DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–111950–20]

RIN 1545–BP91

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)

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* (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 Once submitted to the Federal eRulemaking Portal, comments cannot be edited or withdrawn.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, P.O. Box 7604, Ben Franklin Station, Washington, DC 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* (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, Public Law 115–97, 131 Stat. 2234 (2017) (the ''Act''), former section 1297(b)(2)(B) provided that passive income generally did not include investment income derived in the active conduct of an insurance business by a corporation that is predominantly engaged in an insurance business and that would be subject to tax under subchapter L if it were a domestic corporation. Congress was concerned about a lack of clarity and precision in the PFIC insurance exception, and in particular about the lack of precision regarding how much insurance or reinsurance business a company must do to qualify under the exception, which made the exception difficult to enforce. H.R. Report 115–409 at 409–10. 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) [1] requires a taxpayer to calculate QBAI by determining the adjusted basis of property using the ADS under section 168(g) ''notwithstanding any provision 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 recovery period as determined under section 168(g)(2)(C).[2] 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) [3] 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 [4] 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, Public Law 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

[1] 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.

[2] 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).

[3] Section 168(g)(2)(C)(ii) and (iii) refer to personal property with no class life and residential rental property, respectively.

[4] The phrase ''made by a taxpayer'' was added by section 2307(a)(2) of Public Law 116–136, discussed below.

(''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.[5]

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.

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

[5] 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).

types of financial institutions, based on both the statutory framework and the history of section 1297(b).[6]

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). Public Law 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. Public Law 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 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.[7] 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).[8] 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

[6] *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).

[7] *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'').

[8] 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.'').

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 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.[9]

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

[9] 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, 105th 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).'')

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 corporation 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 produces 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 formulas, 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'' transactions 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 ordering 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 financial 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 corporation 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 exclude 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 active 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 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 1 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.[10]

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 decision 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.[11] *See* section 7805(b)(2). U.S. shareholders and domestic corporations (including any individuals 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.

[10] 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).

[11] 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.

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 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 corporations (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 incomes. 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 definition 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 selling 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 purpose 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.

TABLE

	Number of entities filing Form 8621		
	2016	2017	2018
Individuals	36,978	40,891	43,406
Passthrough Entities	15,326	16,133	16,607
C Corporations	713	733	739
Unreported Filer Type	1,114	1,053	1,084

TABLE—Continued

	Number of entities filing Form 8621		
	2016	2017	2018
All Entities	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 section 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 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.

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* 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*. 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.*

Drafting Information

The principal drafters of these regulations are Christina G. Daniels, Josephine Firehock, Jorge M. Oben, and Larry R. Pounders of the Office of Associate Chief Counsel (International). Other personnel from the Treasury Department and the IRS also participated in the development of these regulations.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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, Public Law 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, Public Law 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.

* * * * *

■ **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—

(I) Accept bank deposits from residents of that country; and

(II) 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 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. 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 accompany 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 insurance 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 contract 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 officers 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 customer 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 asset 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.

* * * * *

* * * * *

■ **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 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 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 engaged 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.

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