NEW SUBPART F AND P.F.I.C. REGULATIONS – *EX UNO PLURES*

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Flow-through entities raise the question of when the entity stands in its own name versus being a collection of its owners. This is commonly referred to the entity versus aggregate approach to partnerships, that was at the heart of the *Grecian Magnesite* case,[1] applying entity treatment for sales and other dispositions of partnership interests, and the adoption of Code §864(c)(8) and §1446(f), prospectively applying aggregate treatment for those transactions. The Internal Revenue Code allows entity treatment in certain situations and aggregate in others. Four years ago, the I.R.S. issued regulations on the proper approach for certain purposes of Code §951A, related to Global Intangible Low-Taxed Income ("G.I.L.T.I.).

The I.R.S. initially contemplated a hybrid approach for U.S. partnerships that were shareholders in controlled foreign corporation ("C .F.C.'s"). U.S. partners who also owned shares of the C.F.C. directly would follow the aggregate approach and compute their G.I.L.T.I. share directly. For all other partners, the partnership would calculate its G.I.L.T.I. share, and the partners would report a distributive share of the partnership's G.I.L.T.I. inclusion.

The final G.I.L.T.I. regulations scrapped this complex method and adopted the aggregate approach for all partners for purposes of Code §951A. The I.R.S. has now set its sights on similar questions in different areas. On January 25, 2022, the I.R.S. released final regulations for C.F.C.'s under Subpart F and proposed regulations on Passive Foreign Investment Companies ("P.F.I.C.'s"). As with the G.I.L.T.I. regulations, the new Subpart F and P.F.I.C. regulations reflect aggregate treatment for partnerships.

SUBPART F

Background

Under Code §951, U.S. Shareholders in a C.F.C. must include in income their respective shares of the C.F.C.'s Subpart F Income. A foreign corporation is a C.F.C. if shares representing more than 50% of the total value of all shares of stock outstanding or more than 50% of the total voting power of all shares of stock of the foreign corporation entitled to vote are owned directly, indirectly, or by attribution from others, by one or more persons who are "U.S. Shareholders."[2] A U.S. Shareholder is a U.S. Person who owns directly, indirectly, or by attribution from others, shares representing at least 10% of the total value of all shares of stock outstanding or at least 10% of the total voting power of all shares of stock of the foreign corporation

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1 *Grecian Magnesite Mining, Industrial & Shipping Co., SA, v. Commr.,* 149 T.C. 63 (2017), *affd.* 926 F/3d 819 (D.C. Cir. 2019).

2 Code §957(a).

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entitled to vote.[3] A "U.S. Person" includes a citizen, a tax resident, a domestic corporation, and domestic partnership, and a domestic trust or estate.[4]

Entity treatment was the proper method prior to the new regulations. A domestic partnership or S-Corporation that owned shares in a C.F.C. would calculate its Subpart F inclusion and add it to the distributive shares of its owners.

Proposed Regulations

The initial set of proposed regulations, which were released in 2019, used a hybrid treatment: there would be entity treatment with regard to foreign owners but aggregate treatment with regard to domestic owners. But as with the G.I.L.T.I. regulations, the final regulations choose a simpler approach of aggregate for all.[5] In addition to partnerships and S-Corporations, aggregate treatment applies to domestic grantor trusts but not to domestic non-grantor trusts or domestic estates.

The new regulations[6] eliminate Subpart F Income inclusions for many partners and S-Corporation shareholders. Previously, Subpart F Income inclusion was determined at the entity level, meaning that each partner included his or her share of the partnership's Subpart F Income. Now, a partner who owns less than 10% of a partnership that owns 100% of a C.F.C. will no longer have Subpart F Income with respect to that C.F.C. The partnership does not have Subpart F Income that the partner must take into account, and the partner is not a U.S. shareholder in his or her own right because less than 10% of the C.F.C. is deemed held by the partner.

More broadly, the regulations apply aggregate treatment for purposes of Code §§951 and 951A and any provision that refers to them. In the proposed regulations, this created a bit of ambiguity. Code §951(a)(1)(B) requires the inclusion of sums calculated under Code §956, but Code §956 does not refer to Code §§951 or 951A. Code §956 governs a C.F.C.'s investment in U.S. property. The final regulations explicitly add Code §956(a) to the scope of the new regulations.

Entity treatment still applies for certain aspects. Whether a foreign corporation is a C.F.C. is still determined at the entity level. A foreign corporation that is owned solely by a domestic partnership is still a C.F.C. This is true even if none of the partners are U.S. shareholders of a C.F.C. under aggregate analysis. If the partnership then sells C.F.C. stock and recognizes gain, the gain is still subject to dividend treatment under Code §1248, determined at the entity level. Entity treatment also applies in identifying controlling domestic shareholders of a C.F.C. Finally, entity treatment still seems applicable with regard to Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*. A domestic partnership or S-Corporation that is a U.S. shareholder of a C.F.C. can relieve its partners or shareholders of the duty to file Form 5471 by filing the form itself. The new regulations do not mention any changes to this requirement.

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[3] Code §951(b).

[4] Code §7701(a)(30).

[5] T.D. 9960.

[6] Treas. Reg. §1.958-1(d).

Examples in Regulations

The final regulations contain three examples[7] that illustrate the treatment of a U.S. partnership and its members when applying Subpart F and G.I.L.T.I.

Example (1)

(A) *Facts*. USP, a domestic corporation, and Individual A, a United States citizen unrelated to USP, own 95% and 5%, respectively, of PRS, a domestic partnership. PRS owns 100% of the single class of stock of FC, a foreign corporation.

> ***"The final regulations contain three examples that illustrate the treatment of a U.S. partnership and its members when applying Subpart F and G.I.L.T.I."***

(B) *Analysis*

(1) *United States shareholder and CFC determinations*. Under paragraphs (d)(2)(i) and (ii) of this section, respectively, the determination of whether PRS, USP, and Individual A (each a United States person) are United States shareholders of FC, and whether FC is a controlled foreign corporation, is made without regard to paragraph (d)(1) of this section. PRS, a United States person, owns 100% of the total combined voting power or value of the FC stock within the meaning of section 958(a). Accordingly, PRS is a United States shareholder under section 951(b), and FC is a controlled foreign corporation under section 957(a). USP is also a United States shareholder of FC because it owns 95% of the total combined voting power or value of the FC stock under sections 958(b) and 318(a)(2)(A). Individual A, however, is not a United States shareholder of FC because Individual A owns only 5% of the total combined voting power or value of the FC stock under sections 958(b) and 318(a)(2)(A).

(2) *Application of sections 951 and 951A*. Under paragraph (d)(1) of this section, for purposes of sections 951 and 951A, PRS is not treated as owning (within the meaning of section 958(a)) the FC stock; instead, for purposes of determining the persons that own the FC stock within the meaning of section 958(a), the FC stock is treated as if it were owned by a foreign partnership under paragraph (b) of this section. Therefore, for purposes of sections 951 and 951A, USP is treated as owning 95% of the FC stock under section 958(a), and Individual A is treated as owning 5% of the FC stock under section 958(a). USP is a United States shareholder of FC, and therefore USP determines its income inclusions under sections 951 and 951A directly with respect to FC based on its ownership of FC stock under section 958(a). However, because Individual A is not a United States shareholder of FC, Individual A does not have an income inclusion under section 951 with respect to FC or a *pro rata* share of any amount of FC for purposes of section 951A. This is the case even though PRS is a United States shareholder of FC.

Example (2)

(A) *Facts*. USP, a domestic corporation, and Individual A, a United States citizen, own 90% and 10%, respectively, of PRS1, a domestic partnership. PRS1 and Individual B, a nonresident alien individual, own 90% and 10%, respectively, of PRS2, a domestic partnership. PRS2 owns 100% of the single class of stock of FC, a foreign corporation. USP, Individual A, and Individual B are unrelated to each other.

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[7] Treas. Reg. 1.958-1(d)(3) *Examples*.

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(B) *Analysis*.

(1) *United States shareholder and CFC determinations*. Under paragraphs (d)(2)(i) and (ii) of this section, the determination of whether PRS1, PRS2, USP, and Individual A (each a United States person) are United States shareholders of FC, and whether FC is a controlled foreign corporation, is made without regard to paragraph (d)(1) of this section. PRS2 owns 100% of the total combined voting power or value of the FC stock within the meaning of section 958(a). Accordingly, PRS2 is a United States shareholder under section 951(b), and FC is a controlled foreign corporation under section 957(a). Under sections 958(b) and 318(a)(2)(A), PRS1 is treated as owning 90% of the FC stock owned by PRS2. Accordingly, PRS1 is also a United States shareholder under section 951(b). Further, under section 958(b)(2), PRS1 is treated as owning 100% of the FC stock for purposes of determining the FC stock treated as owned by USP and Individual A under section 318(a)(2)(A). Therefore, USP is treated as owning 90% of the FC stock under section 958(b) (100% x 100% x 90%), and Individual A is treated as owning 10% of the FC stock under section 958(b) (100% x 100% x 10%). Accordingly, both USP and Individual A are also United States shareholders of FC under section 951(b).

(2) *Application of sections 951 and 951A*. Under paragraph (d)(1) of this section, for purposes of sections 951 and 951A, PRS1 and PRS2 are not treated as owning (within the meaning of section 958(a)) the FC stock; instead, for purposes of determining the persons that own the FC stock within the meaning of section 958(a), as the FC stock is treated as if it were owned by foreign partnerships under paragraph (b) of this section. Therefore, for purposes of determining the amount included in gross income under sections 951 and 951A, under section 958(a) USP is treated as owning 81% (100% x 90% x 90%) of the FC stock, and Individual A is treated as owning 9% (100% x 90% x 10%) of the FC stock. Because USP and Individual A are both United States shareholders of FC, USP and Individual A determine their respective inclusions under sections 951 and 951A directly with respect to FC based on their ownership of FC stock under section 958(a). This is the case even though PRS2 is a United States shareholder of FC.

<u>Example (3)</u>

(A) *Facts*. Individual A, a United States citizen, Individual B, a United States citizen unrelated to Individual A, and Individual C, a foreign person unrelated to both Individuals A and B, own 10%, 5%, and 85%, respectively, of PRS, a domestic partnership. PRS owns 100% of the single class of stock of FC, a foreign corporation. FC holds an account receivable from PRS that constitutes an obligation of a United States person within the meaning of section 956(c)(1)(C) and §1.956-2(a)(1)(iii).

(B) *Analysis*.

(1) *United States shareholder and CFC determinations*. Under paragraphs (d)(2)(i) and (ii) of this section, respectively, the determination of whether PRS, Individual A, and Individual B (each a United States person) are United States shareholders of FC, and whether FC is a controlled foreign corporation, is made without regard to paragraph (d)(1) of this section. PRS, a United States person, owns 100% of the total combined voting power or value of the FC stock within the meaning of section 958(a). Accordingly, PRS is a United States shareholder under section 951(b), and FC is a controlled foreign corporation under section 957(a). Individual A is also a United States shareholder of FC because it owns 10% of the total combined voting

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power or value of the FC stock under sections 958(b) and 318(a)(2)(A). Individual B, however, is not a United States shareholder of FC because Individual B owns only 5% of the total combined voting power or value of the FC stock under sections 958(b) and 318(a)(2)(A).

(2) *Application of section 956(a).* Under paragraph (d)(1) of this section, for purposes of section 956(a), PRS is not treated as owning (within the meaning of section 958(a)) the FC stock; instead, for purposes of determining the persons that own the FC stock within the meaning of section 958(a), as the FC stock is treated as if it were owned by a foreign partnership under paragraph (b) of this section. Therefore, for purposes of section 956(a), under section 958(a) Individual A is treated as owning 10% of the FC stock, and Individual B is treated as owning 5% of the FC stock. Individual A is a United States shareholder of FC, and therefore Individual A determines the amount it must include in gross income under section 951(a)(1)(B) by reason of the PRS obligation held by FC based on its ownership of FC stock under section 958(a) as determined under paragraph (d)(1) of this section. However, because Individual B is not a United States shareholder of FC, Individual B does not have an amount to include in income under sections 956(a) and 951(a)(1)(B).

(3) *Application of section 956(c) and (d).* Under paragraph (d)(2)(iii) of this section, for purposes of section 956(c) and (d), the determination of whether FC holds United States property is made without regard to paragraph (d)(1) of this section. Therefore, PRS is treated as owning stock of FC within the meaning of section 958(a) for purposes of determining the amount of United States property held by FC arising from its account receivable from PRS.

P.F.I.C.'S

The P.F.I.C. rules are designed to prevent a U.S. person from avoiding tax by deferring receipt of income from a P.F.I.C., thereby allowing profits to be reinvested on a pre-tax basis. By default, Code §1291 mandates ordinary-income treatment when a P.F.I.C. shareholder receives an excess distribution, which includes not only distributions from the P.F.I.C., but gain on disposition of the P.F.I.C. shares of stock. The excess distribution is allocated to each day in the holding period, all income allocated to a prior P.F.I.C. year is taxed at the highest rate prescribed for ordinary income in such year. The tax for each such prior P.F.I.C. year is deemed to be paid late, and late payment interest is calculated for such year. The entire benefit of deferral and often much more is paid the U.S. Fisc as tax on the excess distribution, a much more painful result than a current inclusion in income under Subpart F.

Where a P.F.I.C. is owned by a partnership, the proposed regulations apply aggregate treatment to the excess distribution regime.[8] Mechanically, the proposed regulations exclude domestic partnerships and S-Corporations from the definition of P.F.I.C. shareholder for certain purposes.

As an alternative to the excess distribution regime, P.F.I.C. shareholders can make one of two elections. A shareholder can elect to treat a P.F.I.C. as a Qualifying Electing Fund ("Q.E.F."). A shareholder of a Q.E.F. must include his or her share of the Q.E.F.'s income in gross income on an annual basis. If a shareholder has marketable P.F.I.C. stock, the shareholder can instead make a mark-to-market ("M.T.M.")

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[8] REG-118250-20.

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election, which requires the shareholder to include the year-to-year change in the value of the stock in gross income. These elections are made shareholder and once made affect only that shareholder. Consequently, a P.F.I.C. can be a Q.E.F. with respect to one of its shareholders while remaining a P.F.I.C. for some or all other shareholders. Additionally, if the shareholder makes the election after the first year in which P.F.I.C. stock is acquired – or if the individual is an arriving resident in the U.S. and not a citizen, in the year residence begins – the P.F.I.C. stock is considered tainted and will be subject to both the excess distribution regime and the rules of the shareholder's elected regime as to future capital gains. Removing the taint requires a purging election, or a deemed sale or dividend.

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As with old rules for G.I.L.T.I. and Subpart F, Q.E.F. and M.T.M. elections were previously made at the entity level. This will change under the proposed regulations. When effective, they will require that each partner or S-Corporation shareholder make the election and notify the entity upon doing so. Purging elections are also to be done at the owner's level. Allowing the entity's individual owners to make the election puts decision-making in the hands of those who are ultimately affected by such elections. This aligns with the I.R.S.'s goal of consistency but is likely to greatly increase the volume of reporting and coordination between partners/shareholders and partnerships/S-Corporations. The problem is exacerbated for funds and their investors, as each investor wishing to make an election would have to file an election that the fund previously could have filed once for all of its investors. In a nod to administrability concerns, the I.R.S. is floating the idea of allowing partnerships and S-Corporations to also make Q.E.F. or M.T.M. elections. Additionally, the proposed regulations would maintain existing Q.E.F. or M.T.M. elections but conform to the new approach by treating the election as though it were made by the partners or S-Corporation shareholders. The objective is to mitigate the number of elections that will have to be made.

There are similar concerns over information reporting. Shareholders of a P.F.I.C. must file Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*. Currently, if a partnership or S-Corporation owns shares of stock in a P.F.I.C., the entity can file the form and relieve its owners of this obligation. This is similar to the requirements regarding Form 5471, discussed above. However, in comparison to Form 5471, the proposed regulations shift this duty to the partners or S-Corporation shareholders. The owners would receive the necessary information on the new Schedule K-3 prepared by the entity. As with the elections, aggregate treatment will result in massive growth in reporting obligations. With the number of forms growing, the likelihood of errors will increase exponentially, likely leading to the assessment of penalties for late or inaccurate filing.

As discussed above, the new Subpart F regulations mean that many partners or S-Corporation shareholders will no longer have Subpart F inclusions. As mentioned above, their relief might be fleeting. Under the C.F.C.-P.F.I.C. overlap rule, a U.S. person who holds shares in a company that is both a C.F.C. and a P.F.I.C. is not subject to P.F.I.C. rules while the person is a U.S. Shareholder of the C.F.C. But if C.F.C. status is eliminated, P.F.I.C. rules will apply in their place. Not surprisingly, the proposed regulations confirm that the overlap rule is analyzed at the level of the partner or shareholder.

CONCLUSION

After adoption of the earlier G.I.L.T.I. regulations, it was no surprise that the I.R.S. extended aggregate treatment to Subpart F and P.F.I.C.'s. Consistency was the Service's stated goal. But this may lead to more onerous filing and reporting requirements for taxpayers. That result is likely to be confirmed when the I.R.S. publishes final P.F.I.C. regulations. Next on the I.R.S.'s aggregate-vs-entity agenda is previously taxed earnings and profits, which will be the subject of a new set of proposed regulations. In sum, not only will there be a long and bumpy transition to aggregate filing that will be accompanied by errors, compliance costs will skyrocket. Less-for-more truly is the mantra of our age.

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