



This is in response to a letter received in this office dated July 25, 2012, in which a ruling is requested to clarify the proper application of certain look-through rules for purposes of determining whether Corp X is a passive foreign investment company within the meaning of section 1297.

The rulings contained in this letter are based upon information and representations submitted by the taxpayer and accompanied by a penalty of perjury statement executed by an appropriate party. While this office has not verified any of the material submitted in support of the request for rulings, it is subject to verification on examination.

## FACTS

Taxpayers are a married couple who own shares in Corp X and have filed joint federal income tax returns for all taxable years beginning after Year 2. Corp X is a Country M corporation that was founded in Year 2, and is a passive foreign investment company (PFIC) within the meaning of section 1297. Since its formation in Year 2, Corp X has owned all of the outstanding shares of US Corp Y, a domestic corporation. US Corp Y has owned all the outstanding shares of US Corp Z since the formation of US Corp Z in Year 4.

Corp X has always been a holding company and has never been engaged directly in the conduct of business activities. Since its formation in Year 1, US Corp Y has been engaged in a business involving the development, marketing, and support of certain application software for businesses. US Corp Z has been engaged in the conduct of a financing business since its formation.

Nearly all of the income of US Corp Z has consisted of interest earned on receivables purchased in the course of US Corp Z's financing business. The amount of income earned by US Corp Y in the conduct of its business is less than % of the total income of Corp X, US Corp Y, and US Corp Z combined. In Year 3 and each subsequent taxable year, the gross amount of interest income earned by US Corp Y has been less than the amount of gross income earned by US Corp Y in the course of its business.

The income of Corp X has consisted almost exclusively of dividends received from US Corp Y. Nearly all of these dividends have been immediately re-distributed by Corp X as dividends to its shareholders. In Year 3 and each subsequent taxable year, the gross amount of interest income earned by Corp X (when aggregated with the gross amount of interest income earned by US Corp Y) has been less than the amount of gross income earned by US Corp Y in the course of its business from the sales and support of software applications.

US Corp Y and US Corp Z have historically earned significant amounts of taxable income, all of which has been subject to U.S. federal income tax.

The portion of the outstanding shares of Corp X owned, directly or indirectly, by individuals who are citizens or residents of the United States for federal income tax purposes has been greater than % at all times since the beginning of Year 3.

The board of directors of Corp X has adopted a resolution confirming that Corp X has irrevocably waived any protection under the U.S.-Country M treaty against the imposition of the U.S. accumulated earnings tax, effective for all prior, current, and future taxable years.

## LAW

Section 1297(a) provides that a foreign corporation is a passive foreign investment company (PFIC) with respect to a taxable year if either (1) 75 percent or more of the gross income of the corporation for the taxable year is passive income, or (2) the average percentage of assets held by the corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.

Section 1297(b)(1) provides that, for purposes of section 1297(a), the term “passive income” means any income (other than income qualifying under the exceptions set forth in section 1297(b)(2)) which is of a kind which would be foreign personal holding company income as defined in section 954(c).

Section 1297(b)(2)(C) contains a look-through rule under which a dividend, interest, or royalty payment that is received by a foreign corporation from a related person is not treated as passive income to the extent that the payment is allocable to income of the payor that is not passive income.

Section 1297(c) contains a look-through rule that provides that if a foreign corporation owns, directly or indirectly, at least 25 percent of the value of the stock of another corporation, then the foreign corporation is treated (for purposes of section 1297(a)) as holding its proportionate share of the assets, and as receiving directly its proportionate share of the income of, the 25-percent owned subsidiary.

Section 1298(b)(7) contains a look-through rule that provides that if a foreign corporation owns 25 percent or more of the shares of a domestic corporation (first-tier domestic corporation), and if the foreign corporation is either subject to the U.S. accumulated earnings tax or waives any benefit under any treaty which otherwise would prevent the imposition of the accumulated earnings tax, then for purposes of determining whether the foreign corporation is a PFIC: (1) any shares of another domestic corporation, other than a regulated investment company or real estate investment trust (second-tier domestic corporation), that are held by the first-tier domestic corporation are treated as not being a passive asset; and (2) any amount included in the gross income of the first-tier domestic corporation with respect to the

shares of such second-tier domestic corporation are treated as not being passive income.

Unless an income tax treaty provides otherwise, a foreign corporation (other than a PFIC) that has any shareholder who is a U.S. citizen or resident is subject to the accumulated earnings tax with respect to the corporation's U.S.-source income (including U.S.-source dividend and interest income that is not effectively connected with a trade or business conducted within the United States by the foreign corporation). See section 532; Treas. Reg. §§ 1.532-1(c) and 1.535-1(b).

An article of the U.S.-Country M treaty provides that a Country M corporation may be subject to the U.S. accumulated earnings tax for a particular taxable year if 50% or more in value of the outstanding voting shares of the corporation is owned, directly or indirectly, throughout the last half of the taxable year by citizens or residents of the United States (other than certain citizens of Country M) or by residents of a country other than the U.S. or Country M.

The legislative history of section 1298(b)(7) states:

The bill further treats stock of certain U.S. corporations owned by another U.S. corporation which is at least 25-percent owned by a foreign corporation as a non-passive asset. Under this rule, in determining whether a foreign corporation is a PFIC, stock of a regular domestic C corporation owned by a 25-percent owned domestic corporation is treated as an asset which does not produce passive income (and is not held for the production of passive income), and income derived from that stock is treated as income which is not passive income. Thus, a foreign corporation, in applying the look-through rule applicable to 25-percent owned corporations, will be treated as owning nonpassive assets in these cases. This rule does not apply, however, if, under a treaty obligation of the United States, the foreign corporation is not subject to the accumulated earnings tax, unless the corporation agrees to waive the benefit under the treaty. This rule is designed to mitigate the potential disparate tax treatment between U.S. individual shareholders who hold U.S. stock investments through a U.S. holding company and those who hold those investments through a foreign holding company. If a foreign investment company attempts to use this rule to avoid the PFIC provisions, it will be subject to the accumulated earnings tax and, thus, the shareholders of that company will be subject to tax treatment essentially equivalent to that of the shareholders of PFICs.

H.R. Rep. No. 795, 100th Cong., 2d Sess., 273 (1988); S. Rep. No. 445, 100th Cong., 2d Sess., 286-87 (1988); Joint Committee on Taxation, Description of the Technical Corrections Act of 1987 (H.R. 2636 and S. 1350), 213 (JCS-15-87 June 15, 1987).

## RULING

For purposes of determining whether Corp X is a PFIC:

- (1) Pursuant to section 1298(b)(7), Corp X is treated as not receiving any portion of the income earned by US Corp Z, and Corp X is treated as not owning the assets held by US Corp Z.
- (2) Any dividend received by US Corp Y from US Corp Z, and any other income received by US Corp Y, is treated under section 1297(c) as being received directly by Corp X.
- (3) The shares of US Corp Z that are held by US Corp Y, and any other assets held by US Corp Y, are treated under section 1297(c) as being owned directly by Corp X.
- (4) Pursuant to section 1298(b)(7), any dividend received by US Corp Y from US Corp Z is treated as not being passive income, and the shares of US Corp Z that are held by US Corp Y are treated as not producing passive income and as not being held for the production of passive income.

Except as expressly provided herein, no opinion is expressed or implied concerning the tax consequences of any aspect of any transaction or item discussed or referenced in this letter.

This private letter ruling is directed only to the taxpayer who requested it. Code section 6110(k)(3) provides that it may not be used or cited as precedent.

A copy of this letter must be attached to any income tax return to which it is relevant. Alternatively, taxpayers filing their returns electronically may satisfy this requirement by attaching a statement to their return that provides the date and control number of the letter ruling.

In accordance with the Power of Attorney on file with this office, copies of this letter are being sent to Taxpayer's representatives.

Sincerely,

Jeffery G. Mitchell  
Chief, Branch 2  
Office of the Associate Chief Counsel  
(International)