DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
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CC:INTL:Br2

Number: **200031015**
Release Date: 8/4/2000

April 17, 2000

UILC: 1296.02-01; 1296.02-04

INTERNAL REVENUE SERVICE
NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM:

SUBJECT:

This Field Service Advice responds to your memorandum dated January 10, 2000. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

LEGEND:

a =
Amount 1 =

Amount 2 =
Amount 3 =
Amount 4 =
Amount 5 =
Amount 6 =
Amount 7 =
Amount 8 =
Amount 9 =
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Amount 16	=
Amount 17	=
Amount 18	=
Amount 19	=
Amount 20	=
Amount 21	=
Amount 22	=
Amount 23	=
Corporation A	=
Corporation B	=
Corporation C	=
Corporation D	=
Corporation E	=
Costs A	=
Costs B	=
Costs C	=
Country	=
Customers	=
Date A	=
Date B	=
Entities	=
Event A	=
Event B	=
Payments	=
Property A	=
Property B	=
Property C	=
Property D	=
Service A	=
Service B	=
Service C	=
Service D	=
Service E	=
Service F	=

Service G	=
Service H	=
Service I	=
Service J	=
Service K	=
Year 1	=
Year 2	=
Year 3	=
Year 4	=
Year 5	=
Year 6	=
Year 7	=
Year 8	=
Year 9	=
Year 10	=
Year 11	=
Year 12	=
Year 13	=

<u>ISSUES</u>:

1. Whether Corporation C is a passive foreign investment company ("PFIC") under Section 1296(a)[1] of the Code for each taxable year, commencing with Year 2 through Year 13.

<u>CONCLUSIONS</u>:

1. Based on the limited facts provided, we cannot determine for each of the Years 2 through 13 whether Corporation C is a PFIC. However, with respect to Years 2 through 9, Corporation C does not qualify for the insurance exception under section 1296(b)(2)(B), and for Years 5 through 9 Corporation C does not qualify for the active rents or royalties exception under section 954(c)(2)(A), for purposes of excluding its income from the classification of "passive income", or excepting the assets that produce that income from the classification of passive

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[1] Pub.L. No. 105-34, Sec. 1121, (1997) redesignated the provisions contained under section 1296 of the Code as section 1297, and redesignated the provisions contained under section 1297 as section 1298, effective as of August 5, 1997. For purposes of this document, all references to former section 1296 and current section 1297 will be referred to as section 1296. Similarly, all references to former section 1297 and current section 1298 will be referred to as section 1297.

assets. In addition, for Years 5 though 13, there is insufficient information to determine whether the PFIC related person look-thru rents or royalties exception under section 1296(b)(2)(C) applies. Also, with respect to Years 10 through 13, there is insufficient information to determine whether Corporation C would be subject to taxation under subchapter L if it was a domestic corporation, or whether its leasing activities would qualify for the active rents or royalties exception.

FACTS:

Corporation A is a domestic corporation and provides Service A to Customers. For the years at issue, as part of this service, Corporation A also provided Service B . If Customers desired, they could purchase Service C by making Payments to Corporation A. Historically, Payments for Service C were included in the gross income of Corporation A.

On any particular date, the shareholders of Corporation A were substantially identical to the shareholders of Corporation C, although the proportionate ownership interest of a particular shareholder in Corporation A and Corporation C would likely not be identical.

Transaction I

Transaction II

In Year 1, Corporation A also entered into a contract for the performance of Services F and G by Corporation E. In recognition for such services, Corporation A agreed to pay Corporation E Amount 1, and deducted such amount on its income tax return.

Following the execution of this contract, Corporation E entered into a separate contract with Corporation C whereby the latter agreed to perform Service H for Amount 1, minus certain expenses retained by Corporation E. Pursuant to this contract, Corporation C agreed to assume Costs B in connection with Event B, and Corporation E agreed to assume Costs C with respect to such event.

Subsequent to Year 1, Corporation A disregarded the terms of its contract with Corporation E by paying a sum in excess of Amount 1 to Corporation E. The effect of such overpayment was to recompense Corporation C for Costs B that it incurred.

Activities of Corporation C in Years 2 through 13

During Years 2 through 13, Corporations A, D, E and C continued to engage in the respective activities described under Transactions I and II. Furthermore, Corporation C had additional sources of income as described below.

During Years 2 and 3, Corporation C had earnings from its investment portfolio. For Year 2, Corporation C earned investment income totaling Amount 2. No information was provided with respect to Year 3.

In Year 4, Corporation C started to provide Service I, but such activity did not generate any income. However, Corporation C earned investment income totaling Amount 3.

In Year 5, Corporation C earned Amount 4 from Service J, and Amount 5 from investments. In addition, Corporation C entered into two new activities. First, Corporation C acquired Property A and leased it to Corporation A. Second, Corporation C acquired Property B from Corporation A, and entered into a lease-back of such property to Corporation A. These two new activities produced income of Amount 6 in Year 5.

In Year 6, Corporation C expanded Service J and earned Amount 7 from such activity. Revenue from leasing and investment activities for that year totaled Amounts 8 and 9 respectively. Corporation C’s balance sheet for that year disclosed asset values of Amount 10 for Properties A and B; Amount 11 for investments; and Amount 12 for other non-financial assets. Hence, Corporation C had assets totaling Amount 13, out of which Amount 14 is claimed to be assets from an active business.

In Years 7 and 8, Corporation C sustained a significant decrease in income from Service J, while the income from leasing operations increased. No financial information was provided with respect to the amount of income earned or value of assets held for either Year 7 or 8.

In Year 9, Corporation C expanded its leasing business including the acquisition of Property C, which was managed by a third party. Corporation C also engaged in Service K and derived significant revenue therefrom. However, it sustained a loss from investment related activities. The leasing related assets totaled Amount 17 and assets related to Service J totaled Amount 18. In addition, assets related to Service K totaled Amount 19.

In Years 10 and 11, Corporation C expanded Service J, however there is no indication as to the amounts earned in connection with such activity. Corporation C also expanded its leasing activities.

In Years 12 and 13, Corporation C increased Service J and continued to engage in leasing activities. Assets related to leasing activities totaled Amount 20, and Service J activities totaled Amount 21.

<u>LAW AND ANALYSIS</u>:

The consequence of this determination is to treat such income as constructive dividends to its shareholders, followed by deemed contributions of capital to Corporation C by the shareholders. Accordingly, the assets resulting from the deemed contributions of capital by those shareholders belong to Corporation C.

The issue in this case is whether Corporation C is a PFIC. To determine whether Corporation C is a PFIC, it must satisfy either the asset or income test set forth under section 1296(a). The assets received by Corporation C by virtue of the deemed contributions of capital would be subject to the asset test under section 1296(a)(2). Similarly, the income generated by such assets would be included in determining the income test under section 1296(a)(1). To the extent that Corporation C is determined to be a PFIC, section 1291 imposes a tax, and special interest charge on the tax, upon U.S. persons who own stock in a PFIC with respect to distributions received from the PFIC, and gain recognized upon disposition of the PFIC stock. The tax is imposed based on the highest rate of tax applicable to the U.S. person for the particular taxable year.

Furthermore, if a foreign corporation is determined to be a PFIC, section 1297(b)(1) provides that the stock held by the taxpayer shall be treated as stock in a PFIC if, at any time during the holding period of the taxpayer with respect to such stock, such corporation (or any predecessor) was a PFIC which was not a qualified electing fund. This provision effectively operates to taint the stock held by a U.S. shareholder in a foreign corporation as stock in a PFIC if at any time during the shareholder's entire holding period such foreign corporation was a PFIC for any taxable year. Hence, it is necessary to analyze each of Years 2 through 13 because it is assumed that there were some changes in shareholder ownership of Corporation C during those years.

A. <u>Law and Analysis for Years 2 and 3</u>:

Section 1296(a) defines the term "passive foreign investment company" as any foreign corporation if —

> (1) 75 percent or more of the gross income of such corporation for the taxable year is passive income, or
>
> (2) the average percentage of assets (by value) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent.

Section 1296(b)(1) defines "passive income" as any income which is of a kind which would be foreign personal holding company income ("FPHCI") as defined in section 954(c). Section 954(c)(1) defines FPHCI to include dividends, interest, income equivalent to interest, royalties, rents and annuities. However, section 1296(b)(2) sets forth four exceptions to "passive income" that are primarily related to income earned in connection with certain business activities. One of these exceptions, section 1296(b)(2)(B), provides that "passive income" does not include any income—

> derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business

> and which would be subject to tax under subchapter L if it were a domestic corporation…

Section 831 of subchapter L sets forth the rules governing the taxation of insurance companies other than life insurance companies. Although section 831 does not define what constitutes an insurance company, Treas. Reg. § 1.831-3(a) states that for purposes of sections 831 and 832, the term "insurance companies" means only those companies which qualify as insurance companies under former § 1.801-1(b).[2] Specifically, Treas. Reg. § 1.801-3(a)(1) provides:

> The term "insurance company" means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code.

Several courts have addressed whether a particular taxpayer should be treated as an insurance company for tax purposes. In Bowers v. Lawyers Mortgage Co., 285 U.S. 182 (1932), the taxpayer examined titles; procured and furnished information relating to titles; purchased and sold notes and mortgages; guaranteed and insured bonds, mortgages and real estate against loss by reason of defective titles; and insured the payment of debts. Thus, the taxpayer derived income from performance of services and insuring risks. During the year at issue, approximately 33% of the taxpayer's income were derived from insurance premiums. To determine whether the taxpayer was taxable as an insurance company, the Court explained that such determination "depends on the character of the business actually done during the taxable year." Id. at 188. Accordingly, the Court compared the amount of the taxpayer's premiums to the amount of its income derived from other sources, and concluded that the taxpayer was not an insurance company. The Court noted that the insurance portion of the taxpayer's business was incidental to its business of making and selling mortgage loans.

Similarly, the Court in Inter-American Life Ins. Co. v. Commissioner, 56 T.C. 497 (1971), aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), also compared the taxpayer's insurance related and non-insurance related income in determining whether the taxpayer was taxable as an insurance company. In that case, the taxpayer's shareholders formed the taxpayer for the ostensible purpose of reinsuring life insurance risks, and contributed to the taxpayer cash and other

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[2] Former Treas. Reg. § 1,801-1(b) is now § 1.801-3(a)(1).

assets. During the years in issue, taxpayer did not maintain an active sales force, and although it initially secured a small amount of reinsurance business, its predominant source of income was from investments. For the taxable years at issue, the amount of premiums earned by the taxpayer did not exceed 15% of its gross investment income. The taxpayer's "insurance" income was attributable to related party risks, and thus, it was able to generate premium income without an active sales force. Upon reviewing the taxpayer's financial data, the Court concluded that the taxpayer's primary and predominant source of income was from investments and not from the insuring of risks. Moreover, the taxpayer's primary and predominant "efforts" were not expended in pursuit of its insurance activities. Thus, since the taxpayer had not used its "capital and efforts" for the purpose of earning income from the issuance of insurance, the taxpayer was not taxable as an insurance company.

The Courts in Cardinal Life Ins. Co. v. United States, 300 F. Supp. 387 (N.D. Tex. 1969), and Industrial Life Ins. Co. v. United States, 344 F. Supp. 870 (D.S.C. 1972), aff'd per curiam, 481 F.2d 609 (4th Cir. 1973), have employed similar approaches in rejecting taxpayers' contentions that they were taxable as insurance companies. The Court in Cardinal Life explained that the taxpayer earned no insurance premiums during two of the five years at issue, and its premium income with respect to the remaining three years represented no more than 9.11% of its total income, which included income from dividends, interest, rent and capital gains. The Court also noted that the taxpayer did not employ any brokers, agents or sales people in an attempt to sell its policies. Similarly, the Court in Industrial Life explained that although the taxpayer generated 20% of its income by issuing credit life insurance, its primary source of income was attributable to its investment portfolio and the sale and leasing of real estate. Thus, the Court concluded that taxpayer's "primary and predominant" business activity was not insurance.

In a case where the taxpayer derived more than 50% of its income from premium income, a Court has held that such taxpayer was taxable as an insurance company. For instance, in Service Life Ins. Co. v. United States, 189 F. Supp. 282 (D. Neb. 1960), the taxpayer issued a significant amount of life, health and accident policies, and invested and managed the premiums derived therefrom. In addition to its insurance activities, the taxpayer derived income by making mortgage loans and by investing amounts that it borrowed from the Federal Home Loan Bank. More than 50% of the taxpayer's income was attributable to premium income, and more than 50% of the taxpayer's income-producing assets were held for policy reserves. Notably, the Court seemed to make a distinction between investment assets held as insurance reserves, and other investment assets. After a consideration of all facts, the Court concluded that the "actual character of the business done" by the taxpayer was the sale, issuance, and servicing of insurance contracts.

The amounts received by Corporation C in connection with Transaction I were constructive dividends to its shareholders, followed by deemed contributions by the shareholders to the capital of Corporation C. The PFIC tax provisions were not in effect for Year 1. Based on the facts presented, the income earned by Corporation C is not excepted from the definition of "passive income" pursuant to section 1296(b)(2)(B) for Years 2 and 3. In order to exclude Corporation C's income from passive classification under the "active conduct of an insurance business", Corporation C must be taxable as an insurance company under subchapter L if it was a domestic corporation. The amounts purportedly received by Corporation C in connection with Transaction I do not constitute insurance related income given that those activities had no economic substance or business purpose.

As for the amounts received by Corporation C in connection with Transaction II, you requested that we assume such amounts are not considered insurance related income. In light of such assumption, Corporation C would not be subject to tax as an insurance company under subchapter L if it were a domestic corporation, and thus would not qualify for the exception to "passive income" under section 1296(b)(2)(B) with respect to that transaction. To the extent that Corporation C would not be subject to tax under subchapter L if it was a domestic corporation based on Transactions I and II, we need not address whether its activities in Years 2 and 3 rose to the level of being "predominantly engaged in an insurance business".

Accordingly, to the extent that Corporation C's investment income is of the kind described in section 954(c), then such income would be treated as passive income. If that income is 75% or more of the gross income earned by Corporation C, then Corporation C is a PFIC for both Years 2 and 3. Given that the amounts received by Corporation C under Transaction I are treated as contributions to capital, such amounts should be disregarded from Corporation C's total gross income in determining whether it satisfies the 75% income test. However, the assets resulting from the deemed contributions of capital related to Transaction I should be included in determining whether Corporation C had 50% or more of its assets held for the production of passive income. To the extent that Corporation C had 50% or more of its total assets held for the production of passive income in each of Years 2 and 3, Corporation C is a PFIC for each of those years respectively.

A. <u>Law and Analysis for Years 4 through 13</u>:

In Year 4, Corporation C started to provide Service I but derived no income from such service. In addition, Corporation C continued to receive amounts in connection with Transactions I and II, and earned investment income totaling Amount 3. To the extent that Corporation C would not be subject to tax under subchapter L if it was a domestic corporation based on the limited facts presented, Corporation C would thus not qualify for the active conduct of insurance business exception under the PFIC rules.

In Year 5, Corporation C had income totaling Amount 4 from Service J, Amount 5 from investments and Amount 6 from leasing activities. However, information was not provided regarding the assets that were set aside as Property D in connection with Service J. Since Corporation C's investment and leasing income totaled Amount 15, we assume that the amount of Corporation C's assets far exceeded what was necessary to cover its losses in connection with Service J. If this is correct, Corporation C would not be subject to tax as an insurance company under subchapter L if it was a domestic corporation, and hence, neither Amount 4 nor Amount 5 would be subject to the "passive income" exception under section 1296(b)(2)(B).

However, since Corporation C also engaged in leasing activities with Corporation A and earned Amount 6 therefrom, the issue is whether that income qualifies for the active rents or royalties exception set forth under section 954(c)(2)(A). In determining whether a particular item of income is "passive income", the PFIC rules adopt the categories of income that are considered FPHCI under section 954(c). Under that provision, section 954(c)(2)(A), provides an exception for active rents or royalties. That is, "rents or royalties derived in the active conduct of a trade or business and received from a person other than a related person" are not considered FPHCI. Therefore, such rents or royalties derived from unrelated persons in the active conduct of a trade or business would also be excepted from "passive income" under section 1296(b).

The term "related person" is defined in section 954(d)((3)(B) to include a corporation which is controlled by the same person or persons which control the controlled foreign corporation ("CFC"). Although the rules under section 954(d)(3)(B) were enacted to define what constitutes a related party within the context of a CFC, such definition also applies to the PFIC regime in determining whether the income from Corporation C's leasing activities with Corporation A constitute income from a "related person". Since both Corporations C and A are controlled by substantially identical shareholders, the income earned by Corporation C from its leasing activities to Corporation A is considered income from a related person. As such, the active rents or royalties exception under section 954(c)(2)(A) does not apply.

The leasing activities in Year 5 however, may be subject to the section 1296(b)(2)(C) related person look-thru rents or royalties exception. Section 1296(b)(2)(C) provides that "interest, a dividend, or a rent or royalty, which is received or accrued from a related person (within the meaning of section 954(d)(3)) to the extent such amount is properly allocable...to income of such related person which is not passive income..." would be excepted from the definition of "passive income" under section 1296(b)(1). We do not have sufficient information to determine whether this exception applies to the leasing activities of Corporation C for Year 5 or any subsequent year.

In Year 6, Corporation C had income from Service J totaling Amount 7, and income from leasing and investment activities totaling Amounts 8 and 9, respectively. Although Corporation C engaged in Service J, it is unclear how much of Property D was necessary with respect to the business involving Service J. Since Corporation C generated total income of Amount 16 and had assets totaling Amount 13, based on such limited information, it appears that Corporation C's primary and predominant activity was managing assets unrelated to its business involving Service J. As such, Corporation C would not be subject to taxation under subchapter L for Year 6, and thus neither the income from Service J nor any of the investment income would qualify for the insurance exception under section 1296(b)(2)(B).

As for the income from leasing activities, to the extent that such income was derived from transactions with Corporation A, the foregoing analysis described in Year 5 would apply equally to the leasing activities in Year 6.

In Years 7 and 8, Corporation C sustained a significant decrease in income from Service J, while the income from leasing operations increased. Since Corporation C's income from Service J had decreased in comparison to Year 6, while its level of leasing income increased, it appears that Corporation C's primary and predominant activity remained the management of assets unrelated to the business involving Service J. Accordingly, Corporation C would neither be subject to tax under subchapter L nor qualify for the active rents or royalties exception.

In Year 9, Corporation C expanded its leasing business. We do not have sufficient information to determine whether the leasing activities in Year 9 would qualify for the active rents or royalties exception, or the PFIC related person look-thru exception for rents or royalties, given that we do not have any facts surrounding such activities. As such, we cannot determine whether income from leasing activities would be considered passive income. Furthermore, since there is no indication that Corporation C provided Service J or earned any income in connection with such service, Corporation C would not be subject to taxation under subchapter L, thus not qualify for the insurance exception.

In Years 10 through 13, Corporation C expanded both Service J and its leasing activities. In light of the limited factual information, we cannot determine whether Corporation C would be subject to taxation under subchapter L, and thus qualify for the insurance exception. Furthermore, we cannot determine whether the degree of leasing activities would qualify for the active rents or royalties exception, or the PFIC related person look-thru exception for rents or royalties. As such, we cannot determine whether Corporation C derived any passive income or held sufficient assets for the production of passive income.

In sum, if Corporation C satisfies either the income or asset test for any of the foregoing taxable years, Corporation C would be a PFIC. Consequently, section

1297(b)(1) operates to treat the stock held by Corporation C's U.S. shareholders as stock in a PFIC if at any time during such shareholders' holding period of such stock, Corporation C was considered a PFIC. For example, if Corporation C is a PFIC with respect to Year 2, those U.S. shareholders who own stock in Corporation C as of Year 2 would be treated as owning stock in a PFIC for all subsequent years within their respective holding periods.

The shareholders' basis in the stock of Corporation C may be relevant for purposes of the PFIC provisions. That is, if a PFIC shareholder disposes of PFIC stock, the PFIC rules apply to any gain recognized on such disposition in the same manner as if such gain were an excess distribution. *See* I.R.C. § 1291(a)(2). To the extent that the statute of limitations has expired for the shareholders to include the constructive dividends as income for a particular taxable year, the doctrine of duty of consistency bars those shareholders from the benefit of a step-up in basis as a result of the deemed contributions to capital of Corporation C with respect to such taxable year.

[redacted]

[redacted]

By: /s/ Phyllis E. Marcus
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(International)