through partnership, as applicable, of the common parent. Also, a partnership is included in the affiliated group only if more than 50 percent of the value of its capital interests, profits interests and any other partnership interests is owned by one or more corporations that are included in the affiliated group. The related entity rule applies only if the QIC bears the compensation costs on an arm's length basis and exercises oversight and supervision with respect to the services provided by affiliated officers and employees. *See* proposed §1.1297-5(e)(3).

As noted in Part VI.A of the Summary of Comments and Explanation of Revisions to the final regulations, comments requested broader attribution rules that would cover employees of entities that are related to the QIC within the meaning of section 954(d)(3) or are under common practical control with the QIC. These comments have not been adopted. Because the active conduct test is designed to assess the activities of a QIC on a separate entity

basis (rather than the activities conducted by an insurance group as a whole), services performed by officers and employees of other entities cannot be attributed to a QIC except in the circumstances described in proposed §1.1297-5(e). However, the Treasury Department and the IRS determined that it was appropriate to align the common ownership requirements for purposes of the insurance active conduct rule with the ownership requirements used in §1.1297-2(e)(2) for look-through subsidiary activity attribution purposes, except including a vote as well as value requirement to ensure a heightened level of common control of the related entity officers and employees.

#### *D. Proposed §1.1297-6(e)(2): qualifying domestic insurance corporation non-passive income and asset limitations*

##### 1. Qualifying Domestic Insurance Corporation Rule

Sections 1.1297-6(b)(2) and (c)(2) of the final regulations provide that income and assets, respectively, of a qualifying domestic insurance corporation (“QDIC”) are non-passive for purposes of determining whether a non-U.S. corporation is treated as a PFIC (the “QDIC Rule”). Section 1.1297-6(e)(1) of the final regulations defines a QDIC as a domestic corporation that is subject to tax as an insurance company under subchapter L, is subject to Federal income tax on its net income, and is a look-through subsidiary of a tested foreign corporation. The QDIC Rule is intended to address situations where a tested foreign corporation owns a 25 percent or greater interest in a domestic insurance corporation through a structure to which section 1298(b)(7) does not apply, such that the income and assets of the QDIC are taken into account in determining whether the tested foreign corporation is a PFIC.

The previous 2019 proposed regulations also provided that the QDIC Rule did not apply for purposes of section 1298(a)(2) and determining if a U.S. person indirectly owns stock in a lower tier PFIC (“Proposed QDIC Attribution Exception”). Consequently, for attribution purposes, the 2019 proposed regulations required a tested foreign corporation to

apply the Income Test and Asset Test without applying the QDIC Rule.

Several comments on the 2019 proposed regulations requested that the Proposed QDIC Attribution Exception be removed because U.S. shareholders of a tested foreign corporation that would not otherwise be a PFIC but owns a PFIC and a U.S. insurance subsidiary that is a QDIC could become indirect owners of a PFIC as a result of the section 1298(a)(2) attribution rule. Comments asserted that turning off the QDIC Rule when testing for lower-tier PFIC ownership attribution would undermine the purpose of the rule and create significant burden for U.S. minority shareholders of the tested foreign corporation, who would have to separately evaluate the PFIC status of all of the tested foreign corporation’s foreign subsidiaries.

##### 2. Proposed §1.1297-6(e)(2) QDIC Limitation Rule

The Treasury Department and IRS agree that the Proposed QDIC Attribution Exception was overbroad and removed it from the final regulations. However, the Treasury Department and IRS believe that limits on the amount of a QDIC’s assets and income that are treated as non-passive may be appropriate in cases where a QDIC holds substantially more passive assets than necessary to support its insurance and annuity obligations. Thus, proposed §1.1297-6(e)(2) provides that the amount of a QDIC’s otherwise passive income and assets that may be treated as non-passive is subject to a maximum based on an applicable percentage of the QDIC’s total insurance liabilities (“QDIC Limitation Rule”).

Proposed §1.1297-6(e)(2)(i) provides that the amount of a QDIC’s passive assets that are treated as non-passive under the QDIC Rule may not exceed an applicable percentage of the corporation’s total insurance liabilities. This amount is the QDIC’s non-passive asset limitation. Proposed §1.1297-6(e)(2)(ii) provides that the amount of a QDIC’s passive income that is treated as non-passive under the QDIC Rule may not exceed the corporation’s passive income multiplied by the proportion that the QDIC’s non-passive asset limitation bears to its total passive

assets (determined without the application of the rules under §1.1297-6(c)(2)).

Under proposed §1.1297-6(e)(2)(iii), the applicable percentage is 200 percent for a life insurance company and 400 percent for a nonlife insurance company. Proposed §1.1297-6(e)(2)(iv)(A) provides that, for a QDIC taxable under Part I of Subchapter L (that is, a life insurance company), total insurance liabilities means the sum of the company’s total reserves (as defined in section 816(c)) plus (to the extent not included in total reserves) the reserve items referred to in paragraphs (3), (4), (5), and (6) of section 807(c). For a company taxable under Part II of Subchapter L (that is, a nonlife insurance company), the term total insurance liabilities means the sum of unearned premiums and unpaid losses. See proposed §1.1297-6(e)(2)(iv)(B). Because a QDIC will be subject to tax under Subchapter L, it is appropriate to determine the amount of its insurance liabilities for purposes of the QDIC Limitation Rule in accordance with Subchapter L rules governing insurance liabilities because the QDIC will already be determining these amounts for U.S. income tax purposes. See proposed §1.1297-6(e)(3) for an example illustrating the application of these rules.

The Treasury Department and the IRS request comments on the QDIC Limitation Rule and in particular on whether the specified applicable percentages are reasonable based on industry data. The Treasury Department and IRS expect most QDICs to not exceed the passive asset and income limitations based on the applicable percentages. In addition, a tested foreign corporation may hold less than 50 percent passive assets and receive less than 75 percent passive income without being classified as a PFIC. Thus, the QDIC Limitation Rule provides a disincentive for a foreign corporation to shift excessive passive assets into its U.S. insurance subsidiary in order not to qualify as a PFIC and is likely to affect the PFIC classification of only a very small number of companies. Comments are also requested on whether the final regulations should specifically allow for the applicable percentages to be adjusted or supplemented in subregulatory guidance (for example, to reflect possible future changes in industry practice).

### *E. Life insurance and annuity contract status*

Section 1297(f)(1)(A) provides that a QIC must be a foreign corporation that would be subject to tax under subchapter L if it were a domestic corporation. An insurance company is defined in sections 816(a) and 831(c), which limit insurance company status to a company more than half the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsurance of risks underwritten by insurance companies. Thus, the status of a company as an insurance company under subchapter L depends upon the characterization of the contracts that a company issues or reinsures. In addition, section 816(a) provides that if more than half of the company's total reserves (as defined in section 816(c)) are life insurance reserves (as defined in section 816(b)) or unearned premiums and unpaid losses on non-cancellable life, accident, or health contracts, then the company is a life insurance company taxable under part I of subchapter L; otherwise, an insurance company is taxable under part II of subchapter L.

Life insurance contracts and annuity contracts must meet certain statutory requirements to be treated as contracts giving rise to life insurance reserves for subchapter L purposes. Section 7702(a) defines a life insurance contract for purposes of the Code as a life insurance contract under applicable law (which includes foreign law) that satisfies one of two actuarial tests set forth in section 7702. Similarly, section 72(s) sets forth distribution on death requirements that an annuity contract must satisfy in order to be considered an annuity contract for purposes of the Code. In addition, if a contract is a variable contract within the definition of section 817(d), it must satisfy the diversification requirements for variable contracts under section 817(h) to be treated as a life insurance or annuity contract for purposes of subchapter L. These statutory requirements reflect Congress's concern that the tax-favored treatment generally accorded to life insurance and annuity contracts under the Code

should not be available to contracts that are too investment oriented or provide for undue tax deferral.

A taxpayer request (and follow-up submission) was received by the Treasury Department and the IRS regarding promulgating regulations that would provide that these statutory requirements do not apply for purposes of determining whether a foreign corporation satisfies the section 1297(f)(1)(A) requirement that the corporation would be subject to tax under subchapter L if it were a domestic corporation (as well as for other PFIC purposes), if certain requirements are met. The request suggested an approach to the statutory requirements analogous to the approach Congress took in section 953(e) (5). Section 953(e)(5) waives the statutory requirements for purposes of the subpart F insurance and foreign base company income rules if a contract is regulated as a life insurance or annuity contract in the issuer's home country and no policyholder, insured, annuitant, or beneficiary with respect to the contract is a U.S. person. The request asserts that such a waiver is warranted for PFIC purposes because contracts issued by non-U.S. insurance companies are unlikely to satisfy the statutory requirements, since non-U.S. insurance companies that do not target sales to the U.S. market typically do not take the statutory requirements into account when setting the terms of their life insurance and annuity contracts. The request also states that local law requirements may in some cases conflict with the statutory requirements. The follow-up submission suggested that additional qualification rules could be imposed that restrict the rule to cases in which the issuing company meets substantial home country requirements (such as deriving more than 50 percent of its aggregate net written premiums from insuring or reinsuring home country risks of unrelated persons).

The proposed regulations do not address the request as it is beyond the scope of the current rulemaking. The Treasury Department and the IRS are evaluating whether further guidance is necessary or appropriate regarding the application of

these provisions in the context of PFICs and request comments on this issue.

### *II. QIP's 20-Year ADS Recovery Period Applies to Determine QBAI for FDII and GILTI*

The proposed regulations contain certain rules announced in Notice 2020-69. Proposed §1.250(b)-2(e)(2) and proposed §1.951A-3(e)(2) clarify that the technical amendment to section 168 enacted in section 2307(a) of the CARES Act applies to determine the adjusted basis of property under section 951A(d)(3) as if it had originally been part of section 13204 of the Act. The Treasury Department and the IRS have determined that this clarification is consistent with congressional intent. See JCT CARES Act Report at 69-70.

The Treasury Department and the IRS request comments on whether a transition rule should be provided that would allow a corrective adjustment in the first taxable year ending after the date of publication in the **Federal Register** of the Treasury Decision adopting proposed §1.250(b)-2(e)(2) and proposed §1.951A-3(e)(2) as final regulations for taxpayers that took a position that is inconsistent with proposed §1.250(b)-2(e)(2) and proposed §1.951A-3(e)(2) on a return filed before September 1, 2020 and that do not file an amended return with respect to such year.<sup>10</sup>

### **Applicability Dates**

#### *I. Applicability Dates Relating to the General PFIC Rules*

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 filing of the Treasury Decision adopting these rules as final regulations in the **Federal Register**. However, until these regulations are finalized, taxpayers may rely on one or more of the following proposed rules with respect to a tested foreign corporation for any open taxable year beginning before the date of publication of the Treasury de-

<sup>10</sup> The Treasury Department and the IRS requested comments on the need for a transition rule in Notice 2020-69. The Treasury Department and the IRS will consider comments that are timely submitted in response to the request for comments in Notice 2020-69, along with any comments received in response to this notice of proposed rulemaking, when finalizing proposed §1.250(b)-2(e)(2) and proposed §1.951A-3(e)(2).

cision adopting these rules as final regulations in the **Federal Register**, provided they consistently follow each such rule for each subsequent taxable year beginning before the date of filing of the Treasury decision adopting these rules as final regulations in the **Federal Register**: proposed §1.1297-1(c)(1)(i)(B) (exceptions to section 954 not taken into account); proposed §1.1297-1(c)(2) (exception for active banking income of certain foreign banks); proposed §1.1297-1(d)(1)(v)(D) (valuation of assets); proposed §1.1297-1(d)(2) (regarding working capital); proposed §1.1297-2(b)(2)(ii)(A), (b)(3)(ii)(A), and (e)(4) (regarding application of exception for active banking income of certain foreign banks); proposed §1.1297-2(c)(2)(i) and (4)(ii)(A) (regarding not taking into account certain dividends); proposed §1.1297-2(f)(1) and (2) (regarding gain on disposition of stock in a look-through subsidiary), and proposed §1.1298-4(e) (regarding safe harbors to the domestic subsidiary anti-abuse rule). For a taxable year ending on or before December 31, 2020, a taxpayer may rely on proposed §1.1297-1(c)(1)(A) of the 2019 proposed regulations concerning the application of section 954(h) rather than proposed §1.1297-1(c)(2) with respect to a tested foreign corporation, without regard to whether the taxpayer consistently applies all of the provisions of these proposed regulations or the 2019 proposed regulations with respect to the tested foreign corporation. As discussed in greater detail in the preamble to the final regulations published in the Rules and Regulations section of this edition of the **Federal Register** (RIN 1545-BO59), when a tested foreign corporation no longer qualifies as a PFIC (due to a change in facts or law), the foreign corporation nonetheless retains its PFIC status with respect to a shareholder unless and until the shareholder makes an election under section 1298(b)(1) and §1.1298-3 (“purging election”) on Form 8621 attached to the shareholder’s tax return (including an amended return), or requests the consent of the Commissioner to make a late election under section 1298(b)(1) and §1.1298-3(e) (“late purging election”) on Form 8621-A.

## II. *Applicability Dates Relating to the Insurance Exception*

For a taxable year beginning after December 31, 2017 and before the date of filing of the Treasury Decision adopting these rules as final regulations in the **Federal Register**, taxpayers may rely on §§1.1297-4, 1.1297-5, and 1.1297-6 of the proposed regulations with respect to a tested foreign corporation, provided they consistently follow the rules of §§1.1297-4, 1.1297-5, and 1.1297-6 of the proposed regulations with respect to such tested foreign corporation for such taxable year and for each subsequent taxable year beginning before the date of filing of the Treasury decision adopting these rules as final regulations in the **Federal Register**. In addition, taxpayers may rely on proposed §1.1297-4(e)(4), provided they consistently apply §1.1297-4 of the final regulations for the same taxable year.

Alternatively, for a taxable year beginning after December 31, 2017 and before January 14, 2021, taxpayers may rely on proposed §§1.1297-4 and 1.1297-5 of the 2019 proposed regulations with respect to a tested foreign corporation, provided they consistently apply the rules of proposed §§1.1297-4 and 1.1297-5 of the 2019 proposed regulations with respect to such tested foreign corporation for such taxable year.

## III. *Applicability Dates Relating to Regulations under Sections 250 and 951A*

Consistent with section 2307(b) of the CARES Act, the proposed regulations addressing QIP are proposed to apply retroactively. The modification to proposed §1.951A-3(e)(2) is proposed to apply to taxable years of foreign corporations beginning after December 31, 2017, and to taxable years of U.S. shareholders in which or with which such taxable years of foreign corporations end. The modification to proposed §1.250(b)-2(e)(2) is proposed to apply to taxable years beginning after December 31, 2017.<sup>11</sup> See section 7805(b)(2). U.S. shareholders and domestic corporations (including any in-

dividuals that elect to apply section 962) may, before the date of publication of the Treasury Decision adopting these rules as final regulations in the **Federal Register**, rely on proposed §§1.951A-3(e)(2) and 1.250(b)-2(e)(2) for any taxable year beginning after December 31, 2017, provided they consistently apply those rules for purposes of FDII and GILTI under sections 250 and 951A to such taxable year and all subsequent taxable years.

## 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 final regulations will be informed by comments received.

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

### A. *Background*

The passive foreign investment company (PFIC) rules of the Internal Revenue Code address situations in which

<sup>11</sup> The rule in proposed §1.250(b)-2(e)(2) in this notice of proposed rulemaking applies to taxable years beginning after December 31, 2017 and before January 1, 2021 regardless of whether the taxpayer has relied on proposed §§1.250(a)-1 through 1.250(b)-6 (as proposed in REG-104464-18, 84 FR 8188), the final regulations under §§1.250(a)-1 through 1.250(b)-6 under §1.250-1(b) (T.D. 9901, 85 FR 43042), or neither.

taxable U.S. persons indirectly hold assets that earn “passive income” (generally, interest, dividends, capital gains, and similar types of income) through a foreign corporation. If not subject to the PFIC rules, the income earned on these assets would be subject to U.S. tax only when that income is distributed as dividends by the foreign corporation or when shares of the foreign corporate stock are sold for a gain by the U.S. shareholder. If the income were subject to a low or zero rate of foreign tax, the U.S. investor would have a tax incentive to hold passive assets in this manner rather than hold the securities directly. By creating tax-deferral opportunities, these types of investment arrangements could significantly lower the effective tax rate on passive income ultimately received by participating U.S. investors. This potential result would decrease U.S. tax revenues and possibly lower the cost of capital faced by foreign and domestic corporations whose securities were held in this manner.

A foreign corporation is considered a PFIC if at least 75 percent of the corporation’s gross income for a given taxable year is passive income or if assets that produce passive income, or that are held for the production of passive income, comprise at least 50 percent of the corporation’s total assets. A PFIC is not subject to U.S. tax under the PFIC regime; rather, U.S. shareholders of a PFIC are subject to tax on a current, or current-equivalent, basis in proportion to their ownership share in the PFIC’s income.

Passive income generally consists of dividends, interest, rents, royalties, annuities, gains on the sale of property that is not inventory or property used in an active business, and similar forms of income. Passive income is distinguished generally from non-passive income in that it is not earned in the active conduct of a trade or business by the foreign corporation, by a party closely affiliated with the foreign corporation, or by other corporations or partnerships that can be assumed to be controlled by the foreign corporation.

The “subpart F” rules in the Code also address the taxation of passive income earned by foreign corporations but only in the context of U.S. controlled foreign cor-

porations (CFCs), defined as being more than 50 percent owned by U.S. shareholders (where a U.S. shareholder of a CFC is a U.S. person owning at least ten percent of the vote or value of the foreign corporation’s shares). There is no such minimum ownership requirement for a U.S. shareholder of a PFIC. A PFIC that is also a CFC during a portion of a U.S. PFIC shareholder’s holding period is not treated as a PFIC with respect to a U.S. shareholder of a CFC during that portion of the holding period.

A U.S. shareholder of a PFIC is responsible for determining its proportionate share of ownership in the PFIC and the appropriate amount of PFIC income to include on the shareholder’s tax return. The Code and regulations provide ownership attribution rules for determining indirect ownership of PFICs by U.S. persons and rules for determining amounts of a corporation’s annual total and passive income and the amounts of total and passive assets on each of several measuring periods (generally quarterly) throughout the year. Compliance with the PFIC regime requires an ability to negotiate its often-complicated rules and generally means that those willing to invest in potential PFICs are relatively sophisticated taxpayers that have access to professional tax advice in order to navigate the tax complexities presented by the PFIC regime. It is also possible that a less sophisticated taxpayer could invest in a PFIC without a full understanding of the tax treatment of that investment.

The PFIC definition of passive income refers to the passive income definition of “foreign personal holding company income” (FPHCI) used for purposes of the CFC rules. That definition contains exceptions from passive income that involve certain income derived by a CFC in the active conduct of a banking or financing business and certain income derived by a CFC in the active conduct of an insurance business. However, the PFIC statutory rules have separate exceptions from the definition of passive income that include any income “derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States (or, to the extent provided in regulations, by any other corporation)” and any income “derived in

the active conduct of an insurance business by a qualifying insurance corporation.” Regulations under the PFIC banking exception were proposed in 1995 (the “1995 proposed regulations”) to provide greater clarity and additional specification of this exception to passive income. These 1995 proposed regulations have not been finalized. Regulations under the PFIC insurance exception were proposed in 2015 to clarify further the meaning of “active conduct” in this context, but these regulations have not been finalized. More recently, the Tax Cuts and Jobs Act (TCJA) of 2017 amended the statutory provision by requiring that the PFIC insurance exception applies only to an insurance business conducted by a qualifying insurance corporation (QIC) and provided a statutory definition of a QIC.

The Treasury Department and the IRS previously published proposed regulations pertaining to sections 1291, 1297, and 1298 of the Code (the “2019 proposed regulations”). *See* 84 FR 33120. These regulations dealt with several general PFIC implementation issues and with the new requirement (beginning in 2018) that a foreign corporation must be a QIC for its insurance-related income to qualify as non-passive under the insurance business exception. Regulations to finalize these proposed regulations (the “2020 final regulations”) are being published contemporaneously with these newly proposed regulations (“these regulations” or the “2020 proposed regulations”). *See* TD 9936. Upon further reflection on certain issues, and in response to public comments received with respect to the 2019 proposed regulations, certain revised rules and additional specifications are being re-proposed.

#### *B. Need for the proposed regulations*

These regulations are needed because a number of the details behind the relevant terms and necessary calculations required for the determination of PFIC status would benefit from greater specificity beyond that provided by the 2020 final regulations. In particular, these 2020 proposed regulations further clarify the determination of the banking and insurance “active conduct” statutory exceptions to the definition of passive income.

### C. Economic analysis

This economic analysis provides a summary of the economic effects of the regulations relative to the no-action baseline. It further analyzes, first, proposed regulations under the general rules that implement the exception from passive income for income derived in the active conduct of a banking business and, second, proposed regulations under the passive income exception for income earned in the active conduct of an insurance business by a qualifying insurance corporation (QIC). This latter analysis covers, in particular, elements of these proposed regulations as they relate to the primary test ratio that must be satisfied by a QIC. This test requires measurement of certain applicable insurance liabilities (AIL) and total assets of a tested corporation.

#### 1. Baseline

In this analysis, the Treasury Department and the IRS assess the benefits and costs of these 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

These 2020 proposed regulations will provide improved certainty and consistency in the application of sections 1297 and 1298 of the Internal Revenue Code with respect to passive foreign investment companies (PFICs) and qualified insurance corporations (QICs) by providing definitions and clarifications regarding application of the statute's terms and rules. Efficient investment requires planning, and good planning requires knowledge of the proper and consistent application of tax rules. Furthermore, uncertainty regarding the applicability of tax rules invites aggressive taxpayer interpretations and increased enforcement costs, including increased litigation.

Divergence in taxpayers' interpretations of the statute can cause similarly situated U.S. persons to allocate investment funds differently. If economic investment is not guided by uniform tax incentives, the resulting pattern of investment may be inefficient, leading to relatively lower in-

comes. By providing clarity to the law and greater uniformity in its application, the 2020 proposed regulations, when finalized, will help to ensure that similar economic activities are taxed similarly. Thus, the Treasury Department and the IRS expect that the definitions and guidance provided in the proposed regulations will lead to an improved allocation of investment among U.S. taxpayers as well as more equitable treatment of those taxpayers.

To the extent that certain regulatory provisions provide greater opportunities for foreign corporations to avoid PFIC status relative to the no-action baseline, they provide U.S. investors with additional tax deferral opportunities relative to a no-action baseline. An increased use of these tax deferral opportunities would decrease effective shareholder taxes and generally lower the cost of real investment by both domestic businesses and foreign corporations for which U.S. investors are investment funding sources. This would likely increase such investment and thereby increase U.S. GNP relative to the no-action baseline. However, such actions would reduce U.S. tax revenues, although this effect could be offset to a degree by increased taxable capital gains due to a resultant increase in the valuation of corporate equities.

To the extent that other provisions of the regulations reduce the opportunities for foreign corporations to avoid PFIC status, they would eliminate deferral by U.S. persons and thereby increase U.S. shareholder tax burdens. This may dissuade U.S. persons from pursuing profitable investment opportunities in active foreign corporations that would be sought under a no-action baseline. Such provisions also could cause some active foreign corporations to incur additional economic costs in order to avoid designations as PFICs, resulting in lower investment returns and less investment in such corporations. The avoidance of otherwise profitable foreign investment opportunities by U.S. persons can result in a loss of U.S. GNP.

It is unclear whether these proposed regulations have a net effect of increasing or decreasing the ability of foreign corporations to avoid PFIC status relative to the no-action baseline.

The Treasury Department and the IRS have not estimated the differences in

economic activity that might result from implementation of these proposed regulations relative to alternative regulatory approaches, including the no-action baseline. They do not have readily available data or models that capture in sufficient detail the economic activities that taxpayers might undertake under each of these regulatory approaches. The Treasury Department and the IRS have similarly not estimated the differences in compliance costs of U.S. persons or IRS administrative burden that would arise under each of the alternative regulatory approaches because they do not have readily available data or models that capture these aspects in sufficient detail.

The Treasury Department and the IRS solicit comments on this economic analysis and particularly solicit data, models, or other evidence that could be used to enhance the rigor with which the final regulations are developed.

#### 3. Economic Analysis of Specific Provisions

##### a. Income derived in the active conduct of a banking business

The PFIC provisions define passive income as income which is of a kind that would be foreign personal holding company income (FPHCI) as defined in section 954(c), which is part of the subpart F rules of the Internal Revenue Code. A related provision, section 954(h), excludes from FPHCI for subpart F purposes the "qualified banking or financing income" of an "eligible controlled foreign corporation," that is, a CFC that is predominantly engaged in the active conduct of a banking, financing, or similar business and that conducts substantial activity with respect to such business. A banking, financing or similar business includes (i) a lending or finance business, (ii) a banking business conducted by an institution that is licensed to do business as a bank in the United States or is a corporation specified in regulations, and (iii) a securities business conducted by a corporation that is either registered with the SEC as a securities broker or dealer or is otherwise specified in regulations.

The 2019 PFIC proposed regulations would have incorporated this section 954(h) exception to FPHCI into the defi-

inition of passive income for the purpose of the PFIC rules. However, the Treasury Department and the IRS subsequently determined that this exception does not apply for purposes of the PFIC definition of passive income absent regulations and that any such regulations should be issued under the separate PFIC statutory rule described in the next paragraph. Accordingly, these 2020 proposed regulations specify that the FPHCI exception for active banking income of CFCs is not to be taken into account in the general definition of passive income for the purpose of the PFIC regime.

The Treasury Department and the IRS considered two options for the implementation of an active banking exception under the PFIC tax regime. The first alternative would re-propose the 1995 proposed regulations. The second alternative would adopt the statutory rules of the FPHCI exception for CFCs, with modifications (such as not limiting the rule to CFCs). Each alternative is discussed in turn.

i. 1995 proposed regulations

The 1995 proposed regulations treat “banking income” of “active banks” and “qualified bank affiliates” as non-passive. An active bank is either a domestic or foreign corporation that is licensed by federal or state regulators to do business as a bank in the United States or a foreign corporation that satisfies the following requirements:

1. It must be licensed or authorized to accept deposits from its home country residents and must actively conduct a banking business;
2. It must regularly accept such deposits in the ordinary course of business; in addition, the amount of deposits shown on the corporation’s balance sheet must be substantial; and
3. It must regularly make loans to customers in the ordinary course of business.

Banking income is defined as gross income that is derived from the active conduct of a specified banking activity. The regulations list 14 banking activities (plus a provision that allows the IRS Commissioner to specify additional banking activities). The major activities listed include lending activities, the purchasing or sell-

ing of notes or other debt instruments for customers, issuing of letters of credit, performing trust services, arranging foreign exchange transactions, interest rate or currency futures, etc., underwriting issues of securities for customers, engaging in finance leases, and providing credit card services.

The 1995 proposed regulations also extend the banking income definition to certain affiliates of active banks that are not themselves active banks. To be a qualified bank affiliate, at least 60 percent of a foreign corporation’s gross income must be income that qualifies as non-passive income under the PFIC active conduct exceptions. In addition, a qualified bank affiliate must be a member of an affiliated group (based on an affiliation ownership standard of more than 50 percent voting power), and at least 30 percent of the group’s “aggregate gross financial services income” (defined in foreign tax credit regulations) must be banking income earned by active banks that are group affiliates. Also, at least 70 percent of such group income must be income excepted under the PFIC active conduct rules.

ii. FPHCI exception for banking, finance, or similar income of CFCs

The FPHCI exception, while limited to eligible CFCs, applies to a broader group of eligible corporations and qualified financial activities than the 1995 proposed regulations for banking income. The FPHCI rules for CFCs define an eligible business as including a banking business, a securities business, and a “lending or finance” business. While the FPHCI statutory rules include identical language regarding banks as does the PFIC statutory exception; neither set of statutory rules specifically define eligible banks, leaving the definition to regulations.

The FPHCI exception for CFCs applies to qualified banking or financing income. A CFC that is not engaged in a banking or securities business must derive more than 70 percent of its gross income from a lending or finance business with unrelated customers. A “lending or finance” business includes a business that is making loans, purchasing or discounting accounts receivable or certain other assets, engaging in leasing, issuing letters of credit or

providing guarantees, providing credit card services, and rendering services related to the other listed activities. This list is similar to, but not the same as, the list of banking activities provided in the 1995 proposed regulations.

Qualified banking or other financing income can be derived in the active conduct of a branch or other “qualified business unit” (QBU) of an eligible CFC. A QBU is a separate and clearly identified unit that maintains its own separate books and records. Qualified banking or financing income must be derived from transactions with customers located in a country other than the United States. Substantially all of the activities of the business must be conducted directly by the corporation in its home country, or by its QBU in the home country of the QBU. There are no similar requirements in the 1995 proposed regulations. Under the FPHCI exception for CFCs, business activity may include the activity of the employees of a related CFC located in the same home country as that of the corporation or QBU, provided the activity is conducted in the home country of the related person. Unlike the 1995 proposed regulations, the FPHCI exception for CFCs does not treat income of affiliates of an eligible CFC that are not themselves eligible CFCs as non-passive income.

iii. 2020 proposed regulations – definition of a foreign bank

The 2020 proposed regulations generally adopt the approach taken under the FPHCI statutory language but substitute a tested foreign corporation (TFC) (or a related person of the TFC) for a CFC. As in the case of the PFIC banking exception adopted in the 1995 proposed regulations, the 2020 proposed regulations apply only to foreign banks.

Similar to the “active bank” definition of the 1995 regulations, the 2020 proposed regulations require a “foreign bank” to be either licensed as a bank in the United States or as a bank in the country in which it is chartered or incorporated (its “home country”). The 2020 proposed regulations also require that a foreign bank accept bank deposits from home country residents, and indirectly incorporate the “substantial deposits” requirement of the 1995 proposed

regulations. Unlike the 1995 proposed regulations, the 2020 proposed regulations do not require a foreign bank to regularly make loans to customers in the ordinary course of its business. Instead, the bank must carry out with unrelated customers one or more of the activities listed in the FPHCI statute that constitute a lending or finance business. One of those activities is the making of loans, but a foreign bank can have as its business activity any of the other listed finance business activities in order to qualify for the PFIC banking exception. This change in the definition of a qualifying foreign bank may be a significant difference from the 1995 proposed regulations, depending on what activities are required of and permitted to be carried out by a bank under bank regulatory rules. If bank regulatory rules do not require a bank to make loans to customers as part of a banking business, the definition of foreign bank may represent a broadening of the type of institutions that may qualify for an exception under the PFIC active conduct exception for banking compared to the 1995 proposed regulations.

In contrast to the 1995 proposed regulations, the 2020 proposed regulations provide that the banking exception applies separately to the income and activities of a qualified branch (i.e., a QBU) of a foreign bank. Depending on the activities of a branch, this may either increase or decrease the likelihood that income of a foreign bank is treated as non-passive.

#### iv. 2020 proposed regulations – banking income

While it may be easier to qualify as a foreign bank under the 2020 proposed regulations than as an active bank under the 1995 proposed regulations, the conditions that must be satisfied in order to treat income as qualified banking or financing income eligible for the FPHCI exception are more stringent than the requirements for treating income as banking income under the 1995 proposed regulations. The 2020 proposed regulations require that substantially all activities that produce active banking income must be performed by the TFC or its QBU in the home country of the bank or that of the QBU, respectively. However, an affiliated entity can provide employees to perform the requisite

activity, but only if the affiliate is created or organized in the relevant home country and the activity is performed in the home country of the related person. No such requirement exists under the 1995 proposed regulations. This home country activity requirement limits the variety of organizational structures that foreign banks may use in order to qualify for the new PFIC banking exception. If a bank must restructure its operations in order to satisfy the home-country requirement, this might be considered a significant PFIC compliance cost by foreign banks and therefore it may impact the investment choices of U.S. persons.

In addition, under the FPHCI exception, eligible income must be derived in transactions with customers located in a country other than the United States. Relative to the 1995 regulations, this rule imposes an additional compliance burden on foreign corporations that desire to access the U.S. investment community. It requires them to distinguish income derived from U.S.-based customers from income derived from other customers.

#### v. 2020 proposed regulations – affiliates

Under the 2020 final regulations, a tested foreign corporation (TFC) that owns at least 25 percent (by value) of a corporation or partnership may be treated as if it held its proportionate share of the assets of the look-through subsidiary (LTS) or look-through partnership (LTP) and received its proportionate share of the income of the LTS or LTP. The income and assets of the subsidiary entity are treated as passive or non-passive in the hands of the TFC in the same manner as such items are treated in the hands of the LTS or LTP. In general, an exception to the passive income rules applies to income of an LTS or LTP only if the exception would have applied to exclude the income from passive income in the hands of the LTS or LTP. For this purpose, the activities of a specified affiliated group of entities that includes the TFC may be taken into account to judge the active conduct nature of the LTS's or LTP's income.

Under certain conditions, the 1995 proposed regulations permit the banking income of a qualified bank affiliate to be treated as non-passive income for the pur-

pose of determining the PFIC status of its affiliated companies. No similar rule applies under the 2020 proposed regulations for bank affiliates. Thus, for banking income of an LTS to be treated as excepted income, the LTS must itself be an eligible foreign bank.

The income of an LTS that is a U.S. bank conducting business with U.S. residents does not qualify as having excepted income under the 2020 proposed regulations. Such a bank would likely qualify as an active bank under the 1995 proposed regulations and, under the look-through rules, that income would be considered non-passive in the hands of the TFC. In this respect the 2020 proposed regulations make it more difficult for certain foreign corporations to avoid PFIC status relative to the 1995 proposed regulations.

#### vi. Summary of economic effects

The Treasury Department and the IRS expect that the 2020 proposed regulations may produce different outcomes relative to the no-action baseline. However, whether “on net” these different outcomes make it more difficult for income of certain foreign corporations to qualify as non-passive under the banking active conduct exception or make it more likely that income of foreign banking institutions will be treated as non-passive depends heavily on the individual facts and circumstances of the TFC and its affiliates, so that no general conclusion can be drawn in that regard.

#### b. Applicable financial statement and applicable insurance liabilities

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

### i. Definition of an AFS

For the purpose of the QIC test, AIL are based on insurance liabilities as they are accounted for on the taxpayer's applicable financial statement (AFS). Under the statute and the 2020 final regulations, an AFS is a financial statement prepared for financial reporting purposes that is based on U.S. generally accepted accounting principles (GAAP), or international financial reporting standards (IFRS) if there is no statement based on GAAP. If neither of these statements exist, then an AFS can be an annual statement that is required to be filed with an applicable insurance regulatory body. Such a statement would be one that is prepared on the basis of a local regulatory accounting standard. Thus, the statute has a preference for financial statements prepared on the basis of GAAP or IFRS, which are rigorous and widely-respected accounting standards, but will permit a foreign corporation to have an AFS that is prepared on the basis of a local regulatory accounting standard if the foreign corporation does not do financial reporting based on GAAP or IFRS.

This definition of an AFS does not necessarily produce a single financial statement that can be deemed "the" AFS of a foreign insurance company. GAAP and IFRS statements may be prepared for several financial reporting purposes, and there may be differences in the value of assets or in the presentation of results, depending on the purpose and jurisdiction for which it is prepared. This may be particularly true in the case of a financial statement filed with local regulatory bodies. For example, a company that operates branches in more than one jurisdiction may be filing multiple regulatory financial statements, each based on a separate local accounting standard. This variability may be tempered, however, if the local regulatory authorities require their regulatory statements to be filed on a GAAP or IFRS basis.

The Treasury Department and the IRS determined that it was appropriate to modify the definition of AFS in order to impose greater structure on the identification of the AFS used for purposes of the QIC test. These 2020 proposed regulations refine the definition of a financial statement to ensure that an AFS includes a complete

balance sheet, statement of income, a statement of cash flows and related exhibits, schedules, forms, and footnotes that are normal components of such a filing. A complete financial statement is more likely to present an accurate picture of a company's financial position. These 2020 proposed regulations also require that an AFS be an audited financial statement. While an audit requirement may impose additional accounting costs on the foreign corporation (and, therefore, on its shareholders), a financial statement reviewed by independent auditors insures adherence to the relevant accounting standard. The Treasury Department and the IRS have determined that local jurisdictions generally will require audited financial statements to be filed with insurance regulatory bodies, so that this requirement should not impose a significant additional compliance burden on foreign corporations.

The 2020 proposed regulations impose a new set of sub-priorities on financial statements prepared under GAAP and a similar set of sub-priorities on statements prepared under IFRS. These sub-priorities have been used in other regulatory contexts. They are based on the purpose for which a financial statement is being released or filed. In the opinion of the Treasury Department and the IRS, these different priorities represent the reliability of the statement. Thus, a GAAP statement filed by publicly regulated corporations with the Securities and Exchange Commission or with an equivalent foreign agency is deemed highly reliable and is preferred to a statement that is used, say, for credit purposes or for reporting in shareholder reports.

The new rule narrows the potential number of financial statements that might be considered as AFSs relative to the no-action baseline and should thereby reduce compliance and tax administrative costs, while bringing taxpayer behavior closer in line with the intent and purpose of the statute.

If an AFS is a consolidated financial statement in which the tested corporation is not the parent, such statement could include AIL and assets of the parent, as well as AIL and assets of other sibling corporations. Nevertheless, under the 2020 final regulations, the amount of AIL on an AFS that can be AIL for the purpose of the QIC

test includes only the AIL of the corporation being tested. Consequently, the 2020 proposed regulations stipulate that a financial statement that includes parent and sibling assets and liabilities cannot be an AFS unless it is a financial statement filed with a local regulator and is the only such financial statement available, in which case the AIL as reported on the statement would have to be adjusted to remove the double counted parental and sibling AIL. This rule is expected to reduce the likelihood that the AIL shown on an AFS would have to be adjusted prior to the application of the QIC test and thereby reduce compliance costs relative to alternative regulatory approaches. The Treasury Department and the IRS have not estimated this reduction in compliance costs because they do not have data or models with this level of specificity.

If more than one financial statement exists for an AFS subcategory and that subcategory is the highest priority subcategory of AFS for which an AFS is available, then the 2020 proposed regulations dictate that any financial statement prepared on a non-consolidated basis has priority over a statement prepared on a consolidated basis. In most cases, a non-consolidated AFS will be preferred by the tested corporation because assets of the tested corporation will generally include the corporation's net equity share of its subsidiaries and not the full value of its assets. A consolidated statement will include all assets and liabilities of lower-tiered subsidiaries (whether fully or partially owned) other than eliminated items that represent intra-corporate transactions when viewed from a consolidated perspective. Nevertheless, AIL eligible to be taken into account for purposes of the QIC test includes only AIL of the tested corporation. Therefore, use of a consolidated AFS requires that any AIL of entities other than the tested corporation (such as subsidiaries) that are recorded on the consolidated statement must be eliminated for the purpose of the QIC test. Because this would bias downward the QIC test statistic (because the subsidiary assets supporting these eliminated AIL remain on the AFS), the 2020 proposed regulations allow a tested corporation to reduce its assets by the amount of AIL that are eliminated for this reason.

Any AIL of the tested corporation that have been eliminated because of the preparation of a consolidated statement (for example, if the tested corporation had insured or reinsured a subsidiary) are not added back to the AIL reported on the AFS. The corresponding subsidiary assets have also been eliminated in the preparation of the consolidated AFS, so that the reverse process of that described in the previous paragraph is accomplished automatically.

ii. Limitations on applicable insurance liabilities

Pursuant to statutory mandate and explicitly granted regulatory authority, the 2020 final regulations specify that any amount of AIL used in the QIC test cannot exceed the smallest of following three amounts:

- 1) The amount of AIL of the tested corporation shown on any financial statement that is filed or required to be filed with the corporation's applicable insurance regulatory body;
- 2) The amount of AIL determined on an AFS that is prepared on the basis of GAAP or IFRS, whether or not such statement is filed by the tested corporation with its applicable insurance regulatory body;
- 3) The amount of AIL required by law or regulation to be held by the tested corporation (or a lesser amount, if the corporation is holding a lesser amount as a permitted practice of the applicable insurance regulatory body).

These limitation amounts may induce local regulators to require the filing of financial statements based on GAAP or IFRS instead of filing statements based on a local regulatory accounting standard. Such actions would eliminate limitation amount 1) above, and assuming that limitation amount 3) does not apply, would leave the amount of AIL reported on a GAAP- or IFRS-prepared statement as the relevant AIL. This approach will improve the application of the QIC test, relative to the no-action baseline, by increasing the likelihood that AIL and total assets are both derived from consistent accounting principles by the tested corporations affected by the PFIC insurance rules.

A tested corporation that has an AFS based on GAAP or IFRS may be required

to file a financial statement with its home country regulator using local statutory accounting rules, where the AIL on the latter statement are less than those shown on the AFS. The difference in AIL could perhaps be due to the use of dissimilar accounting rules, the use of different discounting assumptions or other assumptions regarding the measurement of liabilities, or disparate methods of valuing assets. Under the 2020 proposed regulations, such accounting differences are not accounted for by prescribed asset adjustments or by other means.

As a regulatory alternative, the Treasury Department and the IRS considered whether to require asset or liability adjustments based on certain identified differences between an AFS based on GAAP or IFRS and a financial statement based on local accounting standards, where the differences were due solely to different accounting standard requirements. For example, in preparing the 2020 final regulations, the Treasury Department and the IRS considered imposing the discounting rules specified by the Code for measuring property and casualty unpaid losses for domestic tax purposes on losses measured on a non-GAAP or non-IFRS basis. Such an option was rejected due partly to its anticipated heavy compliance costs (and thus the possibility that the foreign corporation may not take the steps necessary to attract U.S. investors) without any accompanying, identifiable general economic benefit. The Treasury Department and the IRS determined that prescribing other requirements or adjustments could have similar compliance costs and that the impacts of such accounting discrepancies on the QIC test ratio are generally either unknown or without a consistent bias. In this regard, the Treasury Department and the IRS further determined that they did not have and could not practically obtain sufficient information regarding the differences among GAAP, IFRS, and the various local accounting standard requirements that might apply to tested corporations in different foreign jurisdictions to formulate additional appropriate rules.

iii. Reinsurance recoverable

In the context of reinsurance, however, the differences in the measurement of

AIL and assets under different accounting standards are in some cases due merely to a different presentation of the accounting results with respect to reinsurance, rather than more fundamental differences in measurement or accounting methods. Companies that have ceded business to another insurer under a contract of reinsurance will have amounts recoverable from those reinsurers that could represent a reimbursement of AIL. These amounts may be related to claims that have been paid or unpaid. Generally, if the insurer has paid a claim, the reinsurance recoverable is shown as a receivable (that is, an asset) on its balance sheet. However, the treatment of amounts recoverable with respect to unpaid losses and unpaid loss adjustment expenses can differ amongst different accounting standards. For example, under current GAAP, reinsurance recoverable with respect to unpaid claims is reported as an asset. The same is true under IFRS 17 (an insurance accounting standard that will be effective generally beginning in 2023), where a single reinsurance asset may be reported with respect to both paid and unpaid claims. The situation is different under U.S. statutory accounting rules as specified by the National Association of Insurance Commissioners and implemented by the various states. Under U.S. statutory accounting, reinsurance recoverable for unpaid losses and loss adjustment expenses is treated as an offset to the unpaid loss reserves and would thus reduce AIL. It is likely that some non-U.S. local statutory accounting standards similarly reduce unpaid loss reserves (and thus AIL) by amounts recoverable through reinsurance.

Measuring AIL on a "gross" basis, as under GAAP and IFRS 17, necessarily increases the QIC test ratio relative to a "net" AIL measure. However, if the local accounting standard governing the financial statement filed with an applicable regulatory body requires a "net" measure of AIL, then the AIL of the GAAP- or IFRS-based AFS will generally be limited for the purpose of the QIC test.

Reporting AIL on a "gross" basis could enable a foreign insurer to raise its QIC test ratio to almost any desired level simply by being a reinsurance conduit (that is by reinsuring business and then retroceding all, or virtually all, of

that business to other reinsurers). Such a possibility could allow corporations that might otherwise be designated as PFICs instead to qualify as QICs and thereby avoid PFIC status.

For these reasons the 2020 proposed regulations specify that amounts recoverable from reinsurance and related to AIL, if reported as assets on a financial statement of the tested corporation, must be subtracted from the reported AIL. That is, all AIL are to be determined on a “net” basis with respect to reinsurance recoverable. Furthermore, if such reinsurance amounts are recoverable from an insurance subsidiary of the tested corporation, and such amounts of reinsurance recoverable are eliminated in the preparation of a consolidated financial statement, the AIL of the tested corporation nevertheless must be reduced by the recoverable amount. Under the 2020 proposed regulations, total assets reported on the AFS of the tested corporation may be reduced by amounts equal to the reductions in AIL for the purpose of the QIC test.

#### 4. Number of Potentially Affected Taxpayers

An entity must file a separate Form 8621 for each PFIC for which it has an ownership interest. The accompanying table indicates how many entities have filed at least one form 8621 between 2016 and 2018. These data are based on IRS master files of tax return filings and do not encompass late filings that have not yet been received. For 2018, nearly 62,000 Forms 8621 were filed. Over 70 percent of the entities filing a Form 8621 are individuals, although certain individuals are exempt from filing a Form 8621 if their aggregate holdings are less than \$25,000 (\$50,000 if filing a joint return) and they do not have PFIC income to report. Another 27 percent are pass-through entities, the overwhelming number of which are partnerships, but which also include S corporations, estates, and non-grantor trusts. These pass-through entities primarily have individuals as partners, shareholders, or beneficiaries. It is possible there

is some double counting whereby both partnerships and partners are filing a Form 8621 for the same PFIC. C corporations comprise just over one percent of total entities, while another nearly two percent of Forms 8621 do not identify on the form the filing status of the filer.

In general, only the taxpayer that is the lowest tier U.S. entity owning a PFIC needs to file a Form 8621. Thus, an individual that is a PFIC shareholder because he or she owns an interest in a U.S. partnership that holds shares of a PFIC does not need to file a Form 8621 if the individual is not required to report PFIC-related income on the Form 8621. This may happen if, for example, the individual and the partnership have made a Qualifying Electing Fund (QEF) election with respect to the PFIC. In that case, only the partnership files the Form 8621. The partnership records the QEF income for the year, and that taxable income is reported to the taxpayer as part of his or her distributive share of partnership income.

| <b>Table</b>                               |             |             |             |
|--|-------------|-------------|-------------|
| <b>Number of Entities Filing Form 8621</b> |             |             |             |
|  | <b>2016</b> | <b>2017</b> | <b>2018</b> |
| <b>Individuals</b>                         | 36,978      | 40,891      | 43,406      |
| <b>Passthrough Entities</b>                | 15,326      | 16,133      | 16,607      |
| <b>C Corporations</b>                      | 713         | 733         | 739         |
| <b>Unreported Filer Type</b>               | 1,114       | 1,053       | 1,084       |
| <b>All Entities</b>                        | 54,131      | 58,810      | 61,836      |

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

The Treasury Department and the IRS do not have information in current tax filings regarding how many shareholders own shares in qualifying insurance companies or qualifying banks.

#### 5. Regulatory Flexibility Act

It is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities within the meaning of sec-

tion 601(6) of the Regulatory Flexibility Act (5 U.S.C. chapter 6). The proposed regulations provide guidance with respect to the statutory provisions in sections 1291 through 1298 (the “PFIC regime”), which generally affect U.S. taxpayers that have ownership interests in foreign corporations that are not CFCs. The proposed regulations do not impose any new costs on taxpayers. Consequently, the Treasury Department and the IRS have determined that the proposed regulations will not have a significant economic impact on a substantial number of small entities. Notwithstanding this certification, the Treasury Department and the IRS invite comments on the impact of these rules on small entities.

Pursuant to section 7805(f), 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 business. The Treasury Department and the IRS request comments on the impact of these proposed regulations on small business entities.

#### II. *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 expen-

ditures in any one year by a state, local, or tribal government, in the aggregate, or by the private sector, of \$100 million in 1995 dollars, updated annually for inflation. This rule does not include any Federal mandate that may result in expenditures by state, local, or tribal governments, or by the private sector in excess of that threshold.

### III. 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 amendments to the regulations are adopted as final regulations, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “ADDRESSES” section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. See also the specific requests for comments in the following Parts of the Explanation of Provisions: I.A.1 (concerning rules for foreign banks and the ongoing application of Notice 89-81 and proposed §1.1296-4), I.A.2 (regarding financial statement valuation), I.A.3 (on the treatment of working capital in applying the Asset Test), I.A.4 (concerning the elimination of intercompany dividends and the treatment of pre-acquisition earnings and profits), I.A.5 (on the safe harbor for the anti-abuse rule for section 1298(b)(7)), I.B.1 (on the expanded definition of an AFS and the priority rules provided), I.B.2 (concerning modco arrangements and other special circumstances in which modification of the definition of

AIL is appropriate), I.B.3 (on situations that may warrant an adjustment to total assets), I.C.1 (concerning the active conduct test), I.D.2 (on the QDIC Limitation Rule), I.E (concerning the application of statutory requirements relating to life insurance contracts and annuity contracts), and II (concerning a transition rule). Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at [www.regulations.gov](http://www.regulations.gov) or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically by sending an email to [publichearings@irs.gov](mailto:publichearings@irs.gov). If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4, 2020-17 I.R.B. 667 (April 20, 2020), provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

### Statement of Availability of IRS Documents

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

### Drafting Information

The principal drafters of these regulations are Christina G. Daniels, Josephine Firehock, Jorge M. Oben, and Larry R. Ponders 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 record-keeping requirements.

## 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 continues to read in part as follows:

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

Par. 2. In § 1.250-1 amend paragraph (b) by revising the first sentence and adding a sentence at the end of the paragraph to read as follows:

#### §1.250-1 Introduction.

\* \* \* \* \*

(b) \* \* \* Except as otherwise provided in this paragraph (b)(2), §§1.250(a)-1 and 1.250(b)-1 through 1.250(b)-6 apply to taxable years beginning on or after January 1, 2021. \* \* \* The last sentence in §1.250(b)-2(e)(2) applies to taxable years beginning after December 31, 2017.

\* \* \* \* \*

Par. 3. Section 1.250(b)-2 is amended by adding a sentence at the end of paragraph (e)(2) to read as follows:

#### §1.250(b)-2 Qualified business asset investment (QBAI).

\* \* \* \* \*

(e) \* \* \*

(2) \* \* \* For purposes of applying section 250(b)(2)(B) and this paragraph (e), the technical amendment to section 168(g) enacted in section 2307(a) of the Coronavirus Aid, Relief, and Economic Security Act, Pub. L. 116-136 (2020) is treated as enacted on December 22, 2017.

Par. 4. Section 1.951A-3 is amended by adding a sentence at the end of paragraph (e)(2) to read as follows:

#### §1.951A-3 Qualified business asset investment.

\* \* \* \* \*

(e) \* \* \*

(2) \* \* \* For purposes of applying section 951A(d)(3) and this paragraph (e), the technical amendment to section 168(g) enacted in section 2307(a) of the Coronavirus Aid, Relief, and Economic Security

Act, Pub. L. 116-136 (2020) is treated as enacted on December 22, 2017.

\*\*\*\*\*

Par. 5. Section 1.1297-0 is amended by:

1. Revising the entries for §1.1297-2(f) (1) and (2).

2. Revising the entries for §1.1297-4(e) (4) and (5), (f)(1)(iv), (f)(6)(i), (ii), and (iii), and (g)(1) and (2).

3. Adding an entry for §1.1297-5.

4. Revising the entries for §1.1297-6(e) (2) and (3) and (f)(1) and (2).

The revisions and additions read as follows:

#### **§1.1297-0 Table of contents.**

\*\*\*\*\*

#### **§1.1297-1 Definition of passive foreign investment company.**

\*\*\*\*\*

(c)\*\*\*

(2) Exception for certain income derived in the active conduct of a banking business by a foreign bank.

(i) In general.

(ii) Foreign bank determination.

\*\*\*\*\*

(d)\*\*\*

(1)\*\*\*

(v)\*\*\*

(D) Valuation.

\*\*\*\*\*

(2) Working capital.

\*\*\*\*\*

(g)\*\*\*

(3) Paragraphs (c)(1)(i)(B), (c)(2), (d)(1)(v)(D), and (d)(2) of this section.

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

\*\*\*\*\*

(e)\*\*\*

(4) Active banking business.

(f)\*\*\*

(1) Stock basis adjustment.

(2) Amount of gain taken into account.

\*\*\*\*\*

#### **§1.1297-4 Qualifying insurance corporation.**

\*\*\*\*\*

(e)\*\*\*

(4) Corresponding adjustment to total assets.

(i) Consolidated applicable financial statement

(ii) Insurance risk transferred through reinsurance.

(5) Example.

(i) Facts.

(ii) Results.

(A) AIL reduction.

(B) Asset reduction.

\*\*\*\*\*

(f)\*\*\*

(1)\*\*\*

(iv) Priority of financial statements.

\*\*\*\*\*

(6)\*\*\*

(i) In general.

(ii) Consolidated and non-consolidated financial statement.

(iii) Audited financial statement.

\*\*\*\*\*

(g)\*\*\*

(1) General applicability date.

(2) Exception.

(3) Early application.

#### **§1.1297-5 Active conduct of an insurance business.**

(a) Scope.

(b) Active conduct of an insurance business.

(1) In general.

(2) Exceptions.

(c) Factual requirements test.

(1) In general.

(2) Substantial managerial and operational activities with respect to core functions.

(i) Substantial managerial and operational activities.

(ii) Regular and continuous basis.

(3) Performance of virtually all of the active decision-making functions relevant to a QIC's underwriting activities.

(i) Active decision-making functions.

(ii) Performance requirements.

(iii) Exclusions.

(4) Number of officers and employees.

(d) Active conduct percentage test.

(1) Percentage test.

(2) Outsourcing.

(e) Related officers and employees.

(1) Modified qualified affiliate requirement.

(2) Oversight and supervision requirement.

(3) Compensation requirement.

(f) Definitions.

(1) Applicable reporting period.

(2) Compensation costs.

(3) Contract and claims management activities.

(4) Core functions.

(5) Investment activities.

(6) Qualifying insurance corporation or QIC.

(7) Sales activities.

(8) Total costs.

(9) Underwriting activities.

(10) Virtually all.

(g) Applicability date.

#### **§1.1297-6 Exception from the definition of passive income for active insurance income.**

\*\*\*\*\*

(e)\*\*\*

(2) Qualifying domestic insurance corporation non-passive asset and income limitations.

(i) Qualifying domestic insurance corporation's non-passive assets.

(ii) Qualifying domestic insurance corporation's non-passive income.

(iii) Non-passive asset limitation.

(iv) Total insurance liabilities.

(A) Companies taxable under Part I of Subchapter L.

(B) Companies taxable under Part II of Subchapter L.

(3) Example.

(i) Facts.

(ii) Result.

(A) Non-passive asset limitation.

(B) Non-passive income limitation.

(f)\*\*\*

(1) General applicability date.

(2) Exception.

(3) Early application.

Par. 6. Section 1.1297-1 is amended by:

1. Revising paragraphs (c)(1)(i)(B), (c)(2), (d)(1)(v)(D), and (d)(2).

2. Revising the first sentence of paragraph (g)(1).

3. Adding paragraph (g)(3).

The revisions and addition read as follows:

#### **§1.1297-1 Definition of passive foreign investment company.**

\*\*\*\*\*

- (c) \* \* \*
- (1) \* \* \*
- (i) \* \* \*

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

(2) *Exception for certain income derived in the active conduct of a banking business by a foreign bank*—(i) *In general.* For purposes of section 1297(b)(2)(A), income of a tested foreign corporation is treated as non-passive if—

(A) The income would not be treated as foreign personal holding company income under section 954(h) (relating to entities engaged in the active conduct of a banking, financing, or similar business) if the tested foreign corporation (and, to the extent relevant, any related person as defined by section 954(d)(3)) were a controlled foreign corporation within the meaning of section 957(a); and

(B) The tested foreign corporation is a foreign bank that is engaged in the active conduct of a banking business (within the meaning of section 954(h)(2)(B)(ii)) and the income is derived in the conduct of that banking business.

(ii) *Foreign bank determination.* A tested foreign corporation will be treated as a foreign bank only if it—

(A) is licensed by federal or state bank regulatory authorities to do business as a bank in the United States, or is licensed or authorized by a bank regulatory authority in the country in which it is chartered or incorporated (or, in the case of a qualified business unit, in the country in which the unit maintains its principal office) to do business as a bank in that country, including to—

- (1) Accept bank deposits from residents of that country; and
- (2) Carry out one or more of the activities listed in section 954(h)(4), and

(B) regularly receives bank deposits from and carries out one or more of the activities listed in section 954(h)(4) with

unrelated customers in the ordinary course of a banking business.

- \* \* \* \* \*
- (d) \* \* \*
- (1) \* \* \*
- (v) \* \* \*

(D) *Valuation.* For purposes of determining the value of assets during a measuring period when the shares of a tested foreign corporation are not publicly traded, valuation may be determined on the basis of periodic financial accounting statements provided at least annually. If the tested foreign corporation or one or more shareholders has actual knowledge or reason to know based on readily accessible information that the financial accounting statements do not reflect a reasonable estimate of an asset's value and the information provides a more reasonable estimate of the asset's value, then the information must be used to determine the value of the assets to which it relates.

\* \* \* \* \*

(2) *Working capital.* For purposes of section 1297(a)(2), an amount of currency denominated in functional currency (as defined in section 985(b)) held in a non-interest bearing financial account that is held for the present needs of an active trade or business and is no greater than the amount necessary to cover operating expenses incurred in the ordinary course of the trade or business of the tested foreign corporation (for example, accounts payable for ordinary operating expenses) and reasonably expected to be paid within 90 days is not treated as a passive asset. For purposes of the preceding sentence, cash equivalents are not treated as currency, and amounts held for purposes other than to meet the ordinary course operating expenses of the trade or business, including for the purpose of providing for (i) future diversification into a new trade or business, (ii) expansion of trade or business activities, (iii) future plant replacement, or (iv) future business contingencies, are treated as passive assets.

- \* \* \* \* \*
- (g) \* \* \*

(1) *In general.* Except as otherwise provided, the rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. \* \* \*

\* \* \* \* \*

(3) *Paragraphs (c)(1)(i)(B), (c)(2), (d)(1)(v)(D), and (d)(2) of this section.* Paragraphs (c)(1)(i)(B), (c)(2), (d)(1)(v)(D), and (d)(2) of this section apply to taxable years of shareholders beginning on or after [the date these regulations are filed as final regulations in the **Federal Register**]. A shareholder may choose to apply the paragraphs in the preceding sentence for any open taxable year beginning before [the date these regulations are filed as final regulations in the **Federal Register**] without regard to whether the rules of this section are applied consistently, provided that once applied, each rule must be applied for each subsequent taxable year beginning before [the date these regulations are filed as final regulations in the **Federal Register**].

Par. 7. Section 1.1297-2 is amended by:

1. Revising the third sentence in paragraph (b)(2)(ii)(A), the second sentence in paragraph (b)(3)(ii)(A), the first sentence in paragraph (c)(2)(i), and the second sentence in (c)(4)(ii)(A).

2. Adding subparagraph (e)(4).

3. Revising the first sentence and adding two sentences to the end of paragraph (h).

The revisions and additions read as follows:

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

- \* \* \* \* \*
- (b) \* \* \*
- (2) \* \* \*
- (ii) \* \* \*

(A) \* \* \* The exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in sections 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 income in the hands of the subsidiary, determined by taking into account only the activities of the subsidiary except as provided in paragraph (e) of this section. \* \* \*

\* \* \* \* \*

(3) \* \* \*

(ii) \* \* \*

(A) \* \* \* The exceptions to passive income in section 1297(b)(2) and the relevant exceptions to foreign personal holding company income in sections 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 income in the hands of the partnership, determined by taking into account only the activities of the partnership except as provided in paragraph (e) of this section. \* \* \*

\* \* \* \* \*

(c) \* \* \*

(2) \* \* \*

(i) *LTS stock*. For purposes of section 1297, a tested foreign corporation does not take into account dividends derived with respect to LTS stock, including dividends that the tested foreign corporation is treated as receiving on a measurement date pursuant to section 1297(c) and paragraphs (b)(2) or (b)(3) of this section. \* \* \*

\* \* \* \* \*

(4) \* \* \*

(ii) \* \* \*

(A) \* \* \* During the first quarter of the taxable year, TFC received \$20x of dividends from LTS1 and \$30x of interest on the loan, both of which were paid in cash. \* \* \* \* \*

(e) \* \* \*

(4) *Active banking business*. For purposes of §1.1297-1(c)(2), the activities of the employees of a person that is a related person with respect to a look-through subsidiary or partnership are taken into account to the extent provided in section 954(h)(3)(E).

\* \* \* \* \*

(f) *Gain on disposition of a look-through subsidiary or look-through partnership*—(1) *Stock basis adjustment*. For purposes of determining gain in paragraph (2) of this paragraph (f), a tested foreign corporation's basis in the stock of a look-through subsidiary is decreased, but not below zero, by the aggregate amount of distributions made by the look-through subsidiary with respect to the look-through

subsidiary's stock that are attributable to income of the look-through subsidiary not treated as received directly by the tested foreign corporation pursuant to paragraph (b)(2) of this section.

(2) *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 other than dividends described in paragraph (f)(1) of this section. For purposes of this paragraph (f)(2), the amount of gain derived from the disposition of stock of a look-through subsidiary and income of and dividends received from the look-through subsidiary is determined on a share-by-share basis, determined under a reasonable method. \* \* \* \* \*

\* \* \* \* \*

(h) *Applicability date*. Except as otherwise provided, the rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. \* \* \* Paragraphs (b)(2)(ii)(A), (b)(3)(ii)(A), (c)(2)(i), (c)(4)(ii)(A), (e)(4), (f)(1), and (f)(2) of this section apply to taxable years of shareholders beginning on or af-

ter [the date these regulations are filed as final regulations in the **Federal Register**]. A shareholder may choose to apply the paragraphs in the preceding sentence for any open taxable year beginning before [the date these regulations are filed as final regulations in the **Federal Register**] without regard to whether the rules of this section are applied consistently, provided that once applied, each rule must be applied for each subsequent taxable year beginning before [the date these regulations are filed as final regulations in the **Federal Register**].

Par. 8. Section 1.1297-4 is amended by revising paragraphs (e)(4), (e)(5), (f)(1), (f)(2)(i)(D)(3), (f)(6)(i), (ii), and (iii), and (g) to read as follows:

### **§1.1297-4 Qualifying insurance corporation.**

\* \* \* \* \*

(e) \* \* \*

(4) *Corresponding adjustment to total assets*. For purposes of determining whether a foreign corporation satisfies the 25 percent test or the 10 percent test, the amount of total assets reported on the foreign corporation's applicable financial statement may be reduced as described in paragraphs (e)(4)(i) through (iii) of this section.

(i) *Consolidated applicable financial statement*. If a foreign corporation's applicable financial statement is prepared on a consolidated basis, the amount of total assets may be reduced by the amount of liabilities of another entity that are reported on the applicable financial statement and would be treated as applicable insurance liabilities but for the application of paragraphs (e)(2) or (f)(2)(i)(D)(2) of this section.

(ii) *Insurance risk transferred through reinsurance*. If the applicable financial statement is prepared on the basis of an accounting method that measures insurance liabilities without a reduction for amounts that may be recovered from other parties through reinsurance and the amount that may be recovered through reinsurance is reported as an asset on the applicable financial statement (rather than as a reduction in the amount of an insurance liability), the foreign corporation's total assets may be reduced by the amount

of the corporation's insurance liabilities that are reinsured to another party and are excluded from the definition of applicable insurance liabilities under paragraph (f)(2)(i)(D)(3) of this section.

(iii) No amount may be used more than once to reduce total assets under paragraphs (e)(4)(i) and (ii) of this section.

(5) *Example.* The following example illustrates the application of paragraph (e)(4) of this section.

(i) *Facts.* P, a foreign corporation, issues property and casualty insurance contracts and has a consolidated applicable financial statement (AFS) constructed using IFRS accounting principles, including those of IFRS 17, for the applicable reporting period. The AFS reports insurance contract liabilities for incurred claims that meet the requirements of paragraphs (f)(2)(i)(A) and (f)(2)(i)(B) of this section in an amount equal to 1,100x, 200x of which are liabilities under contracts issued by S, a wholly owned insurance subsidiary, and 900x of which are liabilities under contracts issued by P. The AFS also reports 2,500x of total assets, including 250x of assets related to P's insurance contract liabilities for incurred claims that are recoverable from unrelated parties through reinsurance.

(ii) *Results—(A) Reduction to applicable insurance liabilities (AIL).* Under paragraph (f)(2)(i)(D)(2) of this section, only AIL of the foreign corporation whose QIC status is being determined may be included in AIL. Thus, P's AIL do not include the 200x of insurance contract liabilities on P's consolidated AFS that are liabilities under contracts issued by S. Under paragraph (f)(2)(i)(D)(3) of this section, the amount of insurance liabilities determined under paragraphs (f)(2)(i)(A) through (C) and (D)(1) and (2) of this section are reduced by an amount equal to the assets reported on P's AFS that represent amounts relating to those liabilities that may be recoverable from other parties through reinsurance. Thus, P's AIL are reduced by an amount equal to the 250x of assets for incurred claims related to the insurance liabilities of P that are recoverable from another party through reinsurance. Assuming no other limitation applies (such as those contained in paragraph (e) of this section), P's AIL equals 650x (1,100x – 200x – 250x).

(B) *Reduction to total assets.* Pursuant to paragraph (e)(4)(i) of this section, P may reduce its total assets by amounts of liabilities of another entity that are excluded from P's AIL because of paragraphs (e)(2) or (f)(2)(i)(D)(2) of this section. Under paragraph (f)(2)(i)(D)(2) of this section, P's AIL may include only the liabilities of P, the entity whose QIC status is being determined. Therefore, P may reduce its total assets by 200x, the amount of liabilities under contracts issued by S that are included on P's AFS but excluded from P's AIL. Pursuant to paragraph (e)(4)(ii) of this section, P may also reduce its total assets by 250x, the amount of P's liabilities that are reinsured by another party and excluded from the definition of AIL under paragraph (f)(2)(i)(D)(3) of this section. After these adjustments, P has total assets of 2,050x (2,500x – 200x – 250x).

(C) *AIL to total assets tests.* Accordingly, for purposes of the 25 percent and 10 percent tests, P has

AIL of 650x and total assets of 2,050x, for a test ratio of 650x/2,050x, or 31.7%.

(f) *Definitions.* \* \* \*

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

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

(A) A Form 10-K (or successor form), or annual statement to shareholders, filed with the United States Securities and Exchange Commission (SEC), or filed by the taxpayer with an agency of a foreign government that is equivalent to the SEC, and has reporting standards not less stringent than the standards required by the SEC;

(B) An audited financial statement of the taxpayer that is used for:

(1) Credit purposes;

(2) Reporting to shareholders, partners, or other proprietors, or to beneficiaries;

(3) Filing with the Federal government or any Federal agency, other than the SEC or the Internal Revenue Service or an applicable insurance regulatory body, or filing with a state or foreign government or an agency of a state or foreign government, other than an agency that is equivalent to the SEC or the Internal Revenue Service or is an applicable insurance regulatory body; or

(4) Any other substantial non-tax purpose, including filing with the applicable insurance regulatory body; or

(ii) *IFRS statements.* A financial statement that is prepared in accordance with IFRS and is described in paragraphs (f)(1)(i)(A) or (B) of this section, in the order of priority set forth in those paragraphs; or

(iii) *Regulatory annual statement.* An audited financial statement required to be filed with the applicable insurance regulatory body that is not prepared in accordance with GAAP or IFRS.

(iv) *Priority of financial statements.*

(A) A financial statement that takes into account assets and liabilities of affiliates of the foreign corporation that are

not owned in whole or part by the foreign corporation is not treated as an applicable financial statement for purposes of paragraphs (f)(1)(i) and (ii) of this section, and is not treated as an applicable financial statement for purposes of paragraph (f)(1)(iii) of this section unless it is the only financial statement described in paragraph (f)(1)(iii) of this section.

(B) A financial statement that is described in more than one clause listed in paragraphs (f)(1)(i) through (iii) of this section is treated for purposes of this paragraph (f)(1) as described solely in the highest priority clause. If a foreign corporation has more than one financial statement with equal priority under paragraphs (f)(1)(i) through (iii) of this section, a non-consolidated financial statement has priority over other financial statements.

(2) *Applicable insurance liabilities.* \* \* \*

(i) \* \* \*

(D) \* \* \*

(3) Amounts of liabilities determined under paragraphs (f)(2)(i)(A) through (C) and (D)(1) and (2) are reduced by an amount equal to the assets reported on the corporation's financial statement as of the financial statement end date that represent amounts relating to those liabilities that may be recoverable from other parties through reinsurance. If a foreign corporation's financial statement is prepared on a consolidated basis, to the extent not reduced already under paragraphs (f)(2)(i)(A) through (C) and (D)(1) and (2), liabilities are reduced by an amount equal to the assets relating to those liabilities that may be recoverable through reinsurance from another entity included in the consolidated financial statement, regardless of whether the reinsurance transaction is eliminated in the preparation of the consolidated financial statement.

\* \* \* \* \*

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

pany the balance sheet, income statement and cash flow statement.

(ii) *Consolidated and non-consolidated financial statement.* The term *consolidated financial statement* means a financial statement of a consolidated group of entities that includes a parent and its subsidiaries presented as those of a single economic entity, prepared in accordance with GAAP, IFRS or another financial or statutory accounting standard. A *non-consolidated financial statement* means a financial statement that is not prepared on a consolidated basis and that accounts for investments in subsidiaries on a cost or equity basis.

(iii) *Audited financial statement.* The term *audited financial statement* means a financial statement that has been examined by an independent auditor that has provided an opinion that the financial statement presents fairly in all material respects the financial position of the audited company (and its subsidiaries and controlled entities, if relevant) and the results of their operations and cash flows in accordance with GAAP or IFRS, or an equivalent opinion under GAAP, IFRS or another financial accounting or statutory accounting standard.

\* \* \* \* \*

(g) *Applicability date*—(1) *General applicability date.* Except as provided in paragraph (g)(2) of this section, this section applies to taxable years of shareholders beginning on or after January 14, 2021.

(2) *Exception.* Paragraphs (e)(4), (e)(5), (f)(1), (f)(2)(i)(D)(3), and (f)(6) of this section apply to taxable years of United States persons that are shareholders in foreign corporations beginning on or after [the date these regulations are filed as final regulations in the **Federal Register**].

(3) *Early application*—(i) A shareholder may choose to apply the rules of this section (other than paragraphs (f)(1), (f)(2)(i)(D)(3), and (f)(6) of this section) for any open taxable year beginning after December 31, 2017 and before the applicability dates described in paragraphs (g)(1) and (2) of this section, provided that, with respect to a tested foreign corporation, it consistently applies those rules and the rules described in §1.1297-6(f)(3) for such year and all subsequent years.

(ii) A shareholder may choose to apply paragraphs (f)(1), (f)(2)(i)(D)(3), and (f)

(6) of this section for any open taxable year beginning after December 31, 2017 and before [the date these regulations are filed as final regulations in the **Federal Register**], provided that, with respect to a tested foreign corporation, it consistently applies the rules of this section, §1.1297-5, and §1.1297-6 for such year and all subsequent years.

Par. 9. Section 1.1297-5 is revised to read as follows:

### **§1.1297-5 Active conduct of an insurance business.**

(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. Paragraph (b) of this section sets forth the options for a qualifying insurance company (QIC) to qualify as engaged in the active conduct of an insurance business and describes circumstances under which a QIC will not be engaged in the active conduct of an insurance business. Paragraph (c) of this section describes the factual requirements that are sufficient to show that a QIC is engaged in the active conduct of an insurance business for purposes of section 1297(b)(2)(B). Paragraph (d) of this section describes an alternative active conduct percentage test, pursuant to which a QIC may be deemed to be engaged in the active conduct of an insurance business for purposes of section 1297(b)(2)(B). Paragraph (e) of this section describes the circumstances under which officers and employees of certain entities related to a QIC may be treated as if they were employees of the QIC. Paragraph (f) of this section provides definitions applicable to this section. Paragraph (g) of this section provides the applicability date of this section.

(b) *Active conduct of an insurance business*—(1) *In general.* A QIC is engaged in the active conduct of an insurance business only if it satisfies—

(i) the factual requirements test in paragraph (c) of this section; or

(ii) the active conduct percentage test in paragraph (d) of this section.

(2) *Exceptions.* Notwithstanding paragraph (b)(1) of this section, a QIC is not engaged in the active conduct of an insur-

ance business if either of the following circumstances apply—

(i) It has no employees or only a nominal number of employees and relies exclusively or almost exclusively upon independent contractors (disregarding for this purpose any related entity that has entered into a contract designating its status as an independent contractor with respect to the QIC) to perform its core functions;

(ii) It is a vehicle that has the effect of securitizing or collateralizing insurance risks underwritten by other insurance or reinsurance companies or is an insurance linked securities fund that invests in securitization vehicles, and its stock (or a financial instrument, note, or security that is treated as equity for U.S. tax purposes) is designed to provide an investment return that is tied to the occurrence of a fixed or pre-determined portfolio of insured risks, events, or indices related to insured risks.

(c) *Factual Requirements Test*—(1) *In general.* A QIC satisfies the factual requirements test of paragraph (b)(1)(i) of this section if all the following are met—

(i) The officers and employees of the QIC carry out substantial managerial and operational activities on a regular and continuous basis with respect to its core functions as described in paragraph (c)(2) of this section; and

(ii) The officers and employees of the QIC perform virtually all of the active decision-making functions relevant to underwriting functions as described in paragraph (c)(3) of this section.

(2) *Substantial managerial and operational activities with respect to core functions*—(i) *Substantial managerial and operational activities.* Substantial managerial and operational activities with respect to a QIC's core functions requires all of the following—

(A) Establishing the strategic, overall parameters with respect to each core function;

(B) Establishing, or reviewing and approving, detailed plans to implement the strategic, overall parameters for each of the QIC's core functions;

(C) Managing, controlling and supervising the execution of the detailed plans to carry out each of the QIC's core functions;

(D) Establishing criteria for the hiring of employees or independent contractors

to execute the detailed plans to carry out each of the QIC's core functions, and if independent contractors are hired, prescribing the goals and objectives of the engagement, the scope of work, evaluation criteria for contractor eligibility and for submissions by prospective contractors, and criteria and budget for the work to be performed;

(E) Reviewing the conduct of the work performed by employees or independent contractors to ensure that it meets the goals, standards, criteria, timeline and budget specified by the QIC, and taking appropriate action if it does not; and

(F) Conducting each of the requirements above by officers or senior employees of the QIC, which officers or employees are experienced in the conduct of those activities and devote all or virtually all of their work to those activities and similar activities for related entities.

(ii) *Regular and continuous basis.* Carrying out managerial and operational activities on a regular and continuous basis requires that the parameters and plans described in paragraphs (c)(2)(i)(A) and (B) of this section are regularly reviewed and updated and that the activities described in paragraphs (c)(2)(i)(C) and (E) of this section are carried out on a daily or other frequent basis as part of the ordinary course of the QIC's operations.

(3) *Performance of virtually all of the active decision-making functions relevant to a QIC's underwriting activities*—(i) *Active decision-making functions.* Active decision-making functions are the underwriting activities that are most important to decisions of the QIC relating to the assumption of specific insurance risks.

(ii) *Performance requirements.* Performance of virtually all of the active decision-making functions relating to underwriting activities requires all of the following—

(A) Carrying out virtually all of the activities related to a QIC's decision to assume an insurance risk, as set forth in the definition of underwriting activities, by employees and not by independent contractors; and

(B) Evaluating, analyzing, and conducting virtually all of the decision-making with respect to executing an insurance contract on a contract-by-contract basis, including determining whether the con-

tract meets the QIC's criteria with respect to the risks to be undertaken and pricing and is otherwise sound and appropriate.

(iii) *Exclusions.* The following activities are not active decision-making functions relevant to a QIC's core functions—

(A) Development of underwriting policies or parameters that are changed infrequently without further ongoing, active involvement in the day-to-day decision-making related to these functions; and

(B) Clerical or ministerial functions with respect to underwriting that do not involve the exercise of discretion or business judgment.

(4) *Number of officers and employees.* The number of officers and employees actively engaged in each core function is a relevant factor in determining whether the factual requirements in paragraph (c)(1) of this section have been satisfied.

(d) *Active conduct percentage test.* A QIC satisfies the active conduct percentage test of paragraph (b)(1)(ii) and will be deemed to be engaged in an active insurance business for the applicable reporting period only if it satisfies the percentage requirement in paragraph (d)(1) of this section and, to the extent core functions are outsourced, the oversight requirement in paragraph (d)(2) of this section.

(1) *Percentage test.* For the applicable reporting period covered by the applicable financial statement, total costs incurred by the QIC with respect to the QIC's officers and employees for services rendered with respect to its core functions (other than investment activities) equals or exceeds 50 percent of total costs incurred by the QIC with respect to the QIC's officers and employees and any other person or entities for services rendered with respect to its core functions (other than investment activities).

(2) *Outsourcing.* To the extent the QIC outsources any part of its core functions to unrelated entities, officers and employees of the QIC with experience and relevant expertise must select and supervise the person that performs the outsourced functions, establish objectives for performance of the outsourced functions, and prescribe rigorous guidelines relating to the outsourced functions which are routinely evaluated and updated.

(e) *Related officers and employees.* For purposes of this section, a QIC's of-

ficers and employees are considered to include the officers and employees of a related entity if the requirements of this paragraph (e) are satisfied. In determining whether an activity is carried out by employees, the activities of persons that are independent contractors and that are not related entities are disregarded. An entity may be a related entity regardless of whether it has entered into a contract designating its status as an independent contractor with respect to the QIC. An entity is treated as a related entity only if the requirements of this paragraph (e) are satisfied.

(1) *Modified qualified affiliate requirement.* The entity is a qualified affiliate of the QIC within the meaning of §1.1297-2(e)(2) (determined by treating the QIC as the tested foreign corporation) except that, for purposes of this section, section 1504(a)(2)(A) (with "more than 50 percent" substituted for "at least 80 percent") also applies for purposes of determining qualified affiliate status.

(2) *Oversight and supervision requirement.* The QIC exercises regular oversight and supervision over the services performed by the related entity's officers and employees for the QIC.

(3) *Compensation requirement.* The QIC either—

(i) Pays directly all the compensation costs of the related entity's officers and employees attributable to core functions performed by those officers and employees on behalf of the QIC;

(ii) Reimburses the related entity for the portion of its expenses, including compensation costs 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 §1.482-9(k)(2)) for the performance by its officers and employees of core functions on behalf of the QIC; or

(iii) Otherwise pays arm's length compensation in accordance with section 482 on a fee-related basis to the related entity for services related to core functions.

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

(1) *Applicable reporting period.* The term *applicable reporting period* has the meaning set forth in §1.1297-4(f)(4).

(2) *Compensation costs.* The term *compensation costs* means all amounts incurred by the QIC during the applicable reporting period with respect to an officer and employee (including, for example, wages, salaries, deferred compensation, employee benefits, and employer payroll taxes).

(3) *Contract and claims management activities.* The term *contract and claims management activities* means performing the following activities with respect to an insurance or annuity contract: monitoring a contract (or group of contracts) over its life cycle (that is, maintaining the information on contractual developments, insured risk and occurrences, and maintaining accounts on premiums, claims reserves and commissions); performing loss and claim reporting (establishing and maintaining loss reporting systems, developing reliable claims statistics, defining and adjusting claims provisions and introducing measures to protect and reduce claims in future); and all the activities related to a policyholder's claim, including processing the claims report, examining coverage, handling the claim (working out the level of the claim, clarifying causes, claims reduction measures, legal analysis) and seeking recovery of funds due to the QIC.

(4) *Core functions.* The term *core functions* means the QIC's underwriting, investment, contract and claims management and sales activities; however, contract and claims management activities will not be considered to be a core function of a reinsurance company with respect to indemnity reinsurance contracts to the extent that the ceding company has agreed to retain this core function under a reinsurance contract.

(5) *Investment activities.* The term *investment activities* means investment in equity and debt instruments and related hedging transactions and other assets of a kind typically held for investment, for the purpose of producing income to meet obligations under the insurance, annuity or reinsurance contracts.

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

(7) *Sales activities.* The term *sales activities* means sales, marketing and cus-

tomers relations with respect to insurance or reinsurance policies.

(8) *Total costs.* With respect to the QIC's own officers and employees (and without regard to related officers and employees described in paragraph (e) of this section), the term *total costs* means the compensation costs of those officers and employees 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 §1.482-9(k) (2)) for services performed related to core functions. With respect to services performed by related officers and employees and unrelated persons or entities, the term *total costs* means the amount paid or accrued to the related or unrelated persons or entities for the services related to core functions. For purposes of this section, total costs, however, do not include any ceding commissions paid or accrued with respect to reinsurance contracts or commissions or fees paid or accrued to brokers or sales agents to procure reinsurance contracts.

(9) *Underwriting activities.* The term *underwriting activities* means the performance of activities related to a QIC's decision to assume an insurance risk (for example, the decision to enter into an insurance or reinsurance contract, setting underwriting policy, risk classification and selection, designing or tailoring insurance or reinsurance products to meet market or customer requirements, performing actuarial analysis with respect to insurance products, and performing analysis for purposes of setting premium rates or calculating reserves, and risk retention).

(10) *Virtually all.* The term *virtually all* means all, other than a *de minimis* portion, measured on any reasonable basis.

(g) *Applicability date.* This section applies to taxable years of shareholders beginning on or after [the date these regulations are filed as final regulations in the **Federal Register**]. A shareholder may choose to apply the rules of this section for any open taxable year beginning after December 31, 2017 and before [the date these regulations are filed as final regulations in the **Federal Register**], provided that, with respect to a tested foreign corporation, it consistently applies the rules

of this section, §1.1297-4, and §1.1297-6 for such year and all subsequent years.

Par. 10. Section 1.1297-6 is amended by adding a sentence to the end of paragraph (b)(2), adding a sentence to the end of paragraph (c)(2), and revising paragraphs (e)(2), (e)(3), and (f), to read as follows:

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

\*\*\*\*\*

(b) *Exclusion from passive income of active insurance income.* \*\*\*

(2) \*\*\* See paragraph (e)(2)(i) of this section for additional rules regarding the amount of income of a qualifying domestic insurance corporation that is treated as non-passive.

\*\*\*\*\*

(c) *Exclusion of assets for purposes of the passive asset test under section 1297(a)(2).* \*\*\*

(2) \*\*\* See paragraph (e)(2)(ii) of this section for additional rules regarding the amount of assets of a qualifying domestic insurance corporation that are treated as non-passive.

\*\*\*\*\*

(e) *Qualifying domestic insurance corporation.* \*\*\*

(2) *Qualifying domestic insurance corporation non-passive asset and income limitations.* For purposes of section 1297 and §1.1297-1—

(i) *Qualifying domestic insurance corporation's non-passive assets.* The amount of passive assets of a qualifying domestic insurance corporation that may be treated as non-passive is equal to the lesser of the passive assets of the corporation (determined without application of paragraph (c)(2) of this section) or the corporation's non-passive asset limitation (as defined in paragraph (e)(2)(iii) of this section).

(ii) *Qualifying domestic insurance corporation's non-passive income.* The amount of passive income of a qualifying domestic insurance corporation that may be treated as non-passive is equal to the lesser of the passive income of the corporation (determined without application of paragraph (b)(2) of this section) or the corporation's passive income multiplied by the proportion that its non-passive as-

set limitation (as defined in paragraph (e)(2)(iii) of this section) bears to its total passive assets (determined without application of paragraph (c)(2) of this section).

(iii) *Non-passive asset limitation.* For purposes of paragraph (e) of this section, the non-passive asset limitation equals the corporation's total insurance liabilities multiplied by the applicable percentage. The applicable percentage is—

(A) 400 percent of total insurance liabilities, for a company taxable under Part II of Subchapter L; and

(B) 200 percent of total insurance liabilities, for a company taxable under Part I of Subchapter L.

(iv) *Total insurance liabilities.* For purposes of paragraph (e) of this section—

(A) *Companies taxable under Part I of Subchapter L.* In the case of a company taxable under part I of Subchapter L, the term *total insurance liabilities* means the sum of the total reserves (as defined in section 816(c)) plus (to the extent not included in total reserves) the items referred to in paragraphs (3), (4), (5), and (6) of section 807(c).

(B) *Companies taxable under Part II of Subchapter L.* In the case of a company taxable under part II of Subchapter L, the term *total insurance liabilities* means the sum of unearned premiums (determined under §1.832-4(a)(8)) and unpaid losses.

(3) *Example.* The following example illustrates the application of this section.

(i) *Facts.* X, a qualifying domestic insurance corporation within the meaning of paragraph (e)(1) of this section, is a nonlife insurance company taxable under part II of Subchapter L. X has passive assets of \$1000x, total insurance liabilities of \$200x, and passive income of \$100x.

(ii) *Result—* (A) *Non-passive asset limitation.* The applicable percentage for nonlife insurance companies is 400%. Pursuant to paragraph (e)(2)(iii) of this section, X has a non-passive asset limitation of \$800x, which is equal to its total insurance liabilities of \$200x multiplied by 400%. Under paragraph (e)(2)(i) of this section, \$800x of X's passive assets (equal to the lesser of the non-passive asset limitation (\$800x) or passive assets (\$1000x)) are treated as non-passive, and \$200x remains passive.

(B) *Non-passive income limitation.* X has a non-passive asset limitation of \$800x. The proportion of its non-passive asset limitation (\$800x) to its total passive assets (\$1000x) is 80%. Pursuant to paragraph (e)(2)(ii) of this section, X has \$80x of passive income treated as non-passive (equal to the lesser of passive income (\$100x) or 80% times \$100x) and \$20x remains passive.

(f) *Applicability date—*(1) *General applicability date.* Except as provided in

paragraph (f)(2) of this section, this section applies to taxable years of shareholders beginning on or after January 14, 2021.

(2) *Exception.* Paragraphs (e)(2) and (e)(3) of this section apply to taxable years of shareholders beginning on or after [the date these regulations are filed as final regulations in the **Federal Register**].

(3) *Early application.* A shareholder may choose to apply the rules of this section (other than paragraphs (e)(2) and (e)(3) of this section) for any open taxable year beginning after December 31, 2017 and before January 14, 2021, provided that, with respect to a tested foreign corporation, it consistently applies those rules and the rules described in §1.1297-4(g)(3)(i) for such year and all subsequent years.

Par. 11. Section 1.1298-0 is amended by adding entries for §1.1298-4(e)(2)(i) and (ii); §1.1298-4(e)(2)(ii)(A), (B), (C), and (D); §1.1298-4(e)(3); §1.1298-4(e)(3)(i), (ii), (iii), and (iv); §1.1298-4(e)(3)(i)(A) and (B); §1.1298-4(e)(3)(ii)(A) and (B); §1.1298-4(e)(3)(iii)(A) and (B); and §1.1298-4(e)(3)(iv)(A) and (B) to read as follows:

#### §1.1298-0 Table of contents.

\*\*\*\*\*

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

\*\*\*\*\*

(e)\*\*\*

(2) Safe harbor.

(i) Active business within United States.

(ii) Businesses undergoing change and new businesses.

(A) In general.

(B) Testing date.

(C) Transition period.

(D) Inapplicability.

(3) Examples.

(i) Example 1.

(A) Facts.

(B) Results.

(ii) Example 2.

(A) Facts.

(B) Results.

(iii) Example 3.

(A) Facts.

(B) Results.

(iv) Example 4.

(A) Facts.

(B) Results.

\*\*\*\*\*

Par. 12. Section 1.1298-4 is amended by:

1. Revising paragraphs (e)(2) and (3).

2. Revising the first sentence and adding two sentences to the end of paragraph (f).

The additions and revisions read as follows:

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

\*\*\*\*\*

(e)\*\*\*

(2) *Safe harbor.* Paragraph (e)(1) of this section will not apply if paragraph (e)(2)(i) or (e)(2)(ii) of this section applies.

(i) *Active business within United States.* The value of the assets of the second-tier domestic corporation used or held for use in an active trade or business within the U.S. is more than 80 percent of the fair market value of the gross assets of such corporation. For purposes of this paragraph (e)(2)—

(A) The value of the assets of the second-tier domestic corporation takes into account its pro-rata share of the value of the assets of its domestic subsidiary qualified affiliates and does not take into account the stock of such affiliates;

(B) The term *domestic subsidiary qualified affiliate* means each member of the affiliated group (as defined in section 1504(a) applied by substituting “more than 50 percent” for “at least 80 percent” each place it appears), treating the second-tier domestic corporation as the common parent of such affiliated group; and

(C) For purposes of this paragraph (e)(2), 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 of related entities as provided in §1.367(a)-2(d)(3) include only the officers and employees of related domestic entities within the meaning of section 267(b) or 707(b)(1).

(ii) *Businesses undergoing change and new businesses—*(A) *In general.* The sec-

ond-tier domestic corporation engages in an active U.S. trade or business that satisfies paragraph (e)(2)(i) of this section by the end of the transition period following the testing date.

(B) *Testing date.* For purposes of this paragraph (e)(2)(ii), the term “testing date” means the last day of the month in which either—

(1) The second-tier domestic corporation is created or organized or is acquired, directly or indirectly, by the tested foreign corporation; or

(2) A second-tier domestic corporation that previously satisfied (e)(2)(i) of this paragraph (e) disposes of, to a person that is not related within the meaning of section 267(b) or 707(b)(1), substantially all of the assets used or held for use in its active U.S. trade or business.

(C) *Transition period.* For purposes of this paragraph (e)(2)(ii), the term “transition period” means thirty-six months after the testing date as defined in paragraph (e)(2)(ii)(B)(1) or (2) of this section.

(D) *Inapplicability.* This paragraph (e)(2)(ii) does not apply for any taxable year (including previous taxable years) of the tested foreign corporation if the second-tier domestic corporation does not engage in an active U.S. trade or business that satisfies paragraph (e)(2)(i) of this section by the end of the transition period following a testing date.

(3) *Examples.* The following examples illustrate the rules of this paragraph (e). For purposes of these examples, TFC is a foreign corporation that is not a controlled foreign corporation (within the meaning of section 957(a)) and that is subject to the section 531 tax, USS1 and USS2 are domestic corporations for TFC’s entire taxable year, TFC owns 100% of the single class of stock of USS1, and USS1 owns 100% of the single class of stock of USS2.

(i) *Example 1—(A) Facts.* USS2 operates an active trade or business within the United States within the meaning of §1.367(a)-2(d)(2), (3), and (5). Throughout TFC’s Year 1, the value of USS2’s assets is \$100x, and the value of USS2’s assets that are used or held for use in its active trade or business within the United States is \$20x. USS2 was not created, organized, or acquired within the preceding thirty-six months and has not disposed of an active trade or business within the United States within the preceding thirty-six months.

(B) *Results.* Paragraph (e)(2)(i) of this section does not apply in Year 1 even though USS2 is en-

gaged in an active trade or business within the United States because only 20% (\$20x/\$100x) of its assets are used or held for use in an active U.S. trade or business within the meaning of §1.367(a)-2(d)(2), (3), and (5), an amount that is not more than 80% of the fair market value of the total gross assets of USS2. Accordingly, the general rule in paragraph (e)(1) of this section will apply if there is a principal purpose to hold passive assets through USS2, the second-tier domestic corporation, to avoid classification of TFC, the tested foreign corporation, as a PFIC.

(ii) *Example 2—(A) Facts.* The facts are the same as in as in paragraph (e)(4)(i)(A) of this section (the facts in *Example 1*), except that USS2 also has an investment in USS3, a wholly owned domestic subsidiary of USS2. Throughout TFC’s taxable Year 1, the value of USS3’s assets is \$400x and USS3 uses 100% of its assets in an active trade or business within the United States within the meaning of §1.367(a)-2(d)(2), (3), and (5).

(B) *Results.* Because USS3 is a domestic subsidiary qualified affiliate of USS2, USS2’s pro-rata share of the assets of USS3 is taken into account to determine whether USS2 satisfies paragraph (e)(2)(i) of this section. Accordingly, USS2 takes into account \$400x (its pro-rata share) of USS3’s assets in addition to the \$100x of its own assets and, thus, is treated for purposes of paragraph (e)(2)(i) of this section as owning \$500x of assets, with 84% (\$420x/\$500x) of such assets being used or held for use in an active trade or business within the United States within the meaning of §1.367(a)-2(d)(2), (3), and (5). Therefore, paragraph (e)(2)(i) of this section applies in Year 1 and the general rule in paragraph (e)(1) of this section does not apply.

(iii) *Example 3—(A) Facts.* Throughout Year 1, USS2 uses 100% of its assets in an active trade or business within the United States within the meaning of §1.367(a)-2(d)(2), (3), and (5), and thus satisfied paragraph (e)(2)(i) of this section in Year 1. On the first day of Year 2, USS2 disposes of all of those assets for cash. On the seventh day of Year 5 (before the end of the first month in Year 5), USS2 invests the cash in assets that it immediately begins to use in an active trade or business in the United States.

(B) *Results.* Because USS2, the second-tier domestic corporation, engages in an active U.S. trade or business that satisfies paragraph (e)(2)(i) of this section by the end of thirty-six months after the last day of the month in which it disposed of its entire active U.S. trade or business that previously satisfied paragraph (e)(2)(i) of this section, paragraph (e)(2)(ii) of this section applies in Year 2, Year 3, and Year 4, and the general rule in paragraph (e)(1) of this section does not apply.

(iv) *Example 4—(A) Facts.* The facts are the same as in paragraph (e)(4)(iii)(A) of this section (the facts in *Example 3*), except that at the end of the first month of Year 5, USS2 is still in negotiations to purchase assets to be used in an active trade or business in the United States within the meaning of §1.367(a)-2(d)(2), (3), and (5), and USS2 does not complete the purchase of such assets until the third month of Year 5.

(B) *Results.* The safe harbor in paragraph (e)(2)(ii) of this section does not apply for Year 2, Year 3,

or Year 4, because USS2, the second-tier domestic corporation, did not engage in an active U.S. trade or business that satisfied paragraph (e)(2)(i) of this section by the end of the thirty-six month transition period after the end of the month in which it sold its prior active trade or business. Accordingly, the general rule in paragraph (e)(1) of this section will apply if there is a principal purpose to hold passive assets through USS2, the second-tier domestic corporation, to avoid classification of TFC, the tested foreign corporation, as a PFIC.

(f) *Applicability date.* Except as otherwise provided, the rules of this section apply to taxable years of shareholders beginning on or after January 14, 2021. \* \* \* Paragraphs (e)(2) and (3) of this section apply to taxable years of shareholders beginning on or after [DATE OF FILING OF FINAL RULE IN THE **Federal Register**]. A shareholder may choose to apply the paragraphs in the preceding sentence for any open taxable year beginning before [DATE OF FILING OF FINAL RULE IN THE **Federal Register**] without regard to whether the rules of this section are applied consistently, provided that once applied, each rule must be applied for each subsequent taxable year beginning before [DATE OF FILING OF FINAL RULE IN THE **Federal Register**].

Sunita Lough,  
Deputy Commissioner for Services  
and Enforcement.

(Filed by the Office of the Federal Register on January 14, 2021, 8:45 a.m., and published in the issue of the Federal Register for January 15, 2020, 85 F.R. 4582)

## Notice of Proposed Rulemaking

REG-115057-20

### Mandatory 60-Day Postponement of Certain Tax-Related Deadlines by Reason of a Federally Declared Disaster

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTIONS: Notice of proposed rulemaking.

**SUMMARY:** This document contains proposed regulations relating to the new mandatory 60-day postponement of certain time-sensitive tax-related deadlines by reason of a Federally declared disaster. This document also contains proposed regulations clarifying the definition of “Federally declared disaster.” These proposed regulations affect individuals who reside in or were killed or injured in a disaster area, businesses that have a principal place of business in a disaster area, relief workers who provide assistance in a disaster area, or any taxpayer whose tax records necessary to meet a tax deadline are located in a disaster area. This document invites comments from the public regarding these proposed regulations.

**DATES:** Written or electronic comments and requests for a public hearing must be received by March 15, 2021. Requests for a public hearing must be submitted as prescribed in the “**Comments and Requests for a Public Hearing**” section.

**ADDRESSES:** Commenters are strongly encouraged to submit public comments electronically. Submit electronic submissions via the Federal eRulemaking Portal at [www.regulations.gov](http://www.regulations.gov) (indicate IRS and REG-115057-20) by following the online instructions for submitting comments. Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn. The IRS expects to have limited personnel available to process public comments that are submitted on paper through mail. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Department of the Treasury (Treasury Department) and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket. Send paper submissions to: CC:PA:LP-D:PR (REG-115057-20), room 5203, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, D.C. 20044.

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, William V. Spatz at (202) 317-5461; concerning submission of comments, Regina Johnson, (202) 317-5177; (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:**

### **Background**

These proposed regulations amend the Procedure and Administration Regulations (26 CFR part 301) under section 7508A of the Internal Revenue Code (Code) relating to the discretionary authority of the Secretary of the Treasury or his delegate (Secretary) to postpone certain time-sensitive tax deadlines by reason of a Federally declared disaster. These proposed regulations also amend the Income Tax Regulations (26 CFR part 1) under section 165 to clarify the definition of Federally declared disaster.

#### *I. FEMA Procedures for Declaring a Disaster and Providing Relief*

When it is apparent that a Federal disaster declaration, pursuant to the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act), P.L. 93-288, as amended, 42 U.S.C. § 5121 et seq, may be necessary to assist in the recovery of an affected area, a state, territory, or tribal government may contact the appropriate regional office of the Federal Emergency Management Agency (FEMA) and request a joint Federal-state, territory, or tribal government Preliminary Damage Assessment (PDA). Local government representatives are also included, if possible. Together, the team conducts an assessment of the affected area to determine the extent of the disaster, its impact on individuals and public facilities, and the types of Federal assistance that may be needed. This information is gathered to show whether the disaster is of such severity and magnitude that an effective

response is beyond the capabilities of the state, territory, or tribal governments and the affected local governments and that supplemental Federal assistance is necessary. *See* 44 C.F.R. § 206.33.

After the PDA is complete and the chief executive of the state, territory, or tribal government determines that the damage from the major disaster exceeds the state’s, territory’s, or tribal government’s resources, the executive may submit a declaration request to the President through the applicable FEMA Regional Office.<sup>1</sup> As part of the request, the chief executive must furnish information on the nature and amount of state, territory, or tribal government and local resources that have been or will be committed to alleviating the results of the disaster, provide an estimate of the amount and severity of damage and the impact on the private and public sectors, and provide an estimate of the type and amount of assistance needed under the Stafford Act. The President determines whether a disaster has caused damage of such severity that it is beyond the combined capabilities of state, territory, or tribal governments and local governments to respond. A major disaster declaration provides a wide range of Federal assistance programs for individuals and public infrastructure. *See* Stafford Act section 401 (42 U.S.C. § 5170). A similar declaration request may be submitted to the President in the event of an emergency of such severity and magnitude that effective response is beyond the capabilities of the state, territory, or tribal governments. If the United States has the primary responsibility for response to an emergency, the President may issue an emergency declaration without a request from the chief executive of a state, territory, or tribal government. *See* Stafford Act section 501 (42 U.S.C. 5191).<sup>2</sup>

Once a declaration is made, affected areas and eligible assistance are determined. *See* 44 CFR 206.40. FEMA announces on its website and in the **Federal Register** whether specific counties, parishes, boroughs, tribal lands, or municipalities

<sup>1</sup> In rare catastrophic events, the PDA may not be completed before the disaster is declared. Tribal governments may seek assistance either under a state declaration request or tribal leaders may independently choose to request a major disaster declaration from the President.

<sup>2</sup> More information about the process for declaring major disasters or emergencies under the Stafford Act can be found at 44 CFR 206.31 et seq. and on the FEMA website: <https://www.fema.gov/disasters/how-declared>. It is rare for the President to declare an emergency without a request from a state, territory, or tribal government. Examples include the bombing of the Alfred P. Murrah Federal Building in Oklahoma City in 1995, the loss of the Space Shuttle Columbia in 2003, and the COVID-19 pandemic in 2020.

(counties) within a state that were affected by a major disaster are eligible for Federal “public assistance” and/or “individual assistance.”<sup>3</sup> “Public assistance” relief is described in Stafford Act sections 406 and 407 as including Federal assistance to repair, restore, and replace disaster-damaged public facilities, which may include debris removal, roads and bridges, water control facilities, buildings and equipment, utilities, parks, and recreational facilities. 42 U.S.C. 5172 and 5173. Emergency protective measures, described in Stafford Act section 403 (42 U.S.C. 5170b), are actions taken by state, tribal, territorial and local governments to meet immediate threats to life and property resulting from a major disaster. “Individual assistance” relief is described in Stafford Act section 408 as Federal assistance to individuals and households, including disaster programs for crisis counseling, unemployment assistance, legal services, and supplemental nutrition assistance. 42 U.S.C. 5174. FEMA defines an “incident” as any condition which meets the definition of a major disaster or emergency under the Stafford Act and which causes damage or hardship that may result in a Presidential declaration of a major disaster or an emergency. 44 CFR 206.32(e). FEMA also defines an “incident period” as “[t]he time interval during which the disaster-causing incident occurs.” 44 C.F.R. §206.32(f).

## II. Disaster Relief under Section 7508A(a)

### A. Overview

Under section 7508A(a), the Secretary has discretionary authority to determine which taxpayers can have acts postponed by reason of being affected by a Federally declared disaster and to specify both the time-sensitive acts that are postponed and a period of time that may be disregarded, up to one year, in determining whether such acts were timely performed. The time-sensitive acts that may be postponed under section 7508A(a) include acts due to be performed by taxpayers or the government. *See* §301.7508A-1(c).

The term “Federally declared disaster” is defined in section 165(i)(5) as “any

disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.” The Stafford Act does not use the term “Federally declared disaster.” It uses the defined terms “emergency” and “major disaster” and also uses the generic term “disaster” to refer to both emergencies and major disasters. *See* Stafford Act §101, 42 U.S.C. 5121 (using the term “disaster”); Stafford Act §102, 42 U.S.C. 5122 (defining the terms “emergency” and “major disaster”); H.R. Rep. 93-1037, p. 26 (May 13, 1974) 120 Cong. Rec. 14156 (clarifying that the term “disaster” as used in the Stafford Act “includes an emergency or a major disaster”). As described above, the declaration of either an emergency or a major disaster requires a determination by the President that Federal assistance is warranted under the Stafford Act. Accordingly, the IRS has previously acknowledged that a Federally declared disaster under section 165(i)(5) includes either an emergency or a major disaster declared under the Stafford Act. *See* Rev. Rul. 2003-29, 2003-11 I.R.B. 587 (Mar. 17, 2003); Rev. Rul. 2002-11, 2002-10 I.R.B. 608 (Mar. 11, 2002); Rev. Rul. 2001-15, 2001-13 I.R.B. 922 (Mar. 26, 2001); and Rev. Rul. 2000-15, 2000-12 I.R.B. 774 (Mar. 20, 2000).

Section 7508A(a) of the Code neither mentions FEMA, nor the concept of the “incident period” as determined by FEMA. As noted above, section 7508A(a) leaves it to the Secretary’s discretion to identify the period of postponement, that is, the start and end dates of the “incident,” and the type of relief to provide, from a tax administration perspective. The Secretary has historically looked to FEMA declarations to identify which counties are sufficiently affected by a major disaster for the Secretary to exercise the discretion under section 7508A(a) to postpone periods of time for the taxpayers in these disaster-affected counties to perform certain specified time-sensitive tax actions.

Section 7508A(a) is not self-executing; it does not operate, on its own, to postpone any time-sensitive act in the event of a Federally declared disaster. Instead, the statute authorizes the Secretary to de-

termine who is affected by a Federally declared disaster for purposes of section 7508A, what time-sensitive acts performed by these taxpayers (or performed by the government with respect to these taxpayers) should be postponed, and for what period of time the postponement period should run.

Section 7508(a)(1) enumerates time-sensitive acts that are postponed with respect to a taxpayer serving in a combat zone (and which the Secretary may postpone with respect to taxpayers affected by a Federally declared disaster, via section 7508A(a)(1)). These acts include filing any income, estate, gift, employment, or excise tax return; making any income, estate, gift, employment, or excise tax payment or any installment thereof; filing a petition with the Tax Court for redetermination of a deficiency, or for review of a Tax Court decision; allowing a credit or refund of any tax; filing a claim for credit or refund of any tax; bringing suit upon a claim for credit or refund; making an assessment of any tax; giving or making any notice or demand for the payment of any tax, or with respect to any liability to the United States in respect of any tax; collecting, by levy or otherwise, the amount of any liability in respect of any tax; bringing suit by the United States, or any officer on its behalf, in respect of any liability in respect of any tax; and any other act required or permitted under the internal revenue laws specified by the Secretary. Additional acts that may be postponed in the event of a Federally declared disaster are listed in Rev. Proc. 2018-58, 2018-50 I.R.B. 990, which is the current version of a revenue procedure that is updated periodically to reflect additional acts or other changes. The revenue procedure provides that in order for taxpayers to be entitled to a postponement of the time-sensitive acts listed in the revenue procedure, the IRS needs to issue guidance providing such relief with respect to a Federally declared disaster, typically by cross-referencing the revenue procedure in an IRS news release. This is the case not just for acts listed in the revenue procedure, but for all acts listed in section 7508(a)(1). As a result, in the event of a Federally declared disaster, the IRS generally issues a news release

<sup>3</sup><https://www.fema.gov/disasters/disaster-declarations>.

or other guidance identifying the affected taxpayers for purposes of section 7508A (typically by reference to counties or states), the time-sensitive acts postponed, and the period of time for the postponement.

### *B. Historical Application*

The historical practice before the enactment of section 7508A(d) was generally to postpone time-sensitive tax acts under section 7508A(a) without regard to the latest incident date for a disaster as described by FEMA. The postponement period set by the Secretary generally began on the earliest incident date specified in a FEMA disaster declaration and ended 120 days later, although a longer period for relief could be selected if the disaster coincided with any major filing deadlines. *See* IRM 25.16.1.5.2(2) (rev. 06-26-2018) (“The severity of the disaster and proximity of tax deadlines are primary factors in determining the level of tax relief that is provided.”). These postponement periods typically extended more than 60 days after the latest incident date specified in a FEMA disaster declaration. For example, an end date for the major disaster incident was indicated in FEMA’s initial disaster declarations for 48 of FEMA’s 53 major disaster declarations issued for disasters occurring in 2019 and declared before December 19, 2019. For these 48 FEMA major disaster declarations in 2019 with initial ending incident dates assigned to them by FEMA, the incident period ranged from one day to 130 days, with a median incident period of nine days. For the five 2019-year major disasters where FEMA’s initial declarations did not specify an end date for the disaster, FEMA later amended the declarations to provide an end date to the incident period for the disaster. FEMA major disaster declarations and any amendments thereto are posted on the FEMA website<sup>4</sup> and published in the **Federal Register**.

### *III. Section 7508A(d)*

On December 20, 2019, section 7508A(d) was added to the Code by sec-

tion 205 of the Taxpayer Certainty and Disaster Tax Relief Act of 2019, enacted as Division Q of the Further Consolidated Appropriations Act, 2020, P.L. 116-94, 133 Stat. 2534, 3226 (FCAA). Section 7508A(d) provides qualified taxpayers a mandatory 60-day period that is to be disregarded “in the same manner as a period specified under [section 7508A(a)]” (mandatory 60-day postponement period). Section 7508A(d)(1). Section 7508A(d) does not identify the acts for which a period is disregarded under section 7508A(a). Section 7508A(d)(4) provides that a rule similar to section 7508A(d)(1) applies with respect to any person described in section 7508A(b) for certain pension-related acts. In contrast to the rest of section 7508A(d), section 7508A(d)(4) identifies specific pension-related acts to which the mandatory 60-day postponement period provided in section 7508A(d)(1) applies. In addition, section 7508A(d)(5) coordinates the mandatory 60-day postponement period with a period specified by the Secretary by providing that the mandatory 60-day postponement period with respect to a person (including by reason of the application of section 7508A(d)(4)) is in addition to (or concurrent with, as the case may be) any period specified by the Secretary under section 7508A(a) or (b) with respect to such person.

Because section 7508A(a) does not, on its own, operate to postpone any acts, the Secretary must determine which acts to postpone. As a result, the requirement in section 7508A(d)(1) that the mandatory 60-day postponement period be disregarded “in the same manner as a period specified under [section 7508A(a)]” indicates that the acts covered by the mandatory 60-day postponement period under section 7508A(d)(1) must also be determined by the Secretary in the manner required under section 7508A(a).

Under section 7508A(d)(5), the mandatory 60-day postponement period in section 7508A(d) runs concurrently with the postponement period determined by the Secretary under section 7508A(a) if the period determined by the Secretary under section 7508A(a) is equal to or longer than 60 days. If the Secretary’s postponement

period under section 7508A(a) is less than 60 days, the mandatory 60-day postponement period would run concurrently for the length of the Secretary’s postponement period under section 7508A(a) and then continue running in addition to the Secretary’s postponement period. The mandatory 60-day postponement period generally begins on the earliest incident date specified in a FEMA disaster declaration and ends on the date which is 60 days after the latest incident date.

### *IV. Legislative History of Section 7508A(d)*

The legislative history of section 7508A(d) of the Code is sparse. There are no House, Senate, or Conference Reports concerning the FCAA. The identical text of section 7508A(d) was included in the same session of Congress in H.R. 3301, which was not enacted. Before H.R. 3301 was set to be marked up by the House Ways and Means Committee on June 30, 2019, the staff of the Joint Committee on Taxation prepared a partial description of proposed section 7508A(d) in JCX 30-19 (June 18, 2019) (Joint Committee Report).

The Joint Committee Report (at 86-87) described twelve categories of time-sensitive acts that could be postponed which are performed by taxpayers (for example, filing any return or paying any tax) or by the IRS (for example, assessment or collection of any tax), which are the same eleven items described in section 7508(a)(1)(A)-(K) (for taxpayers serving in a combat zone), plus the set of acts regarding pensions that are described in §301.7508A-1(c)(1)(iii). The Joint Committee Report did not discuss why section 7508A(d) only refers to the acts regarding pensions in section 7508A(d)(4) to be postponed, but not the eleven categories of acts described in section 7508(a)(1)(A)-(K). The Joint Committee Report also did not discuss the intended meaning of section 7508A(d)(1)’s provision that periods of time “shall be disregarded in the same manner as under [section 7508A(a)].”

As regards the proposed length of the mandatory 60-day postponement period, the Joint Committee (at 87) stated

<sup>4</sup><https://www.fema.gov/disasters/disaster-declarations>

only that “[t]he 60-day period begins on the earliest incident date specified in the declaration of the relevant disaster and ends on the date which is 60 days after the latest incident date so specified.” The Joint Committee Report did not refer to or explain how the new proposed section 7508A(d) might be applied in the event that a declaration did not specify an incident date, or in the event of a prolonged and uncertain disaster period, such as in the case of a drought or pandemic.

On January 21, 2020, a month after the enactment of section 7508A(d), the House Ways and Means Committee released a report on H.R. 3301, H. Rept. No. 116-379 (2020) (House Committee Report), which largely repeated (at 97-100) the explanations previously provided by the Joint Committee Report regarding the features of section 7508A(d). In this report, the Ways and Means Committee titled the section discussing the text of what had been enacted as section 7508A(d), “Automatic Extension of Filing Deadlines in Case of Certain Taxpayers Affected by Federally Declared Disasters.” H.R. Rep. No. 116-379, at 97 (2020). Next, the House Committee Report described the current law (prior to enactment of section 7508A(d)), beginning with a discussion of the filing deadlines for Federal income tax returns and quarterly estimated tax payments, and ending with a listing of all of the items in section 7508(a)(1) and section 7508A(a) that the Secretary may postpone in the event of a Federally declared disaster. *Id.* at 97-98. Then, the report identified the reason for change as follows:

The Committee believes that the certainty and additional time provided by an automatic extension of filing deadlines for taxpayers affected by Federally declared disasters will ease the burden of tax compliance for taxpayers dealing with the hardship of disaster recovery.

*Id.* at 99. Again, the House Committee Report only identified an automatic extension of filing deadlines as the purpose for the new statutory text. However, in the Explanation of Provision section that followed, the House Committee Report seems to indicate that the statute was meant to postpone all of the deadlines that it had listed in its description of current law:

The provision provides to qualified taxpayers in the case of a Federally declared disaster a mandatory 60-day period that is disregarded in determining whether the acts listed above were performed in the time prescribed; the amount of interest, penalty, additional amount, or addition to tax; and the amount of credit or refund. The 60-day period begins on the earliest incident date specified in the declaration of the relevant disaster and ends on the date which is 60 days after the latest incident date so specified.

*Id.* at 99. The “Explanation of Provision” section of the House Committee Report is inconsistent with the report’s “Reason for Change” section, and neither section comports with the statutory text of section 7508A(d) as enacted, because the statutory text does not reference which specified acts (let alone all) are postponed under section 7508A(a).

### Explanation of Provisions

The Treasury Department and the IRS have determined it necessary to propose regulations addressing the enactment of section 7508A(d) because the statutory text is ambiguous in at least two respects. First, it is unclear what time-sensitive acts are to be postponed. Second, it is unclear how the mandatory 60-day postponement period is to be calculated when the declaration specified in section 7508A(d) does not contain an incident date. Further, the legislative history described in the Background section is insufficient to explain these areas of ambiguity. The Treasury Department and the IRS have also determined it necessary to propose regulations addressing the ambiguity between the different terms used in the Code and in the Stafford Act to refer to disasters determined by the President to warrant Federal assistance. This Explanation of Provisions section discusses the proposed regulations addressing each of these areas of ambiguity.

#### I. Time-Sensitive Tax Acts

Section 7508A(d) provides a mandatory 60-day period during which qualified taxpayers will receive disaster relief. Except for the rules regarding pensions

described in section 7508A(d)(4), section 7508A(d) does not specify the time-sensitive tax acts to be postponed during the mandatory 60-day postponement period. Section 7508A(d)(1), however, provides that this mandatory 60-day postponement period “shall be disregarded in the same manner as a period specified under [section 7508A(a)].” Section 7508A(a) is not self-executing. Rather, it requires the Secretary to determine whether a taxpayer is affected by a Federally declared disaster for purposes of section 7508A(a), whether any time-sensitive tax acts are to be postponed for such taxpayers, and the duration of such postponement. Section 7508A(d)(1)’s reference to section 7508A(a) thus requires a determination by the Secretary of the time-sensitive tax acts, if any, to be postponed under section 7508A(a). Therefore, these proposed regulations provide that the Secretary’s determination under section 7508A(a) of the acts subject to postponement due to a Federally declared disaster is an essential prerequisite to determining the acts to which the mandatory 60-day postponement period applies with respect to that Federally declared disaster for qualified taxpayers.

There are circumstances when the Secretary has chosen to limit the extent to which the discretion to postpone time-sensitive acts under section 7508A(a) might otherwise be exercised. For example, section 7508A(a)(1) (through its reference to acts described in section 7508(a)(1)) lists several time sensitive acts performed by the IRS – not by taxpayers – that are available for postponement in the event of a Federally declared disaster, including the assessment of any tax, making of notice and demand for payment of any tax, collection of any tax, and initiating litigation with respect to any tax liability. Although all of these acts can be postponed under section 7508A(a) in the same manner as time-sensitive acts performed by taxpayers, the Secretary rarely chooses to postpone them. Over the past 20 years, time-sensitive government acts were only postponed under section 7508A(a) in connection with four Federally declared disasters: the September 11, 2001 terrorist attacks (Notice 2001-68, 2001-47 I.R.B. 504), Hurricane Katrina (Notice 2005-66, 2005-40 I.R.B. 620 and Notice 2005-81, 2005-47 I.R.B. 977), Hurricane Rita

(Notice 2005-82, 2005-47 I.R.B. 978), and the COVID-19 pandemic (Notice 2020-23, 2020-18 I.R.B. 742). The statutory text of section 7508A(d) provides no indication that Congress intended to postpone all time-sensitive acts for which relief potentially could be provided under section 7508A(a), including those acts due to be performed by the government with respect to a qualified taxpayer. It has generally not been the practice of the Secretary to exercise all of the authority given under section 7508A(a) to postpone all time-sensitive government acts with respect to taxpayers affected by a Federally declared disaster.

The Secretary generally also chooses not to exercise the discretion under section 7508A(a) with respect to many time-sensitive acts carried out by taxpayers. For example, section 7508(a)(1)(A)-(B) and section 7508A(a)(1) combine to provide, among other things, that the Secretary has the discretion to specify a period of up to one year that may be disregarded in determining whether an affected taxpayer with respect to a qualifying disaster has timely filed any return of income tax or paid the United States any employment or excise taxes. The Secretary may exercise the discretion under section 7508A(a) to not provide postponement periods for the filing of certain information returns with respect to income, such as Forms W-2 (Wage and Tax Statement) and forms in the 1099 series. These information returns with respect to income are required by most income tax filers in order to timely prepare their own income tax returns, such as Forms 1040 (U.S. Individual Income Tax Returns) or Forms 1120 (U.S. Corporation Income Tax Returns). These information returns may also be used by the IRS to verify withheld amounts that were claimed on an income tax return before tax refunds are issued. As a result, for tax administration reasons, the Secretary generally does not postpone the time-sensitive acts of filing and furnishing these information returns, except for certain information returns relating to individual retirement accounts (IRAs) and certain other tax-exempt accounts.

Finally, the Secretary may choose not to provide any relief under section 7508A in response to a Federally declared disaster. For example, when a disaster is eligi-

ble for assistance that is limited to only the clean-up of public property or other short-term public services, the Secretary may determine that relief is not warranted under section 7508A.

For the foregoing reasons, these proposed regulations provide that the phrase, “shall be disregarded in the same manner as a period specified under [section 7508A(a)]” in section 7508A(d)(1) first requires the Secretary’s exercise of discretion under section 7508A(a) to specify the postponed set of time-sensitive acts for taxpayers (and potentially for the government) during the entirety of the postponement period under both section 7508A(a) and (d). Accordingly, if the Secretary determines not to postpone a time-sensitive act pursuant to the discretionary authority under section 7508A(a), that act will also not be postponed under section 7508A(d). Similarly, if no time-sensitive acts are postponed under section 7508A(a), then none will be postponed under section 7508A(d).

## II. Calculation of the Mandatory 60-day Postponement Period

The earliest and latest incident dates referred to in subsections 7508A(d)(1)(A)-(B) for a Federally declared disaster are the dates for these events set forth in the declaration establishing the Federally declared disaster for purposes of section 7508A. In the circumstances where there is a certain event with an incident date or incident dates stated in the declaration, as described in Examples (1)-(3) of the proposed regulation, the period described in section 7508A(d)(1) will generally run concurrently with the discretionary periods specified by the Secretary under section 7508A(a) or (b), when the postponement period provided by the Secretary is equal to or greater than 60 days. (As explained previously, the postponement period provided by the Secretary is generally 120 days.) If the postponement period provided by the Secretary is less than 60 days, then section 7508A(d) would apply to provide a mandatory 60-day postponement period, running concurrently with the Secretary’s postponement period at the start, and then after the period prescribed under section 7508A(a) ran out, the mandatory period under section 7508A(d)

would continue to run for the remainder of the 60-day period.

In flooding, wildfire, or earthquake disasters, it is not unusual for FEMA initially to issue a major disaster declaration with no known end date for the disaster incident period. However, insofar as Congress could have been aware when section 7508A(d) was enacted, these open-ended disaster incident periods were generally resolved with the addition by FEMA of a closing date within a short time (usually less than 60 days) after the first reported incident date. Also, it is clear from the legislative history that Congress did not anticipate a situation such as a pandemic or drought, where the beginning date and end dates are not clear, or a situation where the declaration does not specify an incident date.

Ambiguities in applying section 7508A(d) arise when the incident date is specified in the declaration as beginning on a certain date but remaining open-ended for an extended period of time. In those cases, the calculation of the mandatory 60-day postponement period could result in a prolonged postponement of specified time-sensitive acts that could span well beyond the one-year discretionary period authorized under section 7508A(a). It defies logic for the Secretary’s discretionary postponement period under section 7508A(a) to be limited to “a period of up to 1 year,” and there be no limit on the mandatory 60-day postponement period under section 7508A(d). If section 7508A(d) were interpreted as requiring such prolonged postponement periods, that interpretation would be contrary to the directive of section 7508A(d)(1) that the mandatory 60-day postponement period must “be disregarded in the same manner as a period specified under [section 7508A(a)].” For the foregoing reasons, these proposed regulations provide that the phrase “shall be disregarded in the same manner as a period specified under subsection (a)” in section 7508A(d)(1) means that the mandatory postponement period cannot exceed the one-year period authorized under section 7508A(a).

Further ambiguities arise when the declaration establishing a Federally declared disaster for purposes of section 7508A does not specify any incident date. Under such circumstances, it is not

possible to apply the statutory language in section 7508A(d)(1) to provide relief “beginning on the earliest incident date specified in the declaration” and “ending on the date which is 60 days after the latest incident date so specified.” For that reason, these proposed regulations provide that where a declaration establishing a Federally declared disaster for purposes of section 7508A does not specify an incident date, there is no mandatory period for relief under section 7508A(d). If the Secretary determines to postpone time-sensitive tax acts in response to such a declaration, under the discretionary authority in section 7508A(a), the only postponement period will be the period determined by the Secretary under 7508A(a).

These proposed regulations apply only to the relief that is made available under section 7508A in the event of a Federally declared disaster. It does not apply to other relief provisions under other provisions of the Code that automatically arise as a result of a Federally declared disaster, such as the loss provisions under section 165 of the Code.

### III. *Federally Declared Disasters*

As noted above, the term “Federally declared disaster” is defined in section 165(i)(5) as “any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act.” The term “Federally declared disaster” does not appear in the Stafford Act, but the term “disaster” is used in the Stafford Act to refer to either an “emergency” or a “major disaster” declared by the President in accordance with the procedures contained therein. The use of different terminology between the Code and the Stafford Act could cause confusion as to whether a declaration of an emergency under the

Stafford Act establishes a “Federally declared disaster” under the Code. Section 165(i)(5) provides that a Federally declared disaster is “any disaster” that is determined to warrant assistance under the Stafford Act. Under the Stafford Act, the President can declare either an emergency or a major disaster. There is no provision to declare a “disaster,” but the term “disaster” is used in the Stafford Act as an umbrella term that encompasses both an emergency and a major disaster. As a result, the term “any disaster” in section 165(i)(5) encompasses both an emergency and a major disaster. The IRS has previously acknowledged in multiple Revenue Rulings that Federally declared disasters include either an emergency or a major disaster declared under the Stafford Act. *See* Rev. Rul. 2003-29, 2003-11 I.R.B. 587 (Mar. 17, 2003); Rev. Rul. 2002-11, 2002-10 I.R.B. 608 (Mar. 11, 2002); Rev. Rul. 2001-15, 2001-13 I.R.B. 922 (Mar. 26, 2001); and Rev. Rul. 2000-15, 2000-12 I.R.B. 774 (Mar. 20, 2000). These proposed regulations formalize that clarification by amending the definition of “Federally declared disaster” in §1.165-11(b)(1) of the Income Tax Regulations to specifically provide that the term “Federally declared disaster” includes both a major disaster declared under section 401 of the Stafford Act and an emergency declared under section 501 of the Stafford Act.

### IV. *The COVID-19 Pandemic*

The disaster relief provided under section 7508A in response to the COVID-19 pandemic illustrates some of the provisions in these proposed regulations. The COVID-19 pandemic became a Federally declared disaster for purposes of section 7508A on March 13, 2020, when the President issued his nationwide emergency declaration under section 501(b) of the Stafford Act.<sup>5</sup> In response to that declaration, pursuant to the discretionary

authority under section 7508A(a) and (b), the Secretary determined the taxpayers affected by the disaster, the time-sensitive tax acts that should be postponed, and the time period for postponement. Those determinations were reflected in several notices released to the public beginning in late March. Notice 2020-17 was issued on March 18, 2020,<sup>6</sup> Notice 2020-18, superseding Notice 2020-17, was issued on March 20, 2020,<sup>7</sup> Notice 2020-20, amplifying Notice 2020-18, was issued on March 27, 2020,<sup>8</sup> and Notice 2020-23, amplifying Notices 2020-18 and 2020-20, was issued on April 9, 2020.<sup>9</sup> Additional notices continued to be released thereafter, as the Secretary continued to exercise his discretionary authority under section 7508A(a) and (b) in response to the President’s March 13 declaration, including a joint notice with the Department of Labor published on May 4, 2020,<sup>10</sup> and Notice 2020-35, issued on May 28, 2020.<sup>11</sup> Because the President’s March 13 emergency declaration did not specify an incident date, there is no mandatory 60-day postponement period under section 7508A(d). The only postponement period provided under section 7508A for the time-sensitive acts postponed in response to that declaration are the periods determined by the Secretary under section 7508A(a) and (b).

Subsequent to the President’s March 13 nationwide emergency declaration, beginning on March 20, 2020, and continuing on almost a daily basis until April 13, 2020, the President approved major disaster declarations under section 401 of the Stafford Act for all 50 states, the District of Columbia, and 5 U.S. territories, in connection with the COVID-19 pandemic. Those declarations specified an incident period of “January 20, 2020 and continuing.” The Secretary did not use his discretion under section 7508A(a) to postpone any time-sensitive tax acts in response to those state-by-state declarations. As discussed earlier, a

<sup>5</sup> <https://www.whitehouse.gov/briefings-statements/letter-president-donald-j-trump-emergency-determination-stafford-act/>

<sup>6</sup> 2020-15 I.R.B. 590 (April 6, 2020).

<sup>7</sup> 2020-15 I.R.B. 590 (April 6, 2020).

<sup>8</sup> 2020-16 I.R.B. 660 (April 13, 2020).

<sup>9</sup> 2020-18 I.R.B. 742 (April 27, 2020).

<sup>10</sup> 85 Fed. Reg. 26351 (May 4, 2020).

<sup>11</sup> 2020-25 I.R.B. 948 (June 15, 2020).

period for performing acts cannot be disregarded under section 7508A(d) “in the same manner as a period specified under [section 7508A(a)]” if no period for performing such acts is in fact disregarded under section 7508A(a) in connection with a declaration. As a result, section 7508A(d) does not operate to postpone any acts for a mandatory 60-day period in connection with those state-by-state declarations.

### Applicability Date

Section 7805(b)(1)(A) and (B) of the Code generally provide that no temporary, proposed, or final regulation relating to the internal revenue laws may apply to any taxable period ending before the earliest of (A) the date on which such regulation is filed with the **Federal Register**, or (B) in the case of a final regulation, the date on which a proposed or temporary regulation to which the final regulation relates was filed with the **Federal Register**. However, section 7805(b)(2) provides that regulations filed or issued within 18 months of the date of the enactment of the statutory provision to which they relate are not prohibited from applying to taxable periods prior to those described in section 7805(b)(1). As noted above, section 7508A(d) was enacted on December 20, 2019, as part of the FCAA.

Accordingly, as provided in section 7805(b)(2) of the Code, these proposed regulations are proposed to apply to disasters declared on or after December 21, 2019.

### Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and affirmed by Executive Order 13563. Therefore, a regulatory assessment is not required.

Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that these proposed regulations will not have a significant economic impact on a substantial number of small entities. The proposed regulations clarify how the Secretary may postpone certain time-sensitive tax deadlines by reason of a Federally declared disaster. Such postponements provide more time for

affected taxpayers to complete time-sensitive acts than they otherwise would have under the internal revenue laws. In addition, the proposed regulations would not impose a collection of information on any person, including small entities, for purposes of the Regulatory Flexibility Act (5 U.S.C. chapter 6). Accordingly, the Secretary certifies that the regulations will not have a significant economic impact on a substantial number of small entities.

Pursuant to section 7805(f) of the Internal Revenue Code, the IRS will submit the proposed regulations to the Chief Counsel for the Office of Advocacy of the Small Business Administration for comments on the regulations’ impact on small businesses.

### Comments and Request for a Public Hearing

Before these proposed regulations are adopted as final, consideration will be given to comments that are submitted timely to the IRS as prescribed in the preamble under the “**ADDRESSES**” section. The Treasury Department and the IRS request comments on all aspects of the proposed regulations. Any electronic comments submitted, and to the extent practicable any paper comments submitted, will be made available at [www.regulations.gov](http://www.regulations.gov) or upon request.

A public hearing will be scheduled if requested in writing by any person who timely submits electronic or written comments. Requests for a public hearing are also encouraged to be made electronically. If a public hearing is scheduled, notice of the date and time for the public hearing will be published in the **Federal Register**. Announcement 2020-4, I.R.B. 2020-17, provides that until further notice, public hearings conducted by the IRS will be held telephonically. Any telephonic hearing will be made accessible to people with disabilities.

### Drafting Information

The principal author of these regulations is William V. Spatz of the Office of Associate Chief Counsel (Procedure and Administration). However, other personnel from the Treasury Department and the

IRS participated in the development of the regulations.

### List of Subjects

#### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

### Proposed Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 301 are proposed to be amended as follows:

#### PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

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

Par. 2. Section 1.165-11 is amended by revising paragraph (b)(1) to read as follows:

#### **§1.165-11 Election to take disaster loss deduction for preceding year.**

\* \* \* \* \*

(b) \* \* \*

(1) A *federally declared disaster* means any disaster subsequently determined by the President of the United States to warrant assistance by the Federal Government under the Robert T. Stafford Disaster Relief and Emergency Assistance Act (Stafford Act). A federally declared disaster includes both a major disaster declared under section 401 of the Stafford Act and an emergency declared under section 501 of the Stafford Act.

#### PART 301—PROCEDURE AND ADMINISTRATION

Par. 3. The authority citation for part 301 continues to read in part as follows:

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

Par. 4. Section 301.7508A-1 is amended by revising paragraph (g) and adding paragraph (h) to read as follows:

**§301.7508A-1 Postponement of certain tax-related deadlines by reasons of a Federally declared disaster or terroristic or military action.**

\* \* \* \* \*

(g) *Mandatory 60-day postponement—*  
(1) *In general.* In addition to (or concurrent with) the postponement period specified by the Secretary in an exercise of the authority under section 7508A(a) to postpone time-sensitive acts by reason of a Federally declared disaster, qualified taxpayers (as defined in section 7508A(d)(2)) are entitled to a mandatory 60-day postponement period during which the time to perform those time-sensitive acts is disregarded in the same manner as under section 7508A(a). A similar rule applies with respect to a postponement period specified by the Secretary under section 7508A(b), to postpone acts as provided in section 7508A(d)(4). Except for the acts set forth in paragraph (g)(2) of this section, section 7508A(d) does not apply to postpone any acts.

(2) *Acts postponed.* The time-sensitive acts that are postponed for the mandatory 60-day postponement period are the acts determined to be postponed by the Secretary's exercise of authority under section 7508A(a) or (b). In addition, in the case of any person described in 7508A(b), the time-sensitive acts postponed for the mandatory 60-day postponement period include those described in section 7508A(d)(4):

(i) Making contributions to a qualified retirement plan (within the meaning of section 4974(c)) under section 219(f)(3), 404(a)(6), 404(h)(1)(B), or 404(m)(2);

(ii) Making distributions under section 408(d)(4);

(iii) Recharacterizing contributions under section 408A(d)(6); and

(iv) Making a rollover under section 402(c), 403(a)(4), 403(b)(8), or 408(d)(3).

(3) *Calculation of mandatory 60-day postponement period—*(i) *In general.* The mandatory 60-day postponement period begins on the earliest incident date specified in a disaster declaration for a Federally declared disaster and

ends on the date that is 60 days after the latest incident date specified in the disaster declaration. In accordance with section 7508A(d)(5), if the period determined by the Secretary in exercising discretion under 7508A(a) is equal to or longer than 60 days, the mandatory 60-day postponement period under section 7508A(d) runs concurrently with the postponement period determined by the Secretary under section 7508A(a). If the period determined by the Secretary in exercising discretion under 7508A(a) is less than 60 days, in accordance with section 7508A(d)(5), the mandatory 60-day postponement period will run concurrently for the length of the period determined by the Secretary under section 7508A(a) and then continue running in addition to the period determined by the Secretary under section 7508A(a).

(ii) *Limitations on the mandatory 60-day postponement period.* (A) In no event will the mandatory 60-day postponement period be calculated to exceed one year.

(B) In the event the Secretary determines to postpone time-sensitive acts pursuant to a declaration establishing a Federally declared disaster for purposes of section 7508A that does not specify an incident date, there is no mandatory postponement period under section 7508A(d). In such cases, the only postponement period will be the period determined by the Secretary under 7508A(a).

(5) *Examples.* The rules of this paragraph (g) are illustrated by the following examples:

(i) *Example (1).* Individual A lives in a state that experienced severe but isolated tornado damage on March 15. On March 20, FEMA issued a **Federal Register** Notice announcing a major disaster declaration approved by the President for the state where Individual A lives, describing the incident date for the tornado as March 15. Based upon that major disaster declaration, the IRS published a news release identifying the taxpayers (by county) affected by the disaster for purposes of section 7508A and specifying the time-sensitive acts that are postponed and a period of postponement from March 15 through July 31, pursuant to section 7508A(a). Under section 7508A(d), the mandatory 60-day postponement period that Individual A is entitled to begins on March 15 and ends 60 days after March 15, on May 14. The mandatory postponement period applies to the same time-sensitive acts and runs concurrently with the relief the IRS provided to Individual A under section 7508A(a).

(ii) *Example (2).* Individual B lives in a coastal state which experienced harmful effects from a hurricane that began to affect the weather in his state on

August 15 and ceased to be a weather factor in his state on August 19. On August 22, FEMA issued a **Federal Register** Notice announcing a major disaster declaration approved by the President, determining that the coastline counties in the state where Individual B lives were severely affected and that these counties were entitled to both individual assistance and public assistance. The major disaster declaration specified the earliest incident date for the hurricane in the state where Individual B lives as August 15 and the latest incident date as August 19. Based upon that major disaster declaration, the IRS published a news release identifying the taxpayers affected by the disaster for purposes of section 7508A and specifying the time-sensitive acts that are postponed and a period of postponement from August 15 through December 31, pursuant to section 7508A(a). Under section 7508A(d), the mandatory 60-day postponement period that Individual B is entitled to begins on August 15 and ends 60 days after August 19, on October 18. The mandatory postponement period applies to the same time-sensitive acts and runs concurrently with the relief the IRS provided to Individual B under section 7508A(a).

(iii) *Example (3).* Individual C lives in a state that is experiencing multiple ongoing wildfires. On August 14, FEMA issued a **Federal Register** Notice announcing a major disaster declaration approved by the President for the state where Individual C lives, specifying the earliest incident date for the wildfires as August 14 and the incident was ongoing. Based upon that major disaster declaration, the IRS published a news release identifying the taxpayers (by county) affected by the disaster for purposes of section 7508A and specifying the time-sensitive acts that are postponed and a period of postponement from August 14 through December 15, pursuant to section 7508A(a). The wildfire disaster remains ongoing, with no ending incident date specified, for several months. The IRS publishes a second news release postponing the time-sensitive acts through January 15. FEMA amends the major disaster declaration to specify the latest incident date of November 19. Under section 7508A(d), the mandatory 60-day postponement period that Individual D is entitled to begins on August 14 and ends 60 days after the latest incident date of November 19. The mandatory postponement period applies to the same time-sensitive acts and runs concurrently with the relief the IRS provided to Individual D under section 7508A(a), and ends on January 18, which is 60 days after the latest incident date and three days beyond the postponement period specified by the IRS under section 7508A(a) in its news release.

(iv) *Example (4).* Individual D lives in the United States, which is experiencing a nationwide emergency as a result of its residents being exposed to a highly infectious and dangerous pandemic disease. On March 13, the President declared a nationwide emergency under section 501(b) of the Stafford Act. The pandemic became a Federally declared disaster for purposes of section 7508A on March 13, however, no incident date was specified in the President's emergency declaration. Pursuant to the President's March 13 emergency declaration, the IRS published several notices identifying the taxpayers affected by the disaster for purposes of section 7508A and specifying the time-sensitive acts that are postponed and a period of postpone-

ment that generally ran from April 1 through July 15, pursuant to section 7508A(a). Because, in this circumstance, the emergency declaration pursuant to which the notices were published did not specify an incident date, there is no mandatory postponement period under section 7508A(d). The only postponement period is the period determined by the Secretary pursuant to the discretionary authority under section 7508A(a).

(h) *Applicability dates*—(1) *In general*. Except as provided in paragraph (h)(2) of this section, this section applies to disasters declared after January 15, 2009.

(2) *Paragraph (g)*. Paragraph (g) of this section applies to disasters declared on or after December 21, 2019.

Sunita Lough,  
*Deputy Commissioner for Services  
and Enforcement.*

(Filed by the Office of the Federal Register on January 11, 2021, 4:15 p.m., and published in the issue of the Federal Register for January 13, 2020, 86 F.R. 2607)

# Definition of Terms

*Revenue rulings and revenue procedures (hereinafter referred to as “rulings”) that have an effect on previous rulings use the following defined terms to describe the effect:*

*Amplified* describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with *modified*, below).

*Clarified* is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

*Distinguished* describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

*Modified* is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the

new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with *amplified* and *clarified*, above).

*Obsoleted* describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

*Revoked* describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

*Superseded* describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the

new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, *modified* and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

*Supplemented* is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

*Suspended* is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

# Abbreviations

*The following abbreviations in current use and formerly used will appear in material published in the Bulletin.*

A—Individual.  
Acq.—Acquiescence.  
B—Individual.  
BE—Beneficiary.  
BK—Bank.  
B.T.A.—Board of Tax Appeals.  
C—Individual.  
C.B.—Cumulative Bulletin.  
CFR—Code of Federal Regulations.  
CI—City.  
COOP—Cooperative.  
Ct.D.—Court Decision.  
CY—County.  
D—Decedent.  
DC—Dummy Corporation.  
DE—Donee.  
Del. Order—Delegation Order.  
DISC—Domestic International Sales Corporation.  
DR—Donor.  
E—Estate.  
EE—Employee.  
E.O.—Executive Order.  
ER—Employer.

ERISA—Employee Retirement Income Security Act.  
EX—Executor.  
F—Fiduciary.  
FC—Foreign Country.  
FICA—Federal Insurance Contributions Act.  
FISC—Foreign International Sales Company.  
FPH—Foreign Personal Holding Company.  
FR.—Federal Register.  
FUTA—Federal Unemployment Tax Act.  
FX—Foreign corporation.  
G.C.M.—Chief Counsel’s Memorandum.  
GE—Grantee.  
GP—General Partner.  
GR—Grantor.  
IC—Insurance Company.  
I.R.B.—Internal Revenue Bulletin.  
LE—Lessee.  
LP—Limited Partner.  
LR—Lessor.  
M—Minor.  
Nonacq.—Nonacquiescence.  
O—Organization.  
P—Parent Corporation.  
PHC—Personal Holding Company.  
PO—Possession of the U.S.  
PR—Partner.  
PRS—Partnership.

PTE—Prohibited Transaction Exemption.  
Pub. L.—Public Law.  
REIT—Real Estate Investment Trust.  
Rev. Proc.—Revenue Procedure.  
Rev. Rul.—Revenue Ruling.  
S—Subsidiary.  
S.P.R.—Statement of Procedural Rules.  
Stat.—Statutes at Large.  
T—Target Corporation.  
T.C.—Tax Court.  
T.D.—Treasury Decision.  
TFE—Transferee.  
TFR—Transferor.  
T.I.R.—Technical Information Release.  
TP—Taxpayer.  
TR—Trust.  
TT—Trustee.  
U.S.C.—United States Code.  
X—Corporation.  
Y—Corporation.  
Z—Corporation.

## **Numerical Finding List<sup>1</sup>**

Bulletin 2021–5

### **Announcements:**

2021-01, 2021-04 I.R.B. 506

### **Notices:**

2021-01, 2021-02 I.R.B. 315

2021-03, 2021-02 I.R.B. 316

2021-04, 2021-02 I.R.B. 319

2021-02, 2021-03 I.R.B. 478

2021-05, 2021-03 I.R.B. 479

2021-07, 2021-03 I.R.B. 482

2021-09, 2021-05 I.R.B. 678

### **Proposed Regulations:**

REG-130081-19, 2021-02 I.R.B. 321

REG-114615-16, 2021-03 I.R.B. 489

REG-111950-20, 2021-05 I.R.B. 683

REG-115057-20, 2021-05 I.R.B. 714

### **Revenue Procedures:**

2021-01, 2020-01 I.R.B. 1

2021-02, 2020-01 I.R.B. 116

2021-03, 2020-01 I.R.B. 140

2021-04, 2020-01 I.R.B. 157

2021-05, 2020-01 I.R.B. 250

2021-07, 2020-01 I.R.B. 290

2021-09, 2020-03 I.R.B. 485

2021-08, 2020-04 I.R.B. 502

2021-10, 2020-04 I.R.B. 503

2021-12, 2020-05 I.R.B. 681

### **Revenue Rulings:**

2021-01, 2021-02 I.R.B. 294

2021-02, 2021-04 I.R.B. 495

2021-03, 2021-05 I.R.B. 674

### **Treasury Decisions:**

9925, 2021-02 I.R.B. 296

9940, 2021-02 I.R.B. 311

9932, 2021-03 I.R.B. 345

9939, 2021-03 I.R.B. 376

9941, 2021-03 I.R.B. 396

9942, 2021-03 I.R.B. 450

9937, 2021-04 I.R.B. 495

9936, 2021-05 I.R.B. 508

9943, 2021-05 I.R.B. 577

9945, 2021-05 I.R.B. 627

<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2020–27 through 2020–52 is in Internal Revenue Bulletin 2020–52, dated December 27, 2020.

## **Finding List of Current Actions on Previously Published Items<sup>1</sup>**

Bulletin 2021-5

---

<sup>1</sup> A cumulative list of all revenue rulings, revenue procedures, Treasury decisions, etc., published in Internal Revenue Bulletins 2020-27 through 2020-52 is in Internal Revenue Bulletin 2020-52, dated December 27, 2020.

# **Internal Revenue Service**

## **Washington, DC 20224**

---

Official Business  
Penalty for Private Use, \$300

---

## **INTERNAL REVENUE BULLETIN**

The Introduction at the beginning of this issue describes the purpose and content of this publication. The weekly Internal Revenue Bulletins are available at [www.irs.gov/irb/](http://www.irs.gov/irb/).

---

## **We Welcome Comments About the Internal Revenue Bulletin**

If you have comments concerning the format or production of the Internal Revenue Bulletin or suggestions for improving it, we would be pleased to hear from you. You can email us your suggestions or comments through the IRS Internet Home Page ([www.irs.gov](http://www.irs.gov)) or write to the Internal Revenue Service, Publishing Division, IRB Publishing Program Desk, 1111 Constitution Ave. NW, IR-6230 Washington, DC 20224.