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Report No. 1462
April 25, 2022

The Honorable Lily Batchelder
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Thomas C. West, Jr.
Deputy Assistant Secretary
Department of the Treasury
1500 Pennsylvania Avenue
NW Washington, DC 20220

Mr. Krishna Vallabhaneni
Tax Legislative Counsel
Department of the Treasury
1500 Pennsylvania Avenue, NW
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Re: Report No. 1462 – Report on the Proposed Regulations Regarding PFICs and CFCs Held by Partnerships and S Corporations

Dear Ms. Batchelder and Messrs. West and Vallabhaneni:

I am pleased to submit Report No. 1462 of the Tax Section of the New York State Bar Association discussing the above mentioned proposed regulations regarding PFICs and CFCs held by partnerships and S corporations.

We appreciate your consideration of our Report. If you have any questions, please feel free to contact us and we would be happy to assist.

Respectfully Submitted,

Robert Cassanos
Chair

Enclosure

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Report No. 1462

New York State Bar Association Tax Section

Report on the Proposed Regulations Regarding PFICs and CFCs Held by Partnerships and S Corporations

April 25, 2022

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Report No. 1462

REPORT ON THE PROPOSED REGULATIONS REGARDING PFICS AND CFCS HELD BY PARTNERSHIPS AND S CORPORATIONS

This Report[1] was prepared by the New York State Bar Association Tax Section in response to the proposed regulations (the "***2022 Proposed Regulations***") dealing with certain passive foreign investment company ("***PFIC***") and controlled foreign corporation ("***CFC***") issues that were published in the Federal Register on January 25, 2022.[2]

We previously submitted a report on proposed PFIC regulations published by the Department of the Treasury ("***Treasury***") and the Internal Revenue Service ("***IRS***") on January 15, 2021.[3] This Report will focus on the 2022 Proposed Regulations and issues on which the preamble to the 2022 Proposed Regulations (the "***Preamble***") requested further comments. This Report does not comment on the provisions of the 2022 Proposed Regulations that address global intangible low-taxed income ("***GILTI***") rules for S corporations and related person insurance income.

I. Summary of Recommendations

We agree with the comment in the Preamble that the 2022 Proposed Regulations, if enacted in their present form, could increase the burden of PFIC compliance on taxpayers, pass-through entities, and the IRS compared to the burden currently borne by these stakeholders under the "entity" approach.

Among the principal areas of such increased complexity are the following:

- Partnerships and S corporations (collectively, "***pass-through entities***") need to institute new information sharing regimes to be able to pass along sufficient information in a timely manner to allow their direct and indirect owners to make a decision about whether a foreign corporation is a PFIC and, if so, whether to make a qualified electing fund ("***QEF***")

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[1] The principal drafters of this Report were Libin Zhang and Andrew Penman. Significant contributions were made by Nehal Patel. Helpful commentators included Kimberly Blanchard, Andrew Braiterman, Robert Cassanos, Olivier De Moor, Samuel Duncan, Rose Jenkins, Colin Kelly, Stephen Land, Jiyeon Lee-Lim, Ron Nardini, Richard Nugent, Yaron Reich, Jason Sacks, Michael Schler, Mark Schwed, Joseph Toce, Philip Wagman, and Andrew Walker. This Report expresses only the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee nor the House of Delegates of the New York State Bar Association.

[2] REG-118250-20, 87 Fed. Reg. 3890 (Jan. 25, 2022). Unless otherwise indicated, all section and regulation references are to the Internal Revenue Code of 1986, as amended (the "Code"), and the Treasury regulations promulgated thereunder.

[3] N.Y. State Bar Ass'n, Report No. 1450 - Report on the Proposed "PFIC" Regulations under Sections 1297 and 1298 (April 14, 2021).

election under section 1295(b), mark-to-market ("***MTM***") election under section 1296, and/or purging election under section 1298(b)(1) (collectively, "***PFIC Elections***"), if available. To take one of many examples, indirect owners of funds or operating partnerships (so-called "feeder" or "access" funds, for instance) often do not obtain information about specific acquisitions made by the lower-tier fund. While Schedules K-2 and K-3 to IRS Forms 1065 and 1120-S[4] would seem to require domestic pass-through entities (and certain foreign partnerships) to provide the required information about the entities' PFICs, we note that these schedules are newly required for the 2021 taxable year and have not been updated for the 2022 Proposed Regulations (such Schedules together, "***Schedules K-2/K-3***"). In addition, a threshold question in many cases is whether the foreign corporation is, in fact, a PFIC. The 2022 Proposed Regulations preserve and may increase the possibility that different pass-through entity owners might come to different conclusions about this question, which would make it difficult for the pass-through entity to determine each owner's inclusions.

- Pass-through entity owners need to be able to file their PFIC Elections in a timely manner. In this regard, we note that the Green Book contains a proposal to streamline the process for late PFIC Elections, because the volume of requests for such relief is already burdening the IRS. Shifting responsibility for this function from pass-through entities to their owners is more likely to increase, rather than decrease, the number of such requests, perhaps greatly.

- Pass-through entities need a regulatory scheme to be able to deal with the fact that once the entity approach is abandoned, it is possible that income allocations to their owners may not match QEF inclusions. A similar issue arises with respect to GILTI and subpart F inclusions of CFCs but the issue gets bigger once the universe expands to include all PFICs. We think these rules are likely to be complex. While the exact contours of these rules are outside the scope of this Report, we believe the cost and expense of complying with them should be considered in determining which approach minimizes compliance and complexity burdens.

In terms of balancing policy outcomes, we think that, on the whole, the interests of Treasury and the IRS are generally well aligned with the interests of taxpayers. Although there may be rare and unusual exceptions, all parties generally favor timely QEF elections in cases where an investment is being made in a foreign corporation that is a PFIC, at least where the information necessary to determine the QEF inclusions is available. Such timely elections are best assured by an entity or similar approach. On the other hand, such an approach may diminish the pass-through entity owner's ability to make a contrary choice, at least where an alternative investment vehicle is not available. However, the questions remain (1) when, if ever, a pass-through entity owner really would want to second guess the pass-through entity that actually made the investment on this issue, (2) even if the owner did, how it would procure and evaluate the information to make the determination, and (3) once it did, how it would make the actual election. In any event, to the extent the incremental costs of such an elective regime are borne by the pass-through entity, the

[4] *See* Schedule K-2 to IRS Form 1065 (2021), *available at* https://www.irs.gov/pub/irs-pdf/f1065sk2.pdf and Schedule K-3 to IRS Form 1065 (2021), *available at* https://www.irs.gov/pub/irs-pdf/f1065sk3.pdf.

owners of the pass-through entity who would otherwise wish to delegate this decision to the entity (who may constitute all or substantially all of such owners) may involuntarily end up bearing all or a portion of these costs.

In the discussion that follows, we seek to address these concerns by discussing three alternative approaches. We start with the "baseline" approach of retaining current law—i.e., the entity approach, which could be done either on an elective basis, on a temporary basis until some of the above issues are ironed out, or both. We next discuss two variants of an agency approach in which a pass-through entity's owners may delegate all or a portion of the PFIC Election process to the pass-through entity. In the first approach, the pass-through entity not only files the PFIC Election, but it also decides whether to make any PFIC Election and it does so consistently on behalf of all of its owners. This approach's goal is to produce results commensurate in their simplicity and ease with those obtained under the entity approach. Any pass-through entity owners who wish to preserve individual flexibility could avoid those pass-through entities or participate through alternative investment vehicles if there is sufficient interest to create them. The final alternative delegates (again on an elective basis) the filing responsibility to the pass-through entity but leaves the choice of whether to elect any PFIC Election with the ultimate pass-through entity owner. This approach maximizes each pass-through entity owner's choice but hopefully reduces the risk of late elections by creating a mechanism for entities to file on behalf of their owners.

In addition:

- We recommend that Treasury and the IRS issue appropriate guidance on how PFIC determinations and calculations are handled under the centralized partnership audit rules of the Bipartisan Budget Act of 2015 ("***BBA***") in connection with any finalization of the 2022 Proposed Regulations.

- We recommend that Treasury and the IRS consider allowing upper-tier pass-through entities to act as agents of their owners for purposes of providing notice of a PFIC Election to a lower-tier pass-through entity, regardless of the approach taken with respect to PFIC Elections generally.

- As noted above, we recommend regulations provide guidance as to how a pass-through entity deals with owners who make inconsistent PFIC Elections, in particular in connection with the pass-through entity's previously taxed earnings and profits ("***PTEP***") and adjustments to tax basis in the PFIC's stock, assuming these adjustments are made at the entity level. In particular, unless forthcoming regulations provide for adjustments solely at the owner level and have retroactive effect, an S corporation should be permitted to make special allocations of PTEP, gain, and other income items to deal with these issues, which should be reconciled with the pro rata income rules that apply to S corporations in section 1377(a). We note that this issue of special allocations is reduced, albeit not eliminated, if pass-through entities make PFIC Elections at the entity level or that are otherwise consistent for all owners.

- We recommend the final regulations clarify that an S corporation's PFIC inclusions are gross receipts for purposes of the section 1375 excess passive investment income tax and

the section 1362(d)(3) excess passive investment income termination of S corporation status.

- We recommend the final regulations clarify that when a domestic pass-through entity sells PFIC stock that is subject to section 1248, section 1248(d)(6) should apply to reduce the PFIC's section 1248 earnings and profits ("***E&P***") by any amounts previously included by the domestic pass-through entity's owners as PFIC inclusions in gross income.

- For the same administrative concerns as are relevant for PFIC Elections, we recommend continuing to allow entity-level elections for the Treas. Reg. § 1.1411-10(g) election. We also recommend that whatever treatment is allowed for domestic pass-through entities be extended to foreign partnerships with direct or indirect domestic non-corporate partners, given that the foreign partnerships and their partners have the same administrative concerns.

- We are supportive of the changes to the CFC Overlap Rule (as defined below). We recommend the final regulations explicitly provide that when a CFC becomes a PFIC with respect to a pass-through entity's owner due to the change in the CFC Overlap Rule, the owner is permitted to make a new QEF election for such PFIC to treat the PFIC as a pedigreed QEF thereafter. We also recommend the final regulations clarify that the CFC Overlap Rule continues to apply during the transitional period when the owner has either subpart F or GILTI inclusions, or both, allocated from the pass-through entity, and that it is not necessary to have both subpart F and GILTI inclusions for the transitional rule to apply.

- We recommend that the final regulations continue to determine the controlling domestic shareholder of a CFC at the domestic pass-through entity level. In contrast to PFIC Elections, a controlling domestic shareholder's elections are binding on all of the CFC's United States shareholders and are better made in a centralized manner.

II. Background

A. Treatment of PFICs Generally

A foreign corporation is a PFIC if either: (1) at least 75 percent of the gross income of such foreign corporation for the taxable year is passive income (the "***Income Test***"), or (2) the average percentage of assets held by such foreign corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent (the "***Asset Test***").[5] Passive income for purposes of the PFIC regime is any income which would be considered foreign personal holding company income as defined in section 954(c), subject to certain exceptions.[6]

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[5] Section 1297(a).

[6] *See* Section 1297(b)(1); Treas. Reg. § 1.1297-1(c).

A U.S. taxpayer (a "***PFIC shareholder***") that owns shares in a PFIC is subject to an excess distribution regime that generally taxes gains and distributions at ordinary income rates with an interest charge,[7] unless either a QEF election under section 1293 or MTM election under section 1296 has been made as to such shares. A PFIC shareholder is generally subject to the excess distribution regime whether it owns the PFIC stock, directly or indirectly, through domestic or foreign pass-through entities. If a domestic pass-through entity is the first domestic shareholder of PFIC stock in a chain of ownership, such entity reports certain information to all domestic owners of such pass-through entity. The domestic owners of such a domestic pass-through entity are PFIC shareholders for purposes of the excess distribution regime.[8]

A PFIC shareholder can avoid the excess distribution regime by making either a QEF election or an MTM election.[9] In a chain of ownership, these mutually exclusive elections must be made by the first U.S. person that is a PFIC shareholder.[10] When the first U.S. PFIC shareholder is a domestic pass-through entity, it is responsible for filing an IRS Form 8621 (Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund) to make the election, report certain information for such election, and report distributions received and gains recognized with respect to the PFIC. The election applies to all direct and indirect domestic owners of the domestic pass-through entity, with respect to the particular PFIC for which the election was made.[11] Such domestic owners of the domestic pass-through entity would take into account their share of the entity's QEF or MTM inclusions.

If a foreign partnership owns PFIC stock, any domestic partners of the foreign partnership are treated as PFIC shareholders for purposes of the PFIC regime.[12] The foreign partnership is thereby treated as an aggregate of its partners, and the domestic partners must make any PFIC Elections.

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[7] Section 1291(a)(1)(A).

[8] *See* Treas. Reg. § 1.1291-1(b)(8)(iii)(A) and (B). If the foreign corporation is a former PFIC as to unpedigreed QEF shares owned by the PFIC shareholder (that is, although the foreign corporation no longer satisfies the Income Test or the Asset Test, the shares are considered unpedigreed QEF shares because at some point during the taxpayer's holding period, the foreign corporation was a PFIC but no election was made as to such taxpayer's shares), purging elections may be made as to such shares under section 1298(b)(1). A taxpayer holds pedigreed QEF shares if the taxpayer made a QEF election effective as of the first day of the taxpayer's holding period or the taxpayer successfully purged the PFIC taint of its unpedigreed QEF shares.

[9] Section 1291(d)(1). The excess inclusion regime also does not apply if the PFIC stock is marked to market under section 475 or any other Code provision.

[10] *See* Treas. Reg. § 1.1295-1(d)(1). *See also* Treas. Reg. § 1.1296-1(b)(1).

[11] *See* Treas. Reg. §§ 1.1295-1(d)(2)(i)(A), 1.1295-1(d)(2)(ii).

[12] *See* Treas. Reg. §§ 1.1291-1(b)(8)(iii)(A), 1.1295-1(d)(2)(i)(B).

If a taxpayer makes a QEF election with respect to a PFIC, the PFIC is treated as a QEF with respect to such electing taxpayer.[13] The taxpayer generally includes its pro rata share of the QEF's ordinary earnings on a current year basis as ordinary income and the QEF's net capital gain on a current basis as long-term capital gains.[14] Late election relief is available for QEF elections generally when a taxpayer reasonably believed a foreign corporation was not a PFIC.[15] Regulations also provide for discretionary relief under a consent procedure when three conditions are met: (1) the taxpayer relied on a qualified tax professional, (2) granting consent will not prejudice the interests of the government and (3) the request for consent is made before the IRS raises the question of whether the foreign corporation is a PFIC.[16]

A shareholder may make an MTM election for "marketable stock" of a PFIC. Marketable stock is either: (1) any stock regularly traded on a registered national securities exchange or an exchange approved by the Secretary, or (2) stock in a foreign corporation which issues shares that are redeemable at net asset value.[17] If the marketable stock's fair market value exceeds its adjusted basis at the close of the taxable year, the MTM-electing shareholder would include such excess as gross income and increase its stock basis in the marketable stock. If the marketable stock's adjusted basis exceeds its fair market value at the close of the taxable year, the shareholder may deduct the lesser of such excess or prior MTM inclusions with respect to such stock as ordinary losses.[18]

B. Subpart F and GILTI

A U.S. person who owns 10% or more of the vote or value of a foreign corporation is a "United States shareholder."[19] A foreign corporation is a CFC if United States shareholders collectively own 50% or more of its vote or value.[20] Certain constructive ownership rules apply in determining ownership for United States shareholder and CFC purposes.[21] United States shareholders must generally include their pro rata share of a CFC's subpart F income and GILTI in gross income.[22]

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[13] A QEF election may be made only if the PFIC complies with certain requirements for purposes of determining the ordinary earnings and net capital gains of such company. *See* Section 1295(a)(2).

[14] Section 1293(a).

[15] Section 1295(b)(2); Treas. Reg. § 1.1295-3.

[16] *See* Treas. Reg. § 1.1295-3(f).

[17] Section 1296(e).

[18] *See* Section 1296(a)(2).

[19] Section 951(b).

[20] Section 957(a).

[21] Section 958.

[22] Section 951(a)(1).

On June 21, 2019, Treasury and the IRS published final regulations that applied aggregate treatment to domestic pass-through entities that own CFC stock for purposes of the GILTI rules, discarding the hybrid approach taken in prior proposed regulations.[23] The aggregate treatment provides that when a domestic pass-through entity owns CFC stock, generally only the entity owners who are themselves United States shareholders of the CFC have GILTI inclusions. At the same time, Treasury and the IRS issued proposed regulations to extend such aggregate treatment to domestic pass-through entities for purposes of subpart F income,[24] which were finalized in January 2022 (the "***2022 Final Regulations***").[25]

The 2022 Final Regulations do not extend aggregate treatment of pass-through entities to the determination of whether a foreign corporation is a CFC or whether a shareholder is a controlling domestic shareholder of the CFC.[26] Domestic pass-through entities therefore continue to be considered United States shareholders for purposes of determining whether United States shareholders collectively own 50% or more of the vote or value of a foreign corporation to make it a CFC.

C. Summary of the 2022 Proposed Regulations

a. *2022 Proposed Regulations*

The 2022 Proposed Regulations would align the PFIC rules as applied to domestic pass-through entities more closely with the 2022 Final Regulations and with the PFIC rules as applied to foreign partnerships.[27]

Currently, a domestic pass-through entity is considered a PFIC shareholder for purposes of making any QEF or MTM elections. The 2022 Proposed Regulations would treat a domestic pass-through entity as an aggregate and not a U.S. person for such purposes.[28] If the domestic owner of a domestic pass-through entity is treated as owning PFIC stock, it would make any available PFIC Elections and determine its own QEF and MTM inclusions as if it held the PFIC stock

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[23] T.D. 9866, 84 Fed. Reg. 29288 (June 21, 2019).

[24] REG-101828-19, 84 Fed. Reg. 29114 (June 21, 2019).

[25] T.D. 9960, 87 Fed. Reg. 3648 (Jan. 25, 2022). The 2022 Final Regulations became effective on, and apply to taxable years of foreign corporations that being on or after, January 25, 2022, and the taxable years of U.S. persons in which or with which such foreign corporations' taxable years end. A domestic partnership may apply the aggregate approach described in the 2022 Final Regulations to any taxable year of a foreign corporation beginning after December 31, 2017 as long as the application of such final regulations is consistently applied to all foreign corporations owned by the domestic partnership.

[26] *See* Treas. Reg. § 1.964-1(c)(5).

[27] *See* 87 Fed. Reg. 3890.

[28] *See* 87 Fed. Reg. 3895 ("Thus, under the proposed regulations, neither domestic partnerships nor S corporations are considered shareholders for purposes of making QEF or MTM elections, recognizing QEF inclusions or MTM amounts, making PFIC purging elections, or filing Forms 8621. Proposed §§1.1291-1(b)(7), 1.1295-1(j)(3), 1.1296-1(a)(4).")

directly. If the domestic owner of a pass-through entity makes a late QEF election and holds unpedigreed QEF shares, the owner would also be responsible for making any available purging elections or obtaining discretionary relief for a retroactive QEF election. The 2022 Proposed Regulations are silent on the issue of whether a domestic owner of a domestic pass-through entity should be responsible for determining whether such owner indirectly owns PFIC stock through such domestic pass-through entity (including such stock owned indirectly through lower-tier domestic or foreign partnerships), which has historically been the case for domestic partners in foreign partnerships. However, we note that the Schedules K-2/K-3 reporting regime (which is referenced in the Preamble[29]) contemplates that domestic pass-through entities (and foreign partnerships that are required to file an IRS Form 1065) are responsible for determining whether a foreign corporation is PFIC. The balance of this report assumes, except where noted, that the Schedules K-2/K-3 reporting regime will be appropriately adjusted to reflect the 2022 Proposed Regulations once finalized in such a way that responsibility for this PFIC status determination will remain with the pass-through entity (except in the case of foreign partnerships not required to file a Form 1065).

The domestic owners of a domestic pass-through entity would file Form 8621 instead of the domestic pass-through entity. To facilitate the domestic owners' PFIC Elections, a pass-through entity would report certain information with respect to the PFIC stock on Schedules K-2/K-3 to its owners.[30] Within 30 days of making a PFIC Election, the domestic owners of the domestic pass-through entity must notify the pass-through entity of any such election.[31]

Any preexisting QEF and MTM elections made by a domestic pass-through entity that are effective for taxable years ending on or before the 2022 Proposed Regulations' effective date would be treated as made by any domestic owner that owns an interest in such domestic pass-through entity as of the effective date.[32]

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[29] *See* 87 Fed. Reg. 3895 ("In addition, the new reporting by partnerships on Schedule K-2, "Partners' Distributive Share Items—International," and Schedule K-3, "Partner's Share of Income, Deductions, Credits, etc.—International" is expected to facilitate a partner's ability to make the QEF election") and 3899 ("While these changes represent a change in the PFIC shareholders required to file an annual report under section 1298(f), a domestic partnership or S corporation will continue to have a responsibility to report information with respect to the PFICs it owns to its interest holders on Schedule K-3, "Partner's Share of Income, Deductions, Credits, etc.—International," of Forms 1065, "U.S. Return of Partnership Income," and 1120-S, "U.S. Income Tax Return for an S Corporation," respectively, when required.").

[30] *Id*.

[31] Prop. Treas. Reg. §§1.1295-1(d)(2)(i)(A) and 1.1295-1(d)(2)(ii)(A). *See also* 87 Fed. Reg. 3905. To the extent the requirement that a PFIC shareholder provide notice of a PFIC Election to a domestic pass-through entity is intended to allow the domestic pass-through entity to provide such PFIC shareholder with information needed to make and maintain such election, we note that there is an apparent timing mismatch since the PFIC shareholder presumably makes the election only after receiving Schedules K-2/K-3 from the pass-through entity indicating that the entity owns any PFICs.

[32] 87 Fed. Reg. 3896, 3897.

b. *CFC Overlap Rule Proposed Regulations*

A foreign corporation is not treated as a PFIC with respect to a shareholder generally during the qualified portion of the period (in 1998 or later) during which the shareholder is a United States shareholder (as defined in section 951(b)) of the corporation and the corporation is a CFC (the "***CFC Overlap Rule***").[33] Legislative history indicates that the CFC Overlap Rule was enacted due to concern about the simultaneous application of the subpart F and PFIC regimes to the same shareholders, explaining that ''a shareholder that is subject to current inclusion under the subpart F rules with respect to stock of a PFIC that is also a CFC generally is not subject also to the PFIC provisions with respect to the same stock.''[34]

When the United States shareholder is a domestic partnership, the CFC Overlap Rule has been applied in several private letter rulings at the partnership level to treat the foreign corporation as a CFC and not a PFIC for the domestic partnership and all of its partners.[35] As a result, the direct and indirect domestic partners of the domestic partnership's subpart F income from the CFC, regardless of whether they indirectly owned more or less than 10% of the CFC. If the same interpretation were to apply to taxable years after the enactment of the Tax Cuts and Jobs Act of 2017 ("***TCJA***") in which the aggregate treatment of partnerships applies for subpart F and GILTI purposes, a domestic partner in the domestic partnership would have neither subpart F (or GILTI) inclusions nor PFIC inclusions from a CFC in which the partner indirectly owns less than 10% of the stock.

The 2022 Proposed Regulations align the aggregate treatment of domestic pass-through entities for purposes of subpart F income and GILTI inclusions, and the CFC Overlap Rule. The 2022 Proposed Regulations provide that a domestic pass-through entity is not a shareholder of a foreign corporation for purposes of the CFC Overlap Rule,[36] notwithstanding the fact that a domestic pass-through entity is a United States shareholder (as defined in section 951(b)) of a CFC under Treas. Reg. § 1.958-1(d)(2)(i). As a result, a foreign corporation owned by a domestic pass-through entity may be a CFC with respect to the larger pass-through entity owners and may be a PFIC with respect to the smaller pass-through entity owners.

The 2022 Proposed Regulations contain a transitional rule for the CFC Overlap Rule that generally applies to a shareholder's taxable years beginning before the finalization of the 2022 Proposed Regulations.[37] The CFC Overlap Rule continues to apply during the period when the shareholder is an indirect shareholder of the CFC through a domestic pass-through entity, and the shareholder includes in gross income its share of any of the domestic pass-through entity's subpart F and GILTI inclusions from the CFC.

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[33] Section 1297(d)(1).

[34] H.R. Rep. 105-148, at 534 (1997).

[35] *See* PLR 200943004 (Oct. 23, 2009); PLR 201106003 (Feb. 11, 2011) (citing the definition of a "U.S. Person" under section 7701(a)(30)).

[36] Prop. Treas. Reg. §§ 1.1291-1(c)(5)(i), 1.1291-1(b)(7).

[37] Prop. Treas. Reg. § 1.1291-1(c)(5)(ii).

c. *Controlling Domestic Shareholder Regulations*

A CFC's "controlling domestic shareholders" are those United States shareholders that collectively own (directly or indirectly under section 958(a)) more than 50% of the CFC's voting stock and undertake to act on the CFC's behalf.[38] If the CFC's United States shareholders do not own (under section 958(a)) in the aggregate more than 50% of the CFC's voting stock, the CFC's controlling United States shareholders are all of the CFC's United States shareholders who own (under section 958(a)) the CFC's stock.[39]

The controlling domestic shareholder concept was originally introduced in 1964 to enable the CFC to make certain tax elections or accounting method changes in computing its E&P,[40] but its scope has expanded significantly after the TCJA to cover decisions such as the CFC group election under section 163(j),[41] the calculation of certain pre-TCJA asset amounts for purposes of the qualified business asset investment rules under GILTI,[42] and the GILTI high tax exclusion.[43]

When a CFC has multiple controlling domestic shareholders, each controlling domestic shareholder decision requires unanimity. Upon making an election or other decision, the controlling domestic shareholders are required to provide notice to the CFC's other United States shareholders who are not controlling domestic shareholders, though they are bound by the decision even if no notice is given.[44]

When a domestic pass-through entity owns stock of a CFC, the controlling domestic shareholder determination of the CFC is made at the pass-through entity level,[45] with the result that the domestic pass-through entity can be the CFC's controlling domestic shareholder that makes the CFC's tax elections.

The 2022 Proposed Regulations would apply aggregate treatment to a domestic pass-through entity in determining a CFC's controlling domestic shareholder.[46] When the domestic pass-through entity owns the stock of a CFC, the CFC's applicable tax elections would be made by the ultimate direct or indirect owners of the pass-through entity that are U.S. individuals, corporations, trusts, or estates. Pursuant to the 2022 Proposed Regulations, the requirement to

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38 Treas. Reg. § 1.964-1(c)(5)(i).

39 *Id.*

40 T.D. 6764, 29 Fed. Reg. 14628 (Oct. 27, 1964).

41 Treas. Reg. § 1.163(j)-7(e)(5) and (k)(12).

42 Treas. Reg. § 1.951A-3(e)(3).

43 Treas. Reg. § 1.951A-2(c)(7)(viii)(A)(*1*)(*i*).

44 Treas. Reg. § 1.964-1(c)(3)(iii).

45 Treas. Reg. § 1.958-1(d)(2)(v).

46 87 Fed. Reg. 3900.

provide notice to United States shareholders of the CFC that hold an interest in such CFC indirectly through a domestic partnership may be satisfied by providing notice to such domestic partnership.[47]

d. *Treas. Reg. § 1.1411-10(g) Election*

Section 1411 imposes a 3.8% net investment income tax on a non-corporate taxpayer's net investment income in excess of certain thresholds. Net investment income generally includes interest, dividends, annuities, royalties, rents, and net gain attributable to the disposition of property.[48] Subpart F, GILTI, and QEF inclusions from a foreign corporation are not net investment income. Instead, the foreign corporation's shareholder has net investment income when the foreign corporation distributes amounts that are PTEP under the regular income tax rules, which are treated as dividends for section 1411 purposes and thus included in net investment income.[49] However, a shareholder can make an election under Treas. Reg. § 1.1411-10(g) to treat its subpart F, GILTI, and QEF inclusions from a foreign corporation as net investment income, in order to better align the regular income tax rules and the section 1411 rules. The irrevocable election is made separately for each foreign corporation and applies to all future taxable years.[50]

When a domestic pass-through entity owns CFC stock, the pass-through entity can make the Treas. Reg. § 1.1411-10(g) election with respect to each CFC or QEF that it holds directly or indirectly through foreign entities. Furthermore, an individual, estate, trust, domestic partnership, or S corporation can make the Treas. Reg. § 1.1411-10(g) election with respect to a CFC or QEF held through a domestic pass-through entity if the domestic pass-through entity does not make such election.[51]

The 2022 Proposed Regulations provide that the Treas. Reg. § 1.1411-10(g) election can only be made by a U.S. individual, estate, or trust, and therefore the election cannot be made by a domestic pass-through entity.[52]

III. Issues with PFIC Elections under the 2022 Proposed Regulations

A. PFIC Determinations

As a threshold matter, we note that in considering the impact of the 2022 Proposed Regulations, there are frequently cases of significant uncertainty regarding whether a given foreign corporation is a PFIC. While one might naturally expect that the responsibility for determining

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47 Prop. Treas. Reg. § 1.964-1(c)(3)(iii)(B).

48 Section 1411(c)(1)(A).

49 Treas. Reg. § 1.1411-10(c)(1).

50 Treas. Reg. § 1.1411-10(g)(2) and (3).

51 Treas. Reg. § 1.1411-10(g)(3).

52 87 Fed. Reg. 3902.

whether an entity is a PFIC would be aligned with the obligation to file Form 8621 and the ability to decide which PFIC Election, if any, to make, we read the Preamble's reference to reporting on Schedule K-3 to imply that domestic pass-through entities that hold stock of foreign corporations will continue to determine whether it holds interests in entities that are classified as PFICs.[53] The current instructions to the Schedule K-3 require a domestic pass-through entity (and a foreign partnership that files Form 1065) to report information concerning each PFIC owned by the pass-through entity, subject to certain exceptions (including if a domestic pass-through entity has made a PFIC Election with respect to such entity under current law).[54]

Assuming the Schedule K-3 reporting requirements with respect to PFICs would remain intact following any finalization of the 2022 Proposed Regulations (with appropriate adjustments to reflect those regulations), it would appear that responsibility for determining PFIC status would be divorced from the responsibility for filing Forms 8621 and making any PFIC Elections, in the sense that the former determination would remain an entity responsibility and the latter determination would become an owner responsibility. We think this division of responsibility may have unintended consequences. For example, under the existing entity approach, at least in the case of domestic entities, whether a late filed Form 8621 should be permitted is presumably evaluated solely by reference to the conduct of the domestic entity in question, which has the responsibility for making the determination and the PFIC Election.

Under the 2022 Proposed Regulations, this responsibility could become diffused. For example, suppose a domestic partnership ("PRS") owns stock in a foreign corporation and erroneously concludes that it is not a PFIC. No PFIC is listed on PRS' Schedule K-3, but the foreign corporation is in fact a PFIC. What standard should one use to determine whether a limited partner of PRS met the standard to permit a late PFIC Election with respect to the PFIC? It seems

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[53] *See* 87 Fed. Reg. 3899 ("The changes to the section 1298(f) information reporting requirements in proposed § 1.1298-1 reflect the general shift in the treatment of domestic partnerships and S corporations as aggregates for purposes of the PFIC regime. *While these changes represent a change in the PFIC shareholders required to file an annual report under section 1298(f), a domestic partnership or S corporation will continue to have a responsibility to report information with respect to the PFICs it owns to its interest holders on Schedule K-3, "Partner's Share of Income, Deductions, Credits, etc.—International," of Forms 1065, "U.S. Return of Partnership Income," and 1120-S, "U.S. Income Tax Return for an S Corporation," respectively, when required.* The general information reporting obligations of domestic partnerships and S corporations with respect to their interest holders should result in the interest holders receiving the information required to satisfy their filing obligations under section 1298(f).") (*emphasis added*).

[54] *See* Partnership Instructions for Schedules K-2 and K-3 (Form 1065) (Aug. 25, 2021), *available at* https://www.irs.gov/pub/irs-pdf/i1065s23.pdf, at page 19 ("Except as otherwise provided, Schedules K-2 and K-3, Part VII must be filed by every partnership that owns PFIC stock, directly or indirectly, unless the partnership knows it has no direct or indirect partners that are U.S. persons, including U.S. persons that own an indirect interest in the partnership through one or more foreign entities. However, a domestic partnership that has elected to treat a PFIC as a pedigreed qualified electing fund (QEF), made a mark-to-market (MTM) election with respect to a PFIC applicable to the partnership's tax year, or made a qualifying insurance corporation (QIC) election with respect to a PFIC for the partnership's tax year is not required to complete Schedules K-2/K-3, Part VII with information regarding such PFIC if the partnership files Form 8621 for that PFIC. Additionally, a domestic partnership that satisfies the deemed election requirements of Regulations section 1.1297-4(d)(5)(iv) with respect to a PFIC eligible for a QIC election is not required to complete Schedules K-2/K-3, Part VII with respect to such PFIC."). *See also* S Corporation Instructions for Schedules K-2/K-3 (Form 1120-S) (Aug. 26, 2021), *available at* https://www.irs.gov/pub/irs-pdf/i1120s23.pdf, at page 14.

difficult to impute to the partner knowledge it did not have or to make it suffer for any shortcomings of PRS's diligence in this regard. On the other hand, moving the determination of PFIC status to the partner level could be even more complicated from a compliance perspective than the approach taken by the 2022 Proposed Regulations. A given partner (especially one in an upper-tier entity in a tiered or fund-of-funds structure) may not even be aware that PRS owns a foreign corporation and may lack the knowledge to make a PFIC determination about it in any event.

While the Green Book has proposed liberalizing the requirements for late filed Forms 8621, both for individuals and entities, the scope of this proposal is not entirely clear and it may not become law. In light of these uncertainties, if the approach of the 2022 Proposed Regulations is retained, we recommend that Treasury and the IRS clarify, via regulation (or failing that, by preamble to the final regulations), (a) that determination of PFIC status of a foreign corporation owned by a pass-through entity is in fact solely the pass-through entity's responsibility, (b) whether such a pass-through entity's determination that a foreign corporation is (or is not) a PFIC is a "position" that a PFIC shareholder must disclose against if it wishes to take an inconsistent position on its own tax return, (c) what the standards are for permitting the late filing of Form 8621 by an owner of a pass-through entity, and (d) whether the determination of PFIC status and any PFIC Elections made with respect to PFIC stock are partnership-related items under the BBA and, if so, how any liabilities resulting from inconsistent PFIC status determinations and/or inconsistent PFIC Elections should be handled.[55]

We note that the adoption of an aggregate approach to PFIC Elections may increase the likelihood of pass-through entity owners taking differing views on whether certain foreign corporations held by the pass-through entity are PFICs. Although domestic pass-through entities will presumably continue to report certain PFIC information on Schedules K-2/K-3 and thereby decide at the entity level whether or not a foreign corporation is a PFIC, it may be more likely for a pass-through entity owner to inadvertently disregard PFIC information reported on Part VIII of Schedule K-3 than to disregard PFIC income inclusions reported on the front of Schedule K-1. Making clear as mentioned above that taking an inconsistent position with a statement on Schedule K-3 triggers a flagging requirement could reduce this risk. The number of inconsistent positions may be further expanded by the change in the CFC Overlap Rule that causes more owners of domestic pass-through entities to indirectly own foreign corporations that are not CFCs and may or may not be PFICs.

B. Potential Compliance Burdens

Treasury and the IRS have requested comments on whether final regulations should permit pass-through entities to make certain PFIC Elections in connection with the general rule that would require owners of pass-through entities to determine whether to make any available PFIC Elections with respect to PFIC stock held through a domestic pass-through entity. We are concerned that the 2022 Proposed Regulations approach of having PFIC Elections made at the pass-through entity

[55] We note that a partner may generally only take an inconsistent positon from the partnership if the partner discloses such position to the IRS on its return. *See* Section 6222.

owner level, rather than at the entity level, will result in significant administrative burdens for taxpayers and the IRS alike. Specifically, we concerned about the following consequences:

- Significant multiplication of annual QEF filings. We are concerned that the shift to a full aggregate approach will dramatically multiply the number of PFIC Elections being filed, as each domestic beneficial owner of a pass-through entity that holds a PFIC must now make its own PFIC Elections with respect to such PFIC. For example, a domestic partnership with 100 domestic partners that holds interests in two PFICs would previously have filed at most two QEF elections (one for each PFIC). Under the 2022 Proposed Regulations, such a structure may result in as many as 200 QEF elections. In reality, it is not unusual for a partnership to hold many more than two PFICs and to have several hundred direct and indirect partners that are U.S. taxpayers in tiered structures, with the result that the 2022 Proposed Regulations would require several thousand additional QEF elections to be filed for each such partnership and its owners. This multiplication of PFIC Elections will create a significant administrative burden for taxpayers and their advisors, as well as the IRS, which will likely be required to receive and process significantly more PFIC Elections than it has handled historically.

- Shift of PFIC compliance burden to small domestic partners. We expect the 2022 Proposed Regulations would, in the aggregate, shift the burden of preparing PFIC Elections from institutions and larger investors to small domestic partners, who tend to be less familiar with the PFIC rules in general and PFIC Elections in particular. For example, with respect to PFICs held through private investment funds, fund sponsors generally employ both in-house and outside accountants and legal professionals to advise them on tax issues, including PFIC status and the ability to make PFIC Elections, and handle the preparation of tax returns and reporting packages. These entities and their advisors are best positioned to negotiate for access to information from underlying PFICs. While pass-through entities may continue to collect and provide information to their owners on Schedules K-2/K-3 under the 2022 Proposed Regulations, such entities and their advisors will likely remain better positioned to evaluate that information and use it to prepare and maintain timely PFIC Elections than smaller taxpayers that are more likely to rely on a single tax accountant or may even be self-preparing returns in certain cases. In any event, small domestic taxpayers with minimal indirect interests in PFICs are likely to incur substantial incremental costs in connection with engaging their accountants to prepare and file individual QEF elections. A small taxpayer may be better served by receiving an income allocation from a domestic pass-through entity that already includes such taxpayer's share of income resulting from a PFIC Election made at the pass-through entity level rather than by receiving all of the information needed to calculate such amounts.

    - In the Green Book for Fiscal Year 2023,[56] the Biden Administration proposed greater flexibility for taxpayers to make retroactive QEF elections, including with respect to closed taxable years. The Green Book notes that QEF elections reduce tax costs to investors while also increasing tax compliance by incentivizing

[56] Dept. of the Treasury, *General Explanations of the Administration's Fiscal Year 2023 Revenue Proposals*, March 2022 (commonly referred to as the "*Green Book*"), at 14-15.

taxpayers to self-report investments in PFICs. In particular, the Green Book is concerned with the burdens that an inadvertent failure to file a QEF election can impose on taxpayers and the IRS and, in suggesting such relief extend to entities, points out that "it is less common for partnerships and other non-individual taxpayers to inadvertently fail to make a QEF election."[57] This tacitly acknowledges that while a partner (or other ultimate taxpayer) is the person most affected by making a PFIC Election, the partner is less likely to be equipped to make a PFIC Election in a timely manner and therefore more likely to have to seek relief for late elections.

- Issues with required access to information; confidentiality concerns. Current rules generally require that the PFIC Annual Information Statement provided by a PFIC must include a statement that the PFIC will permit the electing PFIC shareholder to inspect and copy certain of the PFIC's books of account, records, and other documents.[58] It is less likely that owners of pass-through entities will be able to obtain an agreement to such effect from the pass-through entity's underlying PFICs, particularly for indirect owners that hold PFICs through multiple tiers of pass-through entities. If the 2022 Proposed Regulations are adopted, they should be revised to reflect that if a domestic pass-through entity that provides Schedule K-2/K-3 reporting for a PFIC has obtained a statement from a PFIC that the PFIC will permit the direct shareholder of the PFIC (that is, the lowest-tier domestic pass-through entity itself) to inspect and copy certain of the PFIC's books of account, records, and other documents, each PFIC shareholder that holds an interest in an applicable PFIC through such domestic pass-through entity will be treated as having satisfied the information access requirements.

- Imposition of expanded reporting burdens on pass-through entities. In its current form, Schedule K-3 appears to require pass-through entities that hold PFICs to report all information that may be needed by their owners with respect to a PFIC Election, or to determine their excess distribution inclusions, regardless of whether any indirect PFIC shareholder actually makes any such PFIC Elections. It is not clear whether this information is intended to be prepared generically for owners (i.e., based solely on an owner's share of entity items) or if the report is intended to be specifically modified based on notices received from specific owners pursuant to the notice requirement discussed above, in which case the pass-through entity would need to further tailor any PFIC reporting based on the PFIC Elections made by its owners. The current entity regime allows domestic pass-through entities to limit the amount of PFIC reporting to the information that is needed to make and maintain their own PFIC Elections.

- Issues with determining income inclusions resulting from a PFIC Election in pass-through entities. As described in more detail below under "Tracking Basis Adjustments in PFIC Stock at the Entity Level", a pass-through entity owner's indirect percentage ownership of PFIC stock held by a pass-through entity may be difficult to determine and/or vary year-

[57] *Id.*

[58] Treas. Reg. § 1.1295-1(g)(1)(iv)(A).

by-year (or within a year). Accordingly, such owner's income inclusion pursuant to a PFIC Election may be difficult to determine.

IV. Alternative Approaches to PFIC Elections

While we appreciate Treasury and the IRS's desire to take a theoretically consistent approach as between various aspects of the PFIC rules and the subpart F/GILTI rules, we believe it is appropriate to seek an approach which balances theoretical consistency with ease of administrability. Both taxpayers and the fisc have aligned interests in minimizing the number of late PFIC Elections and inadvertent failures to make PFIC Elections, both of which already occur often enough to be unduly burdensome to Treasury.[59] We believe that Treasury and the IRS should favor whatever approaches are most administrable and likely to result in the highest levels of compliance in a given context.

In the first instance, we consider how these goals are served by the full entity approach taken under current law, which could be retained on an elective and/or temporary basis. Alternatively, in line with Treasury and the IRS's request for comments on "whether final regulations should permit a domestic pass-through entity-level QEF election on behalf of its owners, in conjunction with the general rule requiring the owner of the pass-through entity to make the election,"[60] we consider how the potential adverse effects of the 2022 Proposed Regulations could be mitigated by adopting an elective "agency" approach that retains the aggregate approach with optional modifications to help ensure the PFIC Election rules remain more administrable than the approach suggested in the 2022 Proposed Regulations. The modifications considered under the agency approach are intended (i) to be elective and (ii) to enable taxpayers to make timely PFIC Elections in the greatest number of cases.

This Report considers two ways to implement the agency approach, which for purposes of convenience are called the "delegated" and "direct" agency approaches. Generally, under either agency approach, the pass-through entity in question obtains as a contractual matter the authority to file PFIC Elections on behalf of its owners. In the delegated agency approach, the pass-through entity owners delegate to the pass-through entity the obligation to file any PFIC Election and also the right to determine which election (if any) is made, provided that the entity does so uniformly for all applicable entity owners with respect to each PFIC whose shares are owned by the entity. In the directed agency approach, the pass-through entity would have the obligation to file the PFIC Election and would be obliged to make whichever election was directed by the entity owner in question, which may be pursuant to an advance directive in a subscription document or done on a case-by-case basis. In the directed agency approach the pass-through entity acts in a purely

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[59] *See, e.g., Green Book* at 14-15 ("Additionally, there are large individual and administrative costs under the current law for the existing special consent procedure [under Section 1295(b)(2)]. The existing procedure requires a taxpayer to file a ruling request with the IRS and pay a user fee that is currently several thousand dollars. The IRS receives many requests for consent, which result in the use of IRS time and resources to determine whether consent should be granted and, if so, to issue the private letter ruling.").

[60] 87 Fed. Reg. 3896.

ministerial capacity at least with respect to which PFIC Elections to make, if any, and for whom.[61] We analyze the benefits of the approach taken under current law as well as both agency approaches below and, per Treasury and the IRS's requests, with respect to the agency approaches specifically consider:

(i) the legal mechanism by which the domestic pass-through entity would be delegated the ability to make a QEF election on behalf of its owners;
(ii) the standard of delegation that should be required, including whether delegation should be based on the partnership agreement or the S corporation's organizational documents, or some other instrument, and, if so, whether delegation should be explicit or implicit within the instrument;
(iii) whether the domestic pass-through entity's election should be binding on all owners, or only on certain owners;
(iv) if binding on all owners, whether certain owners should be allowed to opt out and whether an opt-out is consistent with the current rules; and
(v) the timing, filing, and notification requirements that should apply to a domestic pass-through entity-level QEF election, taking into account the possibility of nonconforming taxable years among the pass-through entity and its owners and the QEF.[62]

While each agency approach has benefits and limitations, they both have the potential benefit of equalizing the treatment of foreign and domestic pass-through entities with respect to PFIC Elections. We understand that Treasury and the IRS have historically viewed the reference to "United States persons" in sections 1293 and 1296 as prohibiting them from allowing foreign partnerships to make a PFIC Election with respect to PFIC stock held by such foreign partnerships. Under both agency approaches, a pass-through entity would not make the election for itself, but would instead make the election on behalf of, and as agent for, its domestic owner. As a result, we do not think Treasury and the IRS should be restricted from extending this approach to both foreign and domestic pass-through entities, which could result in lessening administrative complexity for both taxpayers and the IRS compared to the approach taken in the 2022 Proposed Regulations (although not compared to the rules now in effect for domestic pass- through entities). Even if the current law entity approach were to be retained for domestic entities, we note that the agency approach could be implemented to allow foreign partnerships to file PFIC Elections on behalf of their direct or indirect domestic owners.

In addition, both agency approaches would have the benefit of allowing the domestic pass-through entities holding PFIC stock to act as a direct or indirect agent of a PFIC shareholder with respect to the requirement to obtain permission from the PFIC to "inspect and copy the PFIC's permanent books of account, records, and such other documents as may be maintained by the PFIC to establish that the PFIC's ordinary earnings and net capital gain are computed in accordance with

[61] Whether the pass-through entity would still retain the ability to make the determination of PFIC status it would have under current law might require further thought, although, as noted above, the Schedules K-2/K-3 reporting regime indicate that it would.

[62] *Id.*

U.S. income tax principles, and to verify these amounts and the shareholder's pro rata shares thereof" in order to make a QEF election.[63]

Under either agency approach, the election mechanics under section 1294, which allow taxpayers to elect to defer payment of tax with respect to QEF inclusions until an actual distribution is received, would need to be appropriately ported over from the current entity regime. Currently a U.S. person that indirectly holds an interest in a PFIC through a domestic pass-through entity generally does not need to file a Form 8621with respect to such PFIC (assuming certain conditions are met), but the U.S. person would file a Form 8621 to make a section 1294 election for the PFIC.[64] While no special rule would be required under the 2022 Proposed Regulations generally (as the indirect PFIC shareholder would be responsible for filing Form 8621), if either agency approach were to be adopted, a similar rule to the one under current law should make clear that indirect PFIC shareholders would file a separate Form 8621 (in addition to the Form 8621 filed on their behalf by the pass-through entity that directly holds the PFIC) to make a section 1294 election with respect to any PFIC held through a pass-through entity.

Neither the current "entity" approach nor the Delegated Agency Approach discussed in more detail below permit owners of a pass-through entity to come to different judgments about whether or not to make a PFIC Election, and if so, which one. However, both approaches may allow indirect PFIC shareholders to take an inconsistent position with respect to the issue of whether a foreign corporation owned by the pass-through entity is a PFIC. We do not view this PFIC Election consistency issue as an obstacle, however, because these approaches are being proposed only as options which the pass-through entity can determine to adopt or not, assuming in the case of the Delegated Agency Approach that its organizational documents permit it to undertake the relevant tasks of making and/or filing elections on behalf of its owners. Therefore we assume that in the unlikely event there is any call for different PFIC Elections, the market could sort itself out and that pass-through entities that do not care to bind their owners to a particular PFIC Election (which might include closely held entities whose owners are highly sophisticated and are used to evaluating these sorts of tax issues) could be more likely to use the approach set forth in the 2022 Proposed Regulations, while all other entities (including for example, entities with less sophisticated and/or more numerous owners) would be more likely to adopt one of these options if offered. Furthermore, we believe there are many cases in which an investor in a managed entity, such as a fund, would not want to take on the responsibility of filing the PFIC Election and dealing with the consequences if not properly filed, and that there should be a method provided to allow such investors to delegate that responsibility.[65]

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63 Treas. Reg. § 1.1295-1(g)(1)(iv)(A).

64 *See* Instructions for Form 8621 (Dec. 16, 2021), *available* https://www.irs.gov/pub/irs-pdf/i8621.pdf, at page 5.

65 On the other hand, the approach taken by the 2022 Proposed Regulations and the Directed Agency Approach would permit pass-through entity owners to reach different conclusions and take different positions with respect to these items. While we think there are administrative costs and complexity to allowing this flexibility, the possibility that partner-level decisions may skew more strongly towards concluding that the foreign corporation in question is not a PFIC cannot be dismissed out of hand. This may be especially so if, as suggested by the Green Book, the conditions for obtaining late PFIC Elections were to be liberalized, as a greater ability to make late PFIC Elections could reduce the downsides associated with determining that a foreign corporation is in fact a PFIC only after having held it for more than one year (provided that such late election would be permitted under the rules then in effect). At that point, the IRS is placing itself in a potential whipsaw position. While beyond the

Of these three alternative approaches, we think Treasury and the IRS should ultimately adopt the approach, or approaches, that are expected to produce its desired policy outcome. Specifically:

- Current Law Approach - to the extent Treasury and the IRS are seeking to maximize the number of desired PFIC Elections that are made on a timely basis while also minimizing the administrative burden to indirect PFIC shareholders and the collateral consequences associated with the shift to the aggregate approach (such as the concerns related to allocations described below under "Income Inclusions Resulting from a PFIC Election" and "Tracking Basis Adjustments in PFIC Stock at the Entity Level"),[66] we recommend that Treasury and the IRS retain the entity approach set forth under current law.

- Delegated Agency Approach - to the extent Treasury and the IRS are seeking to adopt an aggregate approach to PFIC Elections that harmonizes the PFIC rules with the GILTI/subpart F rules, but also wants to allow pass-through entities the ability to elect into a regime that preserves much of the administrative ease of the current entity regime at the expense of allowing indirect PFIC shareholders to make contrary PFIC Elections with respect to a given PFIC held through a pass-through entity, we recommend that Treasury and the IRS adopt the Delegated Agency Approach as an elective regime for pass-through entities that hold interests in PFICs.[67]

- Directed Agency Approach - to the extent Treasury and the IRS are seeking to adopt an aggregate approach to PFIC Elections that harmonizes the PFIC rules with the GILTI/subpart F rules and allows indirect PFIC shareholders to make inconsistent PFIC Elections, but also wish to allow indirect PFIC shareholders to delegate some election and compliance matters to pass-through entities, we recommend that Treasury and the IRS adopt the Directed Agency Approach as an elective regime for pass-through entities that hold interests in PFICs.

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scope of this Report, attention should be given as to whether such partner-level determinations are "partnership-related items" within the meaning of section 6221 et. seq. and if not, whether they are auditable at the partnership level under the BBA. In addition, if the pass-through entity has no ability to reject a pass-through entity owner's determination that a foreign corporation was not a PFIC, consideration would also have to be given to what standard of care, if any, the pass-through entity is under in undertaking its duties under this approach. Presumably the pass-through entity should not be under a duty to second guess the owner since the entity has no stake in the decision, which is the whole point of the aggregate approach.

[66] We acknowledge that Treasury and the IRS may be concerned that the entity approach may exacerbate such allocation issues in the case of foreign corporations that are both PFICs and CFCs with respect to which some direct and/or indirect pass-through entity owners who are United States shareholders and that ought not have PFIC-related income inclusions, but we believe that the relative infrequency of such structures and the elective nature of this proposal mitigates against such concerns.

[67] We acknowledge that this approach may not address in all cases the allocation issues discussed *supra*, footnote 66.

As discussed above, Treasury and the IRS could adopt more than one (or potentially all three) of the proposed approaches on an elective basis.

A. Entity Approach (Current Law)

In addition to not imposing a new learning curve, we think the full entity approach taken under current law is likely to (i) minimize the number of PFIC filings, (ii) minimize the number of late PFIC Elections and inadvertent failures to make desired PFIC Elections, (iii) maximize the availability of information required to report interests in PFICs and the income inclusions that result from PFIC Elections, and (iv) minimize the collateral consequences associated with making PFIC Elections at the pass-through entity owner level (or above), including concerns associated with appropriate allocations of income and tracking of PTEP (because such items will be tracked at the pass-through entity level). Maintaining the entity approach would also limit the number of inconsistent PFIC determinations and PFIC Elections that are made by owners of pass-through entities.

While there may be significant administrative concerns associated with allowing taxpayers to make divergent determinations as to what PFIC Election, if any, should be made with respect to that PFIC, an approach which allows inconsistent PFIC Elections does permit investor flexibility, which in theory some investors may desire. On the other hand, many other investors may not want to be burdened with these decisions and may wish to delegate these tasks to the entity in the most cost-effective and least intrusive way, especially since the same choice is likely to be desired and optimal in the vast majority of cases (i.e., a QEF election). This group of investors may be concerned that any benefits of this individual freedom will be outweighed by the resulting administrative cost and complexity, particularly if they are less sophisticated taxpayers.[68]

In terms of allowing investor flexibility, the excess inclusion regime does not apply if PFIC stock is marked to market under section 475 or any other Code provision by the taxpayer or any other person, including a domestic or foreign pass-through entity though which the taxpayer holds the PFIC stock. A pass-through entity which is otherwise eligible to do so can therefore make a mark-to-market election under section 475 with respect to its PFIC stock and potentially apply a binding mark-to-market regime for all of its owners. It appears that at least for mark-to-market elections, the more important policy objective is making sure that the owners' accretion to wealth is properly reflected in the method of accounting chosen, not that each pass-through entity owner be given the maximum discretion to make that decision with respect to any PFIC stock that it indirectly holds through pass-through entities. Treasury and the IRS should consider whether any distinction should be made between a pass-through entity's elections to mark-to-market under section 475, section 1296, or other Code provisions that affects all of the entity's owners.

B. The Delegated Agency Approach

The first of two alternative approaches that this Report considers is the "Delegated Agency Approach." Under this approach, a pass-through entity would make PFIC Elections as

[68] As discussed above, foreign partnerships which are not subject to the entity rule already struggle with these issues under current law. Retaining the entity approach will not afford these partnerships any relief, unless possibly its retention is coupled with some form of agency election.

agent for all owners (or perhaps all eligible owners) (e.g., by completing and filing Form 8621 on behalf of such owners) and would be allowed to undertake certain compliance and reporting obligations on their behalf, including the right to inspect and copy certain of the PFIC's books of account, records, and other documents.[69] The pass-through entity would also be authorized to calculate each entity owner's share of a PFIC's ordinary income and net capital gain and to report such amounts to its owners for inclusion on their returns.

The approach would treat the pass-through entity as the agent of its direct or indirect owners with respect to PFIC Elections. Such a delegation of authority could be accomplished by including language in the partnership agreement or other organizational documents and/or any binding agreements entered into by an owner of a pass-through entity in connection with its acquisition or ownership of an interest in the pass-through entity (e.g., subscription documents and/or side letters). Preexisting entities may be presumed to already have this agency delegation given that the entities are able to make the PFIC Elections under current law and that it may be administratively challenging for a preexisting entity to amend its operating documents or solicit consents from its owners if needed.

We propose that the Delegated Agency Approach be elective and an alternative to the approach described in the 2022 Proposed Regulations. A pass-through entity would elect into the regime by filing a statement with its IRS Form 1065 or 1120-S for the first taxable year in which the pass-through entity holds an interest in a PFIC following the effective date of the regulations. In order to ensure the approach is as fair and as administrable as possible, we think an election into the Delegated Agency Approach by a pass-through entity must be binding on all of its owners (or all eligible owners), with no ability for anyone to opt out. Conversely, the pass-through entity would have no ability to make inconsistent elections as between different owners, although the entity would have discretion, for example to make a QEF election for all of its owners with respect to one PFIC, an MTM election with respect to a second PFIC, and no election with respect to a third PFIC. For the reasons set forth above, we do not think that prohibiting owners of pass-through entities from opting out would impose a meaningful burden on taxpayers, as the regime is intended to be elective and only large, sophisticated investors are likely to want to exercise such an opt out right. Subject to the discussion of tiered ownership structures below, an opt out could also be handled through structuring changes, by, for example, allowing investors who wished to make contrary elections to invest through parallel vehicles that would not elect into the Delegated Agency Approach.

a. *Delegated Agency Approach: Advantages*

We think the Delegated Agency Approach has the potential to address the most significant administrative burdens imposed by the 2022 Proposed Regulations. It would allow taxpayers to shift the responsibility for making and maintaining PFIC Elections with respect to PFIC stock held through a pass-through entity to the person that is best positioned to carry out such tasks: the pass-through entity itself. Without the requirement that duplicate calculations be made for elective regimes which are not relevant to pass-through entity owners pursuant to Schedule K-3, this approach has many, if not all, of the benefits of the existing entity approach for those entities that

[69] Treas. Reg. § 1.1295-1(g)(iv)(A).

wish to become discretionary agents for this purpose, while preserving the 2022 Proposed Regulations' regime for those that do not wish to make the PFIC Elections at the entity level.

As between the two agency approaches described in this Report, the Delegated Agency Approach has the advantage of allowing a pass-through entity to make a PFIC Election that is effective with respect to all persons who hold the PFIC stock indirectly through such entity, even if the pass-through entity does not know the actual identity of all such persons. This is possible because a pass-through entity that is a direct holder of PFIC stock that opts into the Delegated Agency Approach (i) could rely on language included in its organizational or subscription documents to assume it has authority to act for indirect PFIC shareholders, and (ii) would report each pass-through entity owner's share of a PFIC's ordinary income and net capital gain, and the information reported by such pass-through entity would flow up through its direct and indirect pass-through owners to the ultimate beneficial owners of such PFIC stock. This produces effectively the same or a very similar result as a domestic pass-through entity making a PFIC Election under current law and reporting the resulting MTM or QEF inclusions to its owners. As described below, a similar result cannot be obtained under the Directed Agency Approach, which requires interest holders to directly instruct a pass-through entity regarding what PFIC Elections, if any, should be made on its behalf.

b. *Delegated Agency Approach: Potential Difficulties and Areas for Further Study*

One concern with the Delegated Agency Approach as compared to the existing entity approach is how to address privity considerations when U.S. persons hold PFIC stock through multiple tiers of pass-through entities.

> Example: Partnership X is owned by a large number of individual and institutional investors and holds PFIC stock. Third Party Feeder Partnership is a direct partner of Partnership X, and Individual A, a U.S. person, own an interest in Third Party Feeder Partnership. The general partners of Partnership X and Third Party Feeder Partnership are separate, unrelated persons. There is no privity of contract as between Partnership X and Individual A, and Individual A would generally not execute any documents explicitly appointing Partnership X as its agent.

One practical solution is to allow intermediate pass-through entities to act as agents of their direct owners for purposes of (1) authorizing lower-tier pass-through entities to act as agents on behalf of the intermediate pass-through entity's owners, and (2) passing on PFIC information provided by the lower-tier pass-through entity. This could be effectuated by the organizational documents and/or subscription documents of pass-through entities authorizing the entity to designate sub-agents with respect to PFIC Elections (and to authorize those sub-agents to themselves designate sub-agents), which may be presumed to be effective for preexisting entities. Any regulations issued implementing the Delegated Agency Approach should authorize a lower-tier pass-through entity to rely on representations from upper-tier pass-through entities that the upper-tier entity can push down the authority to make PFIC Elections on behalf of its direct or indirect owners. The alternative would be to restrict a pass-through entity's ability to act as agent for purposes of making PFIC Elections to only its direct non-pass-through owners (potentially looking through disregarded entities and grantor trusts for these purposes), with upper-tier pass-

through entities making separate PFIC Elections, in turn, for their own direct non-pass-through owners. We think this alternative would materially undermine the benefits of the Delegated Agency Approach and thus urge Treasury and the IRS to take a more comprehensive view of agency principles in any regulations implementing the Delegated Agency Approach. We note that similar concerns were presented by the BBA revisions to the centralized partnership audit rules. In that context, Treasury and the IRS considered the legal basis for the authority of the partnership representative to act on behalf a partnership and bind all the partners. Although other approaches were considered or raised in comments, the final regulations settled on an approach designed to maximize the administrability of the BBA audit regime by clarifying that contractual or state law restrictions on a given partnership representative's ability to bind a partnership or its partners would not apply vis-à-vis the IRS.[70] We think Treasury and the IRS could similarly adopt a broad approach to agency principles, designed to maximize administrability, in the context of PFIC Elections.

Another potential issue arises where a pass-through entity holds stock of a PFIC and one or more owners of the pass-through entity hold additional shares of stock of such PFIC directly or through one or more other pass-through entities. It is possible that a taxpayer will make a PFIC Election with respect to some, but not all of the stock of a particular PFIC it owns or is deemed to own.

> Example: Partnership X is owned by a large number of individual and institutional investors and holds a PFIC's stock. Individual A, a U.S. person, is a 1% owner of Partnership X. Partnership X, as a large holder of PFIC, is able to obtain sufficient information from the PFIC and makes a QEF election with respect to the PFIC stock as agent for its domestic partners and to provide them with appropriate reporting. Individual A also owns 100 shares of PFIC stock directly, but cannot obtain sufficient information to enable Individual A to make a QEF election for the directly held PFIC stock. As a result, Individual A will report two separate positions in the same PFIC, one that is subject to a QEF election and one that is not.
>
> A similar result occurs if Individual A held more PFIC stock through Partnership Y if Partnership Y was unable to (or determined not to) make a QEF election on behalf of its domestic partners and failed to provide its partners with sufficient information to make their own QEF elections.

We do not believe that the possibility of this outcome warrants reconsideration of this structure. First, while it may seem odd that a single taxpayer would make inconsistent elections under an aggregate approach with respect to two separate positions in a single PFIC, the possibility

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[70] *See* T.D. 9839, 83 Fed. Reg. 39331 (Aug 6, 2018), Section D(i) ("The regulations are drafted to provide significant flexibility to the partnership to determine who will represent it and for the partnership and the partnership representative to negotiate the terms of their relationship. The Treasury Department and the IRS have attempted to refrain from creating unnecessary regulatory burdens. The partnership and the partnership representative are free to enter into contractual agreements to define the scope and limits of their relationship. However, because the IRS is not a party to these agreements, it is not bound by them. Any remedy the partnership would have against the partnership representative if the partnership representative failed to act in accordance with those agreements would be under state law with respect to the partnership representative.").

of such inconsistent elections already exists under current law. Second, we believe that in the vast majority of cases, investors will want to make QEF (or MTM) elections for all of their PFIC stock and therefore the likelihood of inconsistent elections, except by reason of mistake or impossibility, is low.[71] Furthermore, we do not think that any such inconsistencies result in any substantive consequences beyond the potentially negative treatment of a portion of the taxpayer's position in an underlying PFIC arising from the failure to make the QEF election. Thus, we would propose that any regulations implementing the Delegated Agency Approach specifically allow for inconsistent elections with respect to PFIC stock held in different chains of ownership.

Both agency approaches raise questions regarding how to treat a taxpayer that becomes an owner of a pass-through entity after the year in which such pass-through entity is deemed to have made elections on behalf of its owners. Because we propose that elections made by a pass-through entity under the Delegated Agency Approach be deemed to be made on behalf of all indirect PFIC shareholders that hold PFIC stock through such entity, existing PFIC Elections made by a pass-through entity under the Delegated Agency Approach should be deemed made on behalf of new members of such entity (or other persons that become indirect PFIC shareholders through such entity) in the tax year in which they first become indirect PFIC shareholders through such pass-through entity.

C. The Directed Agency Approach

The second of the two alternative approaches is the "Directed Agency Approach." This construct would similarly allow a pass-through entity to make PFIC Elections as agent for some or all of its owners, but the pass-through entity would only do so as directed by the owner. The owner may appoint the pass-through entity as its agent with respect to certain compliance and reporting obligations, as discussed above, but the scope of the pass-through entity's actions would be limited to those taken on behalf of its direct non-pass-through owners that have given it specific direction (i.e., those persons that are in direct privity with the pass-through-entity).

Because a lower-tier pass-through entity would not be able to make PFIC Elections on behalf of its pass-through entity owners, each upper-tier entity would make a separate PFIC Election for its own direct non-pass-through owners.

a. *Directed Agency Approach: Advantages*

The Directed Agency approach allows the greatest degree of flexibility for PFIC shareholders to make inconsistent PFIC Elections with each other, while minimizing their involvement with the election process itself. It is also arguably more consistent with the philosophical basis of the 2022 Proposed Regulations than the other suggested approaches and may therefore also be easier to implement (but see "Potential Difficulties and Areas for Further Study" below). Because the Directed Agency Approach explicitly allows for partners to make inconsistent determinations with respect to PFIC Elections, the Directed Agency Approach may also more clearly preserve the ability of different owners of a pass-through entity to make different determinations, subject to the discussion above regarding the significance of a pass-through entity's reporting on Schedule K-2/K-3, regarding the status of certain foreign corporations in

[71] Enactment of the Delegated Agency Approach is likely to minimize such mistakes. *Cf.* Green Book at 14-15.

which it holds interests as PFICs. In addition, from a commercial perspective, an upper-tier entity managed by a company different than a lower-tier entity might want to keep confidential any information about its owners. Although the Delegated Agency Approach should allow for elections to be deemed to be made on behalf of the owners of upper-tier pass-through entities without obtaining identifying information about such persons, as suggested above, if such an approach is not adopted, the Directed Agency Approach avoids confidentiality concerns by allowing an upper-tier entity to file PFIC Elections in respect of its owners at the upper-tier entity level.

b. *Directed Agency Approach: Potential Difficulties and Areas for Further Study*

The converse of the Directed Agency Approach's flexibility is that because it does not require uniform PFIC Elections between the owners of a pass-through entity, it is expected to result in some indirect PFIC shareholders inadvertently failing to make timely PFIC Elections that they would otherwise have preferred to make. In addition it is expected to result in greater complexity. For example, some owners of a pass-through entity might direct the pass-through entity to make a QEF election with respect to a PFIC, while other owners direct the pass-through entity not to make such election, while still others end up making the QEF election independently after directing the pass-through entity not to make it on their behalf. As described above, this could be viewed as an advantage of the Directed Agency Approach over the Delegated Agency Approach, but also seems likely to result in increased complexity and more squarely highlights concerns regarding how to handle income allocation issues described below in "Income Inclusions Resulting from a PFIC Election" and "Tracking Basis Adjustments in PFIC Stock at the Entity Level". Direct partners in the same partnership might have different inclusions, and as a result, different bases in their shares of the PFIC stock held by the partnership. This could present difficult compliance issues and in some cases may not produce correct economic results. The lack of uniform PFIC Elections is exacerbated in tiered entity structures, particularly if less sophisticated partnerships do not contain advance directives in their subscription documents. While the ability for partners to make differing determinations and elections is not necessarily harmful in its own right, we think the results of this approach are potentially at odds with the Biden Administration's stated goal of minimizing inadvertent failures to make QEF elections on a timely basis.[72] This result will also arise under the 2022 Proposed Regulations' approach as much as, if not more than, it would arise under the Directed Agency Approach. On the other hand, we think that the likelihood of such complications could be substantially lessened by the Delegated Agency Approach which allows pass-through entities that elect into such a regime to impose uniform determinations and elections on their direct and indirect owners, compared to either the approach in the 2022 Proposed Regulations or the Directed Agency Approach.

Under the Directed Agency Approach, information will need to flow down through tiers of entities so that each lower-tier pass-through entity knows the extent to which its indirect owners have made (directly or via agency arrangements with an upper-tier pass-through entity) the

[72] *See* Green Book at 14-15. While the Green Book addresses this concern by allowing more leeway to correct such inadvertent failures, presumably preventing them in the first place would be even more desirable. The Green Book notes that entities are less likely to make mistakes in this regard than individuals. *Id*. at 15.

relevant PFIC Election so that the lower-tier pass-through entity can provide relevant information reporting to its owners. Mechanisms for such "downward" information sharing generally do not exist today. In particular, we note two potential difficulties. First, depending on the manner in which this alternative is implemented, it could require transmission of information about upper-tier owners to lower-tier pass-through entities, which is both cumbersome and could be commercially contentious if, for example, it requires identifying investors. Second, assuming that the relevant information is provided to indirect PFIC shareholders through the Schedule K-3 process, it might arrive at the owner level (and especially an upper-tier owner) too late for the owner to use that information to make a decision which is to be reflected in the pass-through entity's Form 1065, which may prevent a timely PFIC Election with respect to the owner. This latter point could be addressed in a number of ways, for example by requiring earlier distribution of draft Schedule K-3s to afford sufficient time or by permitting late PFIC Elections within a specified period. However, we think either approach will increase complexity and degrade the desirability of this alternative for owners and entities alike. While this issue can be minimized via advanced directives (see below), that does not solve the problem for pass-through entity owners who wish to retain the flexibility to make inconsistent PFIC Elections, which we think is the main, if not the only, benefit of the Directed Agency Approach.

If Treasury and the IRS adopt the Directed Agency Approach, they should consider allowing a pass-through entity to permit its owners to appoint it as agent and direct the pass-through entity to make certain PFIC Elections on the owners' behalf, such as by including language in the pass-through entity's subscription document. We note that any taxpayer that prefers to have the flexibility to make its own PFIC Elections may chose not to be bound by the advance directive regime. Use of such an advance directive regime would have the benefit of allowing pass-through entities the ability to establish default rules, which may help to limit the likelihood of inadvertent failures to file PFIC Elections. In addition, nothing would obligate a pass-through entity to adopt such an advance directive option where such an approach is not desired by the entity. The differences between this advance directive approach and the Delegated Agency Approach are at least two fold. In the Delegated Agency Approach, all the owners are deemed to authorize the entity to make uniform choices with respect to each PFIC on their behalf. Under the advance directive approach, each owner continues to make an individual choice; owners are merely given the option to make that choice in advance, which in theory could include a direction of either the choice to be made or a direction that the entity make the choice on behalf of the owner.

V. Additional Issues with PFIC Elections

A. PFIC Items under the BBA Audit Regime

Careful consideration should be given to how any rules regarding PFIC determinations and PFIC Elections will interact with the BBA audit regime and, in particular, whether (i) the determination of whether a foreign corporation held through a partnership is a PFIC and (ii) the amount of income or gain included by a taxpayer in respect of a PFIC Election (or the absence of a PFIC Election) in respect of a PFIC held through a partnership are "partnership-related items" within the meaning of section 6221 et. seq. While not a common occurrence, there may be a number of reasons why an owner of a pass-through entity would want to make a different determination about PFIC status than the determination made by the pass-through entity in which it is an owner, including, e.g., that it might also be an owner of another pass-through entity which

took a contrary position or it may own some stock directly and have come to a contrary conclusion about PFIC status. For example, assume a partnership determines a foreign corporation is a PFIC, a partner takes an inconsistent position that such foreign corporation is not a PFIC (properly flagging the issue on its return pursuant to section 6222), and the partnership's position is correct. Assume that the partner's year is closed but the partnership's year is not closed and it is the subject of a BBA audit. Treasury and the IRS should consider whether such an item should be included in an audit of the partnership and, if so, whether it would result in a partnership-level imputed underpayment in light of the fact that (i) the partnership return position (reflected on the Schedule K-3) was correct and (ii) the income tax consequences of such position would be resolved exclusively at the partner level.

B. Requirement to Notify Pass-through Entity of a PFIC Election

The 2022 Proposed Regulations provide that a domestic shareholder that holds an interest in a PFIC indirectly through a pass-through entity is required to notify such pass-through entity if the owner made a PFIC Election with respect to a PFIC held through such pass-through entity, within 30 days after the filing of the return with which such PFIC Election is made.[73] While we appreciate that failure to provide such notice does not invalidate an otherwise effective PFIC Election, in tiered investment structures the owners of an upper-tier pass-through entity may not be in direct contact with a lower-tier pass-through entity that directly owns the PFIC stock. As a result, it may be difficult as a practical matter for such upper-tier indirect owners to provide timely notice of a PFIC Election to a lower-tier pass-through entity.

Furthermore, if any of the information reported by a pass-through entity on Schedules K-2/K-3 is intended to be dependent on, or specifically tailored in light of, receipt of notice that an indirect PFIC shareholder has made any PFIC Election, it seems unlikely that any such information could be reported in the first year in which an indirect PFIC shareholder makes a PFIC Election (e.g., if a partnership provides an individual partner with a final Schedule K-3 on September 15th and the partner files a PFIC Election with respect to a PFIC held through such partnership on its individual return on October 15th, the partnership may not receive notice of such election until mid-November). Treasury and the IRS should also consider allowing upper-tier pass-through entities to act as agents of their owners for purposes of providing notice of a PFIC Election to the lower-tier pass-through entity, regardless of the approach that is ultimately taken with respect to PFIC Elections generally.

C. Income Inclusions Resulting from a PFIC Election

Under the 2022 Proposed Regulations, the income inclusions resulting from a PFIC Election will generally be determined at the pass-through entity owner level based on information provided by the pass-through entity that holds the PFIC stock. There are several practical complexities that can arise from making the inclusion determination at the pass-through entity owner level, instead of determining QEF or MTM inclusions at the pass-through entity level and then allocating those amounts to the entity owners.

[73] Treas. Reg. §§ 1.1295-1(d)(2)(i)(A), 1.1295-1(d)(2)(ii)(A) and 1.1296-1(h)(1)(i)(B).

Outside of "straight-up" partnerships, the indirect percentage ownership of PFIC stock by partners in a partnership may be difficult to determine and/or may vary year-by-year (or within a year) and the 2022 Proposed Regulations do not provide a uniform method of determining how to allocate PFIC stock among partners.[74] While partnerships will be required to report this information on Schedules K-2/K-3, we think that future guidance should make clear that partnerships are allowed to use any reasonable method to determine how PFIC items are allocated among partners (e.g., based on the allocation of partnership profits or ownership of partnership capital), provided that it is consistently applied as between partners and across partnership years.[75]

The 2022 Proposed Regulations do not address the treatment of PFIC stock that is contributed to a partnership in a transaction to which section 704(c) of the Code applies (i.e., the stock is contributed with a built-in-gain or built-in-loss). We believe that this is an area in need of further study and would encourage Treasury and the IRS to consider addressing the treatment of such situations, including how QEF or MTM inclusions should be calculated with respect to contributing or non-contributing partners.

D. Tracking Basis Adjustments in PFIC Stock at the Entity Level

We note that part of the reason Treasury and the IRS have requested that owners of pass-through entities notify underlying pass-through entities if they make a QEF election at the owner level is to assist the pass-through entity with tracking basis in PFIC stock at the entity level.[76] These rules appear to provide for an increase in stock basis at the pass-through entity level for QEF inclusions at the pass-through entity owner level.[77]

Although partnerships are not subject to the pro rata income rules for S corporations described below, partnerships have issues with stock basis and PTEP when their direct or indirect partners make inconsistent PFIC Elections.

> Example: a partnership is owned 50% by Individual A and 50% by Individual B. The partnership owns 10% of a PFIC's stock with $0 tax basis. The PFIC has $2,000 of total ordinary earnings and zero net capital gains during the taxable year. Individual A makes a QEF election with respect to the PFIC and has gross income equal to $100. Individual B does not make a QEF election with respect to the PFIC. Individual A has $100 of PTEP under section 1293(c) with respect to its share of PFIC stock. Under section 1293(d), it appears that Individual A should increase the basis of her partnership interest by $100, and that the partnership should increase the basis of its PFIC stock by $100 as well.

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[74] Given the relatively simple capital structure of S corporations, we do not think that this problem is as likely to present in the context of an S corporation.

[75] For additional discussion of this issue, *see KPMG Report: Regulations addressing tax treatment of U.S. partnerships and S corporations that own stock of CFCs and PFICs*, January 28, 2022.

[76] *See* Prop. Treas. Reg. § 1.1293-1(c)(3).

[77] Presumably the purpose of these adjustments will be clearer after the PTEP regulations are promulgated, but the fact that the 2022 Proposed Regulations call for basis adjustment at the entity level may imply that a complete partner-level regime is not contemplated.

In the next taxable year when the PFIC has no earnings, the PFIC distributes $200 of cash to the partnership. The $200 distribution should in theory be bifurcated as a $100 tax-free PTEP distribution specially allocated to Individual A (which reduces the PFIC stock basis from $100 to $0) and a $100 taxable dividend specially allocated to Individual B. However, it is not apparent how the partnership should make such special allocations. If the partnership had undergone a 'book-up' event at the beginning of the second taxable year that created $100 of reverse section 704(c) gain for Individual B, it is unclear whether the taxable dividend is a gain item that can be allocated under section 704(c). If the partnership had not undergone a 'book-up' event, it is less clear how the partnership can specially allocate the taxable dividend to Individual B.

Additional complexities may arise in partnerships that have shifting allocations over time. For instance, the partnership in the above example may have issued a carried interest to Individual C with a 'catch-up' that causes all of the partnership's taxable income in the second taxable year to be allocated to Individual C. It is not clear whether the $200 distribution from the PFIC to the partnership in the second taxable year results in (i) no taxable income allocated to Individual C, because the partnership's $100 of recognized dividend income must be specially allocated to Individual B under section 704(c) or similar principles, (ii) $100 of taxable income allocated to Individual C, who is allocated all of the partnership's taxable income, or (iii) $200 of taxable income allocated to Individual C, who should not benefit from the $100 PTEP in the PFIC stock that is allocated only to Individual A.

Similar issues arise in the context of a partnership's GILTI and subpart F income that are allocated differently to different partners, such as if some partners are United States shareholders of a CFC while other partners are not United States shareholders of a CFC, or if some partners who are United States shareholders of a CFC make a section 962 election while others do not make the election. The partners end up with different amounts of PTEP and section 961 basis increases in the partnership's CFC stock, which should be specially allocated to the partners in different ways.

Another approach is for PTEP and PFIC stock basis adjustments to occur only at the partner level. Each partner would keep a special account of PTEP and additional tax basis that are not reflected as stock tax basis at the partnership level, in a manner similar to section 743(b) adjustments.[78]

The final regulations should consider adding rules for domestic and foreign partnerships to make special allocations of PTEP, gain, and other items among its partners to reflect the partners' inconsistent PFIC Elections, which may be mandatory special allocations. We recommend that PTEP, tax basis, and other items that arise from a partner's PFIC Election should be personal to such partner and cannot be used by the partnership's other partners.

We understand that the above partnership issues may be already part of the pending PTEP regulations and updates to Schedules K-2/K-3. In the interim, permitting entity treatment of

[78] However this is arguably inconsistent with the basis adjustment described above at footnote 77.

partnerships may mitigate (but not eliminate) the issues under the PFIC, GILTI, and subpart F rules.[79]

E. S Corporation Pro Rata Share of Income Rule

Each S corporation shareholder's pro rata share of any S corporation tax item is based on the shareholder's ratable share of such item over the days of the calendar year,[80] subject to special closing-of-the-books elections for certain changes in ownership.[81] It is unclear how the PFIC's PTEP and basis adjustment rules in sections 1293(c) and 1293(d), which apply to all shareholders of PFICs that make a QEF election, interact with the pro rata share of income rule for S corporations.

> Example: an S corporation is owned 50% by Individual A and 50% by Individual B. The S corporation owns 10% of a PFIC's stock with $0 tax basis. The PFIC has $2,000 of total ordinary earnings and zero net capital gains during the taxable year. Individual A makes a QEF election with respect to the PFIC and has gross income equal to $100.[82] Individual B does not make a QEF election with respect to the PFIC. Individual A has $100 of PTEP under section 1293(c) with respect to its share of PFIC stock. Under section 1293(d), it appears that the basis of Individual A's S corporation stock should increase by $100, and that the S corporation should increase the basis of its PFIC stock by $100 as well.
>
> In the next taxable year when the PFIC has no earnings, the PFIC distributes $200 of cash to the S corporation, which distributes $100 of cash to each shareholder. In the absence of section 1377(a), the $100 distribution should be bifurcated as a $100 tax-free PTEP distribution specially allocated to Individual A (which reduces the PFIC stock basis from $100 to $0) and a $100 taxable dividend specially allocated to Individual B that is subject to the section 1291(a)(1) excess distribution rules. However, section 1377(a) may require the S corporation to allocate the $100 taxable dividend pro rata $50 to Individual A and $50 to Individual B, to the detriment of Individual A and benefit of Individual B.

Similar issues arise in the context of GILTI and subpart F income, if some S corporation shareholders are United States shareholders of a CFC while other S corporation shareholders are not United States shareholders of a CFC, or if some S corporation shareholders who are United States shareholders of a CFC make a section 962 election while others do not make the election. The S corporation shareholders end up with different amounts of PTEP and section 961 basis increases in the S corporation's CFC stock, which should be specially allocated to the S corporation shareholders in different ways.

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[79] A partnership may have both domestic and foreign partners and therefore still need to track different PTEP amounts and stock basis adjustments for different partners.

[80] Section 1377(a)(1); Treas. Reg. § 1.1377-1(a).

[81] Section 1377(a)(2); Treas. Reg. § 1.1377-1(b); Treas. Reg. § 1.1368-1(g).

[82] Section 1293(a)(1).

Another approach is for PTEP and PFIC stock basis adjustments to occur only at the S corporation shareholder level. Each S corporation shareholder would keep a special account of PTEP and additional tax basis that are not reflected as additional stock tax basis at the S corporation level, in a manner similar to section 743(b) adjustments for a partnership. Special considerations would be required for the section 1374 built-in gains tax, the section 1375 excess passive investment income tax, and the section 1362 excess passive investment income disqualification to take into account the shareholder-level items.

We understand that the above S corporation issues may be already part of the pending PTEP regulations and updates to Schedules K-2/K-3. If Treasury and the IRS do not believe that they have the statutory authority to establish S corporation special allocations or S corporation shareholder special accounts, they should consider requesting legislative action from Congress. We note that section 1375 provides that an S corporation is treated as a partnership for purposes of section 951 through 965, and similarly that an S corporation's shareholders are treated as its partners for such purposes. In the interim, permitting entity treatment of S corporations may mitigate (but not eliminate) the issues under the PFIC, GILTI, and subpart F rules.[83]

F. S Corporation Corporate-level Taxes

An S corporation with accumulated E&P from C corporation taxable years is subject to two special rules: the section 1375 excess passive investment income tax and the section 1362(d)(3) excess passive investment income disqualification of S corporation status.

If more than 25% of the S corporation's gross receipts are passive investment income in any taxable year, the S corporation is subject to a 21% corporate-level income tax on the net amount of such excess passive investment income.[84] If more than 25% of the S corporation's gross receipts are passive investment income for three consecutive taxable years, the S corporation's subchapter S election is revoked on the first day of the next taxable year.[85] In either case, "passive investment income" means gross receipts from royalties, rents, dividends, interest, and annuities.[86]

The final regulations should confirm that passive investment income does not include QEF and MTM inclusions in the numerator of the passive investment income test, as such inclusions are not royalties, rents, dividends, interest, or annuities. QEF inclusions are similar to subpart F income, which is not in the numerator as it does not fall within any of the enumerated types of

[83] An S corporation may have some, but not all, of its shareholders avoid PFIC inclusions under the CFC Overlap Rule and therefore still need to track different PTEP amounts and stock basis adjustments for different S corporation shareholders.

[84] Section 1375.

[85] Section 1362(d)(3).

[86] Section 1362(d)(3)(C). Treas. Reg. § 1.1362-2(c)(5) provides that "passive investment income" also includes gains from the sales or exchanges of stock or securities, but this category was statutorily eliminated in 2007 with the repeal of former section 1362(d)(3)(C)(i).

passive investment income.[87] MTM inclusions effectively accelerate the S corporation's gains on the sale of the PFIC stock, which are not in the numerator either. The final regulations should also confirm that an S corporation's QEF and MTM inclusions with respect to the electing S corporation shareholders are included in the gross receipts denominator of the passive investment income test, as they are similar to gains and other types of gross receipts (and should not be counted again when the S corporation sells its PFIC stock). In the event that the QEF and MTM inclusions are not included in the gross receipts denominator but they nevertheless increase the S corporation's basis in its PFIC stock, the S corporation's gains on the later sale or other disposition of its PFIC stock should be increased by the prior QEF and MTM inclusions and added to the gross receipts denominator, in order to ensure that items are not omitted from gross receipts.

G. Earnings and Profits under Section 1248(d)(6)

Section 1248(a) generally provides that if a U.S. person sells or exchanges stock of a CFC (or a former CFC in some cases), part of the gain is recharacterized as a dividend to the extent of the sold CFC stock's share of the CFC's E&P. A U.S. person includes a domestic partnership[88] or an S corporation.

Section 1248(d)(6) provides that with respect to any U.S. person for section 1248 purposes, the CFC's E&P is reduced by any E&P "attributable to any amount previously included in the gross income of such person under section 1293 with respect to the stock sold or exchanged" under the QEF election rules and not previously distributed as tax-free PTEP under section 1293(c).

A domestic pass-through entity continues to have entity treatment for section 1248 purposes,[89] and thus it may have dividend recharacterization at the entity level even though some or all of its owners had previously included the E&P at the owner level as QEF inclusions.

> Example: a domestic partnership is owned 50% by Individual A and 50% by Individual B. The partnership owns 10% of a PFIC's stock with $0 tax basis. The PFIC has $2,000 of total ordinary income and zero net capital gains during the taxable year. Each individual makes a QEF election with respect to the PFIC and has gross income under section 1293(a)(1) equal to $100. At the end of the same taxable year, the domestic partnership sells its PFIC stock for $400. Prior to the application of section 1248(d), the PFIC has $2,000 of E&P, of which $200 is attributable to the sold PFIC stock. Section 1248(d)(6) does not reduce the $200 of E&P by the $200 of QEF inclusions, because the QEF inclusions were included in the gross income of the two partners and not in the gross income of the selling U.S. person, the domestic partnership. The result is that the two individuals have $200 of taxable dividend income under section 1248(a) instead of capital gain, even though the same $200 of E&P already resulted in QEF inclusions taxed as ordinary income.

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87 CCA 201030024.

88 Rev. Rul. 69-124; 1969-1 C.B. 203.

89 Treas. Reg. § 1.958-1(d)(2).

The double taxation effect is mitigated to some degree by the domestic partnership's tax basis increase in its CFC stock under section 1293(d), because the recharacterized dividend under section 1248(b) is limited to the recognized taxable gain. However, the double taxation still exists for QEF inclusions generated in the same taxable year as the CFC stock sale, or if the total gain on sale is greater than the CFC's E&P.

A similar issue arises in the context of GILTI and subpart F income, because the CFC's E&P for section 1248 purposes is reduced under section 1248(d)(1) by subpart F and GILTI inclusions previously included in the gross income of the selling U.S. person. When the selling U.S. person is a domestic pass-through entity, the subpart F and GILTI inclusions are recognized by the owners of the pass-through entity and are not covered by section 1248(d)(1).

We recommend a clarification that sections 1248(d)(1) and 1248(d)(6) reduce the foreign corporation's E&P for section 1248 purposes to the extent that the E&P is attributable to any amount included in the gross income of any direct or indirect domestic owner of a domestic pass-through entity. If Treasury or the IRS do not believe that they have the statutory authority to do so, they should consider requesting legislative action from Congress.

H. Special Considerations for Publicly Traded Partnerships

The 2022 Proposed Regulations do not address the treatment of PFICs held through publicly traded partnerships. Given the administrative complexities associated with obtaining PFIC information from publicly traded partnerships, we would suggest that Treasury and the IRS consider retaining the entity election approach provided for under current law for PFICs held by publicly traded partnerships without regard to the approach taken with respect to partnerships generally. Any such final regulations should also clarify how PFIC inclusions are treated for purposes of determining a publicly traded partnership's qualifying income.

VI. Treas. Reg. § 1.1411-10(g) Election

The 2022 Proposed Regulations provide that the Treas. Reg. § 1.1411-10(g) election can only be made by an individual, estate, or trust, and therefore the election cannot be made by a domestic pass-through entity.

For the same reasons as described above for PFIC Elections, we recommend that domestic pass-through entities continue to be able to make the Treas. Reg. § 1.1411-10(g) election. The administrative simplicity of a single unified reporting scheme for all of the pass-through entity's owners, along with simpler mechanics for tracking tax basis adjustments, outweighs the relatively low tax burden of accelerating a 3.8% tax for some individuals affected by the net investment income tax.

We also recommend that the election be permitted for foreign partnerships with direct or indirect domestic non-corporate partners, given that the foreign partnerships and their partners have the same administrative concerns with tracking tax basis and capital accounts. If a partner does not wish any domestic or foreign partnership to make the election, a special provision can be negotiated by the parties in the partnership agreement or subscription document.

VII. CFC Overlap Rule

We agree with the 2022 Proposed Regulations' approach to the CFC Overlap Rule and its foreclosure of the argument made by some commentators,[90] that certain smaller partners in a domestic partnership that owns stock of what would otherwise be a PFIC may be able to avoid all inclusions under the subpart F, GILTI, and PFIC regimes.[91]

We recommend that final regulations clarify that in the first year that the CFC Overlap Rule, as applied to pass-through entities based on the PLRs cited in footnote 35, ceases to apply to the owner of a pass-through entity and causes a CFC to be a PFIC with respect to that owner, whether due to the 2022 Proposed Regulations or some other reason, the owner is permitted to make a new QEF election for that PFIC that would cause such PFIC to be a pedigreed QEF.[92]

> Example: a domestic partnership has owned 100% of a foreign corporation's stock since 1997. In 1998, a U.S. individual acquires 5% of the interests in the domestic partnership. Beginning in 1998 until the finalization of the 2022 Proposed Regulations' approach to the CFC Overlap Rule, under the approach of the PLRs, the foreign corporation was treated as a CFC with respect to the U.S. individual and does not cause the U.S. individual to have any PFIC issues. In the U.S. individual's first taxable year that is subject to the changed CFC Overlap Rule as finalized, which is the first taxable year in which the former CFC has become a PFIC with respect to the U.S. individual, the U.S. individual may make a QEF election with respect to the PFIC, which is treated as a pedigreed QEF that does not require a QEF purging election.

The 2022 Proposed Regulations contain a transitional rule for the change to the CFC Overlap Rule. The Preamble suggests that in order for the transitional rule to apply, it is sufficient if the partner includes either the partnership's subpart F or GILTI inclusions, and that it is not necessary to have both ("When this transition rule applies, the CFC overlap rule will benefit certain persons that are indirect PFIC shareholders, but not U.S. shareholders, due to owning stock of foreign corporations through domestic partnerships or S corporations, during periods when the

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[90] *See, e.g.*, Kim Blanchard, *Whether Treating a Domestic Partnership as an Aggregate Causes Small U.S. Partners to Become Subject to the PFIC Regime*, Tax Management International Journal (Dec. 13, 2019).

[91] The Preamble provides that: "[a]lthough section 1297(d) does not define the term "shareholder" for this purpose, under § 1.1291-1(b)(7), a domestic partnership or S corporation is not a shareholder to which the CFC overlap rule applies." 87 Fed. Reg. 3898 n. 2. Treas. Reg. § 1.1291-1(b)(7) defines a PFIC "shareholder" as not including a domestic partnership or S corporation, but this applies for purposes of sections 1291 and 1298 (i.e., in determining the PFIC-related taxable income under section 1291, which is arguably different and separate from the CFC Overlap Rule located in section 1297(d)). Section 1297(d)(2)(B) itself, moreover, expressly treats a person as not being a shareholder with respect to the PFIC for the period during which such person is a "United States shareholder" as defined in section 951(b) of a CFC, which would include a domestic partnership or S corporation. The Preamble's suggestion that the PLRs cited in footnote 35 were superseded by later PFIC regulations released in 2013 and 2016 seems inconsistent with the foregoing interpretation.

[92] An alternative is for all such owners to make late PFIC Elections pursuant to section 1295(b)(2) by deeming them to have satisfied the requirements of Treas. Reg. § 1.1295-3(f), i.e., they reasonably relied on the CFC Overlap Rule before it was changed by the 2022 Proposed Regulations, but such a procedure can be administratively complex and expensive for the owners.

shareholder was subject to current inclusions under section 951 *or* section 951A" (emphasis added)).[93] However, that disjunctive approach is not completely clear from the regulatory text, which refers to both "section 951(a)(1) and section 951A(a)."[94] It therefore appears possible under the regulation that a shareholder may use the transitional rule to benefit from the CFC Overlap Rule only if the shareholder includes both subpart F and GILTI inclusions from the foreign corporation owned by the pass-through entity, and that the transitional rule may not be available if the shareholder includes only subpart F inclusions but not GILTI inclusions from the foreign corporation, even though this result appears contrary to the Preamble's description of this provision.

With limited exceptions,[95] the aggregate treatment of domestic pass-through entities for GILTI purposes applies to taxable years beginning in 2018 or later, whereas the aggregate treatment of domestic partnerships for subpart F purposes is required only for taxable years beginning on or after January 25, 2022.[96] Many domestic partnerships therefore are subject to aggregate treatment for GILTI purposes but entity treatment for subpart F purposes in the 2018 through 2022 taxable years, during which time they may be unable to use the CFC Overlap Rule to avoid the PFIC rules.

> Example: a domestic partnership is owned 95% by U.S. citizen A and 5% by U.S. citizen B. The domestic partnership owns 100% of a foreign corporation, which generated $1,000 of subpart F inclusions and $100 of GILTI inclusions in 2018. The domestic partnership applies entity treatment for subpart F purposes and aggregate treatment for GILTI purposes in 2018, which means that U.S. citizen A has $950 of subpart F inclusions and $95 of GILTI inclusions in 2018, whereas U.S. citizen B has $50 of subpart F inclusions and zero GILTI inclusions. The CFC Overlap Rule applies to U.S. citizen A so that the foreign corporation is not a PFIC with respect to U.S. citizen A. However, the CFC Overlap Rule arguably does not apply to U.S. citizen B because of her non-inclusion of the GILTI inclusions under aggregate treatment of the partnership, with the result that U.S. citizen B has subpart F inclusions and is also subject to the PFIC regime in 2018.

Based on the Preamble and given that the purpose of the CFC Overlap Rule is to avoid the simultaneous application of both the subpart F and PFIC regimes to the same taxpayer, with potential double taxation and other draconian effects, we recommend that the CFC Overlap Rule's transitional rule be clarified to apply, consistently with the explanation of this rule in the Preamble, to domestic pass-through entities which apply the entity treatment of domestic pass-through entities for subpart F purposes in taxable years beginning before January 25, 2022. It should not matter that the same owners of the domestic pass-through entity are not subject to GILTI inclusions during those taxable years, when there is not significant overlap of the types of passive income covered by the PFIC regime and the active low-taxed intangible income covered by the GILTI

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93 87 Fed. Reg. 3894.

94 Prop. Treas. Reg. § 1.1291-1(c)(5)(ii)(B).

95 *See* Prop. Treas. Reg. § 1.951A-1(e)(2).

96 Treas. Reg. § 1.958-1(d)(4)(i).

regime. In other words, in accordance with the Preamble, a taxpayer should be able to use the CFC Overlap Rule for a CFC as long as it has included the CFC's subpart F income in its gross income, which has been the case since the inception of the CFC Overlap Rule in 1997.

If it is determined that the suggested clarification is not what was meant by the quoted portion of the Preamble, then we suggest that the CFC Overlap Rule should continue to apply to domestic pass-through entities which apply the entity treatment of domestic pass-through entities for subpart F purposes in taxable years beginning before January 25, 2022, as long as their GILTI inclusion is (or would have been) zero during the taxable year. In other words, the CFC Overlap Rule should continue to apply even if the domestic pass-through entity uses aggregate treatment for GILTI inclusions, if there are in fact no GILTI inclusions being avoided by the owners of the pass-through entity for using the CFC Overlap Rule.

VIII. Controlling Domestic Shareholder Determination

The 2022 Proposed Regulations would apply aggregate treatment for a domestic pass-through entity in determining a CFC's controlling domestic shareholder. When the domestic pass-through entity owns the stock of a CFC, the CFC's applicable elections would be made by the ultimate direct or indirect owners of the pass-through entity that are U.S. individuals, corporations, trusts, or estates.

While we appreciate the goal of the 2022 Proposed Regulations that the controlling domestic shareholder decisions should be made by the taxpayers that are ultimately affected by such decisions, we recommend that the controlling domestic shareholder should continue to be determined at the domestic pass-through entity level. In contrast to other elections, such as the PFIC Elections, that can be made by the entity owners individually on a separate basis, the controlling domestic shareholder decisions apply to all of the United States shareholders of the CFC and require unanimity among the controlling domestic shareholders. A significant coordination effort is required for all the controlling domestic shareholders, some of whom are minority shareholders who own only 10% of the CFC's stock, to agree on a decision, which is compounded in widely held or tiered entity situations. The practical effect is that the controlling domestic shareholder elections may be virtually impossible to make under the aggregate approach.

In contrast, under the entity approach that has worked for domestic pass-through entities for nearly six decades, the domestic pass-through entity is closer to the CFC and can more easily make a unanimous decision that binds all of the pass-through entity's direct and indirect owners that are United States shareholders. The pass-through entity also has more access to more readily available information about other related CFCs, such as the entity's or related entities' other investments, that sometimes may require consistency in the controlling domestic shareholder elections. The GILTI high tax exclusion election, for example, has a consistency requirement for all members of a "CFC group" that are typically under more than 50% common ownership.[97]

The entity approach for determining controlling domestic shareholder status does not prevent the actual choice of tax elections from being determined at the pass-through entity owner level if that is the business goal of the parties. If an owner of a pass-through entity would like the

[97] Treas. Reg. § 1.951A-2(c)(7)(viii)(E).

entity's CFCs to make certain tax elections, the entity's operating agreement can be negotiated so that the entity and its CFCs are bound to make the desired elections.

Based on the same agency approaches described above in connection with the PFIC Elections, a foreign partnership that owns the stock of a CFC should be able to make the controlling domestic shareholder elections on behalf of the foreign partnership's direct and indirect domestic partners that are the CFC's controlling domestic shareholders.