Comments on the "PFIC" Proposed Regulations and §1297(d)
[REG-118250-20]

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The Treasury Department and the Internal Revenue Service published proposed regulations on January 25, 2022 that address the treatment of foreign corporations owned by partnerships and S corporations.[1] Throughout the preamble to the proposed regulations (the "Preamble"), the government asserts that the proposed regulations are based on an "aggregate" approach to partnerships. Early commentary on the proposals took the government at its word; nearly all of the commentary characterized the proposed regulations as adopting aggregate principles.[2]

I do not agree that the proposed regulations are based on aggregate principles, at least as the term "aggregate," as distinguished from "entity," has generally been understood in Subchapter K. Instead, they are based on pass-through principles. Whether a partnership is treated as an aggregate or as an entity is a common law construct relevant to the manner in which transactions between a partner and a partnership are characterized for income tax purposes, and to whether a partner has a basis and holding period in its partnership interest distinct from the partnership's own basis and holding period.[3] In contrast, the pass-through principle is statutory, attributing a partnership's income items to its partners to reflect the fact that a partnership is not a taxpayer.[4]

The proposed regulations apply to both partnerships and S corporations, but the entity-aggregate distinction is relevant only to partnerships. The fact that an S corporation is treated as a partnership to the extent it has foreign income[5] should not change this immutable fact; among other provisions of Subchapter K, sections 721, 704, 707, 721 and 752 have no application to S corporations. An S corporation is by definition an entity. What partnerships and S corporation

[1] [REG-118250-20].

[2] *See, e.g.*, Velarde, "New PFIC Rules Favor Aggregate Approach to Partnerships," Tax Notes Jan 31, 2022; Olivo, "Power Shift in Proposed PFIC Rules Could Cause Headaches," Law360, Jan. 26, 2022; Jackel, Tax Notes Jan 31, 2022 p. 687.

[3] For a good recent summary of one issue where the aggregate-entity distinction is relevant, *see* Burke, "Sorting Out Partner Payments," 75 Tax Lawyer 1 (Fall 2021). For a more extensive discussion of the confusion between aggregate and pass-through principles, see Blanchard, "Rev. Rul. 91-32: Extrastatutory Attribution of Partnership Activities to Partners," 97 TNT 173-69 (Sept. 8, 1997).

[44] IRC §702(a).

[5] IRC §1373.

have in common is that they are both pass-through entities, and the statutory language implementing pass-through treatment in each case is nearly identical.[6]

Despite the preamble's frequent use of the term aggregate, it is clear that the proposed regulations, as well as final subpart F regulations issued at the same time,[7] are applying only straightforward pass-through principles.[8] The final regulations are issued under the authority of §958, which is a pass-through rule. They expressly reject application of aggregate principles to every issue relevant to the ownership of a foreign corporation other than §958. Specifically, Reg. §1.958-1(d)(2) treats a domestic partnership as owning stock of a foreign corporation (that is, it adopts what it considers to be "entity" principles) for purposes of, inter alia:

- Determining whether any United States person is a United States shareholder (as defined in §951(b));
- Determining whether any foreign corporation is a controlled foreign corporation (CFC) (as defined in §957(a)); or
- Applying §1248.

The retention of traditional "entity" principles for purposes of the above three sets of rules effectively treats domestic partnerships as hybrids: According to the IRS, they are "aggregates" for some purposes and "entities" for other purposes of the subpart F, GILTI and proposed PFIC rules. Because all of these rules work together and cross-reference each other, this hybrid approach is inconsistent with the general rule, referred to in the preamble, that whether a partnership is treated as an aggregate or as an entity should depend upon the purposes of the Code provision being applied.[9]

The hybrid approach gives rise to issues involving the application of the PFIC-CFC overlap rule in §1297(d). That subsection provides:

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[6] Compare §702 (" In determining his income tax, each partner shall take into account separately his distributive share of the partnership's gains and losses . . . exclusive of items requiring separate computation under other paragraphs of this subsection") with §1366(a)(1)(" In determining the tax under this chapter of a shareholder for the shareholder's taxable year in which the taxable year of the S corporation ends . . . there shall be taken into account the shareholder's pro rata share of the corporation's items of income (including tax-exempt income), loss, deduction, or credit the separate treatment of which could affect the liability for tax of any shareholder, and nonseparately computed income or loss.")

[7] TD 9960.

[8] The preamble correctly refers to its approach as a pass-through approach on pages 16 and 22.

[9] Reg. §1.701-2(e).

(1) **In general**. For purposes of this part, a corporation shall not be treated *with respect to a shareholder* as a passive foreign investment company during the qualified portion of *such shareholder's* holding period with respect to stock in such corporation.

(2) **Qualified portion**. For purposes of this subsection , the term "qualified portion" means the portion of *the shareholder's* holding period . . . during which *the shareholder is a United States shareholder (as defined in section 951(b)*) of the corporation *and the corporation is a controlled foreign corporation.* (emphasis added)[10]

Note that the general rule of §1297(d)(1) applies only to a particular shareholder during the qualified portion of *such shareholder's* holding period for the PFIC stock. To apply the qualified portion rule of §1297(d)(1), §1297(d)(2) tells us that we must look to the period in which the shareholder is a U.S. shareholder within the meaning of §951(b). There is no room here to interpret §1297(d) as applying to any U.S. shareholder other than the U.S. shareholder within the meaning of §951(b).

There is a fundamental tension here. Under the final §958 regulations, if a foreign corporation is majority or wholly-owned by a domestic partnership or S corporation, it is unambiguously treated as a CFC of which the domestic partnership or S corporation is the relevant §951(b) shareholder. Yet the proposed regulations ignore the fact that the foreign corporation is a CFC of which the domestic partnership or S corporation is the §951(b) shareholder for purposes of the §1297(d) overlap rule. Instead, the proposed regulations purport to apply "aggregate" principles, on the basis that the PFIC rules treat only the U.S. partners or shareholders as the relevant shareholder.[11] As a result, the §1297(d) overlap rule is not available to minority partners or S corporation shareholders who are not themselves §951(b) shareholders determined at the partner or shareholder level.

In discussing the rationale for not applying §1297(d) to a minority partner or shareholder of a domestic partnership or S corporation, the Preamble never mentions the fact that §1297(d) specifically looks to who is the *§951(b) shareholder* of an entity *treated as a CFC*. In fact, the Preamble's summary of §1297(d) seems to have been deliberately drafted to avoid the issue, by excising the reference to §951(b) from the text of §1297(d)(2).[12] The Preamble refers only to the fact that the PFIC regulations treat the partner or shareholder as the shareholder that takes income into account.

The reasoning behind this rule appears to be as follows. One first applies §1297(d)(1) as if it is referring to any person treated as a U.S. shareholder of a PFIC under the PFIC look-through rules, who might be a partner of a domestic partnership having a 0.1% indirect interest in the

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[10] IRC §1293(g) similarly uses the term §951(b) shareholder.

[11] *See* Prop. Reg. §1.1291-1(c)(5).

[12] The Preamble states at page 9 that "The term 'qualified portion' generally means the portion of the shareholder's holding period during which the shareholder is a U.S. shareholder with respect to the PFIC." Page 30 repeats this, again without mentioning that the term "U.S. shareholder" as used in the Code refers to a shareholder described in §951(b).

PFIC through the partnership. Next, one applies the qualified portion rule in §1297(d)(2) at the partner, not the partnership, level. Since a 0.1% indirect shareholder would never be a §951(b) shareholder, the overlap rule does not apply.

This approach makes mincemeat of the statutory language and the statutory scheme. The term "qualified portion" is used in both §1297(d)(1) and §1297(d)(2). In both places, the statute is clearly referring to the *same* U.S. shareholder. So long as the final regulations treat only the domestic partnership as the relevant §951(b) shareholder, the approach of the proposed regulations does not withstand scrutiny under normal doctrines of statutory interpretation.

The hybrid approach will often result in a foreign corporation being treated as a PFIC even though it would not be treated as a PFIC if owned by a group of owners not investing through a domestic partnership or S corporation. This result comes about because §1297(e) measures assets using adjusted basis, rather than fair market value, where the tested foreign corporation is a CFC. In any case where the tested foreign corporation operates a services or other business the assets of which consist primarily of goodwill, the use of adjusted basis will usually result in the corporation being a PFIC. This result would not arise if the domestic partnership or S corporation were treated as a true aggregate rather than as an entity.

Moreover, as long as the "entity" approach to domestic partnerships and §1248 set out at Reg. §1.958-1(d)(2) remains as it is, the special rule applicable to PFICs as to which a QEF election is made, set forth in §1248(d)(6), will be rendered a dead letter. That paragraph excludes from earnings and profits for §1248 purposes earnings and profits of a foreign corporation "attributable to any amount previously included in the gross income of [a U.S.] person under section 1293 with respect to the stock sold or exchanged, but only to the extent the inclusion of such amount did not result in an exclusion of an amount under section 1293(c)."[13] So long as the government continues to apply "entity" principles for purposes of §1248, this provision will be a dead letter because a domestic partnership or S corporation will never have a §1293 inclusion. This is especially strange given that §1293 is a pure pass-through rule, similar to the pass-through regimes that apply to partnerships and S corporations.

There is no question that as a policy matter, the approach that the proposed regulations take to the overlap issue is correct. What is unclear is why, rather than contradicting clear statutory language and creating unsupportable hybrid issues, the government did not choose simply to extend the same look-through or "aggregate" approach it applies to the attribution of income to the questions of what is a CFC and who is the §951(b) shareholder. Reg. §1.958-1(d)(2) could be changed to provide that in determining who is a §951(b) shareholder, pass-through principles apply. It could be revised to provide that the determination of whether a foreign corporation is a CFC is determined at the partner or S corporation shareholder level. That approach would be consistent with Prop. Reg. §1.1291-1(c)(5), and would be consistent with the policy of the overlap rule.

There is no policy reason why domestic partnerships should be treated differently from foreign partnerships under any of the subpart F or GILTI rules, or the PFIC rules that reference them.

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[13] IRC §1293(c) is to similar effect.

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Certainly, if the full pass-through or "aggregate" approach were applied for purposes of §1248, the government's approach to §1248 issues would need to change.[14] But those changes would greatly improve the manner in which §1248 dovetails with the final subpart F and GILTI regulations. Where a partnership is foreign, the §1248 regulations already look through the partnership, which they must do if §1248 is to be applied at all.

For many years, the government's position was that it did not have the authority to treat domestic and foreign partnerships in the same way, because subpart F applies to a "U.S. person," and a domestic partnership, unlike a foreign one, is clearly a U.S. person. But the government got over this literalism when it issued the now-final subpart F and GILTI regulations under §958 – because it had to, in order to make the GILTI rules operate properly.[15] It wasn't a big leap. Nothing in the Code says that a domestic partnership cannot be treated as an aggregate or as a pass-through entity for purposes of subpart F. And it should be.

Finally, if the proposed regulations are finalized is substantially their current form, they should provide automatic relief from the "late QEF" election rules that apply when a U.S. shareholder of a PFIC has not made a QEF election with respect to the PFIC for the first year in its holding period. Prior to the adoption of the final regulations under §958 treating a domestic partnership as an "aggregate" or pass-through entity, a minority U.S. shareholder owning stock of a foreign corporation indirectly through a domestic partnership would have had no reason to, or even ability to, make a QEF election for the underlying foreign corporation, because §1297(d) unequivocally applied such that the underlying foreign corporation was simply not a PFIC.[16] The IRS's change to the treatment of domestic partnerships was the sole cause of the underlying foreign corporation having to be tested for PFIC status. In this situation, it is inappropriate to look to the usual test for late QEF elections set out in §1295(b)(2), as the minority shareholder could not possibly have held any belief at all about the PFIC status of the tested foreign corporation prior to the change in the treatment of domestic partnerships.

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[14] *See* Blanchard, "U.S. Buyer Beware of Selling §1248 Wine in New Bottles," 48 TMIJ 512 (Oct. 11, 2019).

[15] The government also overcame it scruples on this point in order to deal with what it perceived as an abuse and are now referred to as "controlled domestic partnerships." *See* Reg. §1.951-1(h). *See also* Blanchard, "Notice 2010-41: Schrödinger's Cat," 39 Tax Mgmt. Int'l J. 402 (7/9/10).

[16] Following the issuance of these proposed regulations, for the reasons noted above, taxpayers could take different views of how §1297(d) applied. But even if it was clear following the issuance of the proposed regulation that §1297(d) would no longer apply, the problem remains that it was the change to the treatment of domestic partnerships made in the final regulations that gave rise to potential PFIC issues where none had existed before.

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