

Reproduced with permission from Tax Management International Journal, Vol. 48, No. 8, 08/09/2019. Copyright © 2019 by The Bureau of National Affairs, Inc. (800-372-1033) <http://www.bna.com>

PFIC Proposals Punt on Partnerships

By Kim Blanchard
Weil, Gotshal & Manges LLP
New York, New York

After 33 years, the Treasury and IRS have finally published useful PFIC guidance, in the form of proposed regulations.¹ The immediate prodding came from Congress, which in the Tax Cuts and Jobs Act modified the exception from PFIC status for active insurance companies set forth in §1297(b)(2)(B).² Apparently the fact that Congress thought this was a subject important enough to address in the 21st century spurred the administration into dusting off a project on general PFIC guidance that had been sitting on the shelf for decades. And although the proposed regulations address the new insurance company exception, they also address a number of general PFIC issues that have long vexed taxpayers and practitioners.³

The proposed regulations are, like three lawyers at the bottom of the ocean, a good start. They do a good job at identifying and providing guidance on a number of issues that sorely need guidance. Among these are what types of foreign personal holding company income listed in §954 constitute passive income for PFIC purposes, at what level to apply the PFIC rules as between a foreign corporation being tested under these rules (a “Tested Foreign Corporation”) and its

25%-or-greater look-through subsidiaries covered by §1297(c), whether to apply §1297(c) on a top-down or bottoms-up basis, and how to apply the change-of-business rule of §1298(b)(3). The proposed regulations request comments on these and several other issues worth commenting on.

Unfortunately, the proposed regulations do not do a good job dealing with partnerships. In my view, the drafters of these regulations didn’t really get a grip on partnerships at all, and seem unfamiliar with the most basic differences between partnerships and corporations. This note will outline where the proposed regulations went astray, and what needs to be done to get back on track.

Let’s start with what the proposed regulations got right about PFICs and partnerships. In discussing the decision to adopt a “top down” model for applying the attribution of ownership rules to stock held by partnerships, the preamble to the proposed regulations noted with approval that the top-down model produces the same result that would be obtained if the partnership did not exist, and the partners owned their shares of stock directly.⁴ The preamble went on to observe that the top-down model would not apply to stock owned through a corporation rather than through a partnership.⁵ And that is clearly correct, although as a policy matter one might consider applying a top-down model to corporations as well. The reason it is correct is that a partnership is normally treated as an aggregate of its partners, whereas a corporation never is. And aggregate treatment should generally lead to a tax result that is the same as if the partnership did not exist.

But then the preamble turns to the subject of income earned through partnerships, and things go south fast. Observing that a Tested Foreign Corporation must own at least 25% of the stock of a *corpo-*

¹ REG-105474-18, Tax Notes Today Doc. 2019–26642 (July 11, 2019).

² All section references are to the Internal Revenue Code (Code), as amended, and the Treasury regulations thereunder, unless otherwise specified.

³ Meaningful guidance on how to apply the most important PFIC rules has never been issued. Prior to these regulations, the only guidance addressing the definition of PFIC was Notice 88-22, which was issued just weeks before the statute was completely rewritten in 1988. For a complete description of what has been missing all these years, see Blanchard, 6300 T.M., *PFICs*.

⁴ Preamble at 8.

⁵ Preamble at 9.

rate subsidiary in order for the look-through rule of §1297(c) to apply, the proposed regulations unaccountably apply the same rule to a *partnership*, looking through to its assets and income, only if it is at least 25% owned. It should be obvious that a statutory rule is needed to look through a corporation, since a corporation can never be treated as an aggregate. But no statutory rule is needed to look through a partnership. A partnership should be and usually is treated as an aggregate, without any threshold percentage interest, even when the Code is silent.

It gets worse. The preamble correctly observes that the regulations under subpart F (generally referred to as the *Brown Group* regulations after a case by that name) generally treat partnerships as aggregates. And since the PFIC definition of passive income is tied to the definition of foreign personal holding company income under subpart F, one would think it would be a simple matter to conclude that the PFIC rules would look through partnerships without regard to any artificial threshold. Yet the preamble insists that the PFIC rules can diverge in this respect from the subpart F rules, because the “policies” of the two regimes are different.⁶

The preamble never explains what different “policies” might lead one to conclude that partnerships should not be treated as aggregates for PFIC purposes. The policy of the PFIC rules is to treat as a PFIC a foreign corporation that resembles a mutual fund. Foreign corporations that conduct a business, directly or through a partnership, do not implicate this policy.

It is possible that the fact pattern that the drafters were worried about was a case in which the Tested Foreign Corporation invests as a passive minority investor in active foreign portfolio companies that are able to “check the box” for U.S. tax purposes. This fact pattern might be seen as implicating the policy of the PFIC rules, in that the Tested Foreign Corporation could own a number of portfolio investments without becoming a PFIC due to the flow-through of active income and assets from the underlying portfolio companies. This would not have been possible if the underlying portfolio companies were classified as corporations for U.S. tax purposes.

That this was probably the concern of the drafters is suggested by the preamble’s terse description of its rationale:

The different treatment [from the aggregate approach of subpart F] is warranted because of the flexibility that entities have in their characterization for U.S. Federal income tax purposes under §301.7701-3 and because of the fact that treating a subsidiary as a partnership may not have U.S.

income tax consequences for a Tested Foreign Corporation, as it could for a CFC.⁷

The preamble correctly points out that the purpose of the PFIC income and assets tests is to determine whether the Tested Foreign Corporation is primarily engaged in an active or passive activity. From this it leaps to the conclusion that an ownership interest of a small amount is “unlikely to give the [Tested Foreign Corporation] significant *control* over the partnership activities [of the lower-tier entity] such that it represents an active business interest.”⁸ This is a non-sequitur. Not only would this be untrue in the case of a small interest as a general partner, there is no suggestion anywhere in the PFIC rules that “control” has any relevance to the active vs. passive distinction.

The same portion of the preamble goes on to observe that providing a lower threshold for partnership look-through than for corporate look-through “creates incentives for foreign corporations to hold minority interests in partnerships rather than corporations.”⁹ This is clearly true, but irrelevant to the purpose of the PFIC rules. Under current law, taxpayers routinely check the box on subsidiaries of foreign corporations in order to combine the activities of passive and active group members. Not only is this entirely permissible, it makes good sense in light of the purpose of the PFIC rules.

The preamble also states that a check the box election might <gasp!> be made solely for U.S. tax purposes and that “[t]his means that the *same investment* that Congress determined could only be active if it accounted for 25 percent of the value of the entity would now qualify as active even though *the nature of the investment has not substantially changed.*”¹⁰ This statement is false in its assumptions. One might have hoped that the drafters of these proposed regulations would appreciate that, despite the “flexibility” of the check-the-box regulations (which is not really different from the “flexibility” of the antecedent *Kintner* regulations), there are mammoth tax consequences that hinge upon the choice between the corporate and partnership forms. In fact that is the entire *raison d’etre* of the entity classification rules. If corporations were treated in the same way partnerships are treated for PFIC purposes, many of the problems that the proposed regulations seek to help with, such as the inability to integrate the activities of a management company and its related property holding company, would be solved. In fact, “checking open” prop-

⁶ Preamble at 18–19.

⁷ Preamble at 19.

⁸ Preamble at 81.

⁹ *Id.*

¹⁰ *Id.* (emphasis added).

erty companies has traditionally been the one safe route to avoid this common trap for the unwary under the PFIC rules.¹¹

What the drafters seem to be assuming here is that, insofar as foreign corporations are concerned (at least foreign corporations that are not CFCs), the world consists solely of foreign entities and foreign shareholders that are indifferent to those consequences. This might be true, for example, if the Tested Foreign Corporation carried on no business of its own, all of its less-than-25% owned subsidiaries were foreign entities having no U.S. assets or business, and all other owners of those subsidiaries were foreign persons indifferent to U.S. tax issues.

But those assumptions will very often be inaccurate. The Tested Foreign Corporation may operate a business. It might own those lower-tier entities as part of its business; the lower-tier companies may be joint ventures or partnerships among affiliates, rather than portfolio investments. The Tested Foreign Corporation may act as a manager or general partner of the businesses of the lower-tier entities. The lower-tier entities may have U.S. or even foreign owners who care about their entity classification. They may even own U.S. businesses.

Even if there were no direct consequences of the entity classification of lower-tier entities, the Tested Foreign Corporation might be a CFC in the hands of some of its U.S. shareholders and a PFIC in the hands of other, smaller U.S. shareholders.¹² In such a case it would seem impossible to implement the “different policies” of the PFIC and subpart F rules in respect of the single Tested Foreign Corporation.

Moreover, even if the assumption of indifference to entity classification were true, it is not self-evident that the fact pattern apparently envisioned by the drafters violates any policy of the PFIC rules. There is no “policy” justifying the 25% threshold of §1297(c) for corporate subsidiaries; it is an arbitrary rule that was probably not set lower as a matter of ad-

ministrative convenience. Given that partnerships, unlike corporations, are generally treated as aggregates for tax purposes, any rule that does not treat a partnership as a pure aggregate should be justified by reference to a policy far stronger than that potentially present here—certainly far stronger than “If 25% is good enough for corporations it ought to be good enough for partnerships”!

And now that the government has raised the issue, let’s talk about the different policies of the PFIC and subpart F regimes. As I’ve written elsewhere at length,¹³ the PFIC rules would work far better to home in on their target if Congress had not made the mistake, in 1988, of rewriting the PFIC rules to define what is passive by reference to §954(c), rather than §904(d) as had been the case in 1986. Section 954(c)’s definition of foreign personal holding company income is aimed at subpart F policy, which is to tax income that has been artificially moved offshore by a U.S. person and has no good business reason to be earned offshore. This policy is completely unrelated to PFIC policy: the PFIC rules assume that the Tested Foreign Corporation is not controlled by U.S. persons and is inherently foreign. The policy of the active-passive distinction of the foreign tax credit rules of §904, to distinguish between income that is passive and income that is active, is much more similar to this PFIC policy than are the rules of §954(c).¹⁴

The proposed regulations recognize this difference in policies in attempting to ameliorate the PFIC problem encountered when a foreign group has its active business in a corporate entity other than the one that owns the managed property.¹⁵ The reason the subpart F rules insist that a CFC that earns active rents and royalties, for example, must do so through its “own” employees is because the policy of subpart F is to tax income that has no business being earned by a CFC. This policy is irrelevant to PFIC policy, and the regulations recognize this fact. So it is certainly odd that the same preamble would object to treating a partnership as an aggregate, since it is the use of partnerships treated as aggregates that helps to achieve rational PFIC policy.

Oddly, the drafters of the proposed regulations seemed bothered by the fact that multiple persons could take into account the activities of a partnership under aggregate principles.¹⁶ Nothing seems as fundamental to partnership policy as the attribution of partnership activity to all partners, even to partners who own a 0.0001% limited partnership interest. This has

¹¹ See Blanchard, 6300 T.M., *PFICs*.

¹² A foreign corporation can be a CFC, excluded from PFIC status by reason of §1297(d), as to U.S. shareholders described in §951(b) but a PFIC as to other U.S. shareholders. This unfortunate situation will be far more common following the ill-advised repeal of §958(b)(4). A foreign corporation that would not have been a CFC under pre-2017 law can easily become one by virtue of that law change. As a result, the foreign corporation will no longer be able to use the fair market value of its assets to test its PFIC status, but will be forced to use adjusted basis instead. §1297(e)(2)(A). To the extent that the foreign corporation was relying, as many do, on the value of its self-developed goodwill to avoid PFIC status, it may become a PFIC even if it is clearly engaged in an active business. See Blanchard, *Top Ten Reasons To Limit §958(b)(4) Repeal*, 47 Tax Mgmt. Int’l J. 405 (June 8, 2018).

¹³ See Blanchard, 6300 T.M., *PFICs*.

¹⁴ The Preamble acknowledges some of the difficulties posed by applying §954 literally. See, e.g., pgs. 12–13.

¹⁵ See, e.g., Preamble at 39–42, 45, 77–80.

¹⁶ See Preamble at 40–41, 78.

long been the rule of §875 and §512(c), and at least in the case of §875 the IRS long sought to extend the principle beyond the distributive share cases to the sale of a partnership interest.¹⁷ The PFIC rules will

¹⁷ Rev. Rul. 91-32, 1991-1 C.B. 107. For a discussion of activ-

work properly if and only if the activities of a partnership are attributed to all partners.

ity attribution vs. general look-through principles, see Blanchard, *Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners*, 97 Tax Notes Today 173 (Sept. 8, 1997).