Passive Foreign Investment Company Rules

Treatment of Income from Certain Government Bonds for Purposes of the Passive Foreign Investment Company Rules

SUMMARY

In an important notice responding to current economic conditions, the Internal Revenue Service has acknowledged that banks may be holding larger amounts of government securities than they ordinarily would, and that it does not intend this situation to cause them to be treated as "passive foreign investment companies," a category that may discourage U.S. persons from investing in their shares.

Generally, negative U.S. tax consequences apply to U.S. shareholders of a "passive foreign investment company" (a "PFIC"), a foreign corporation that has passive income or passive assets in excess of certain thresholds—i.e., if 75 percent or more of the foreign corporation’s gross income for the taxable year is passive income or the average percentage of assets held by the corporation during the taxable year which produce passive income or which are held for the production of passive income is at least 50 percent. For these purposes, "passive income" does not include any income derived in the active conduct of a banking business by an institution licensed to do business as a bank in the United States or, to the extent provided in regulations, by any other corporation (the "active banking exception"). The Internal Revenue Service previously issued guidance on the active banking exception in the form of Notice 89-81 and proposed regulations issued in 1995.

On June 28, 2012, the Internal Revenue Service issued a notice (the “Notice”) providing that, for purposes of the PFIC rules and for taxable years beginning in 2011, 2012, and 2013, the income from certain government bonds held by an “Active Bank” qualifies for the active banking exception.
BACKGROUND
The PFIC rules were intended to discourage U.S. taxpayers from deferring (on an interest-free basis) U.S.
taxation on passive investments, or converting ordinary income to capital gains, by making those
investments through foreign corporations. Generally, under the PFIC rules, negative U.S. tax
consequences apply to U.S. shareholders of PFICs. Under these rules a PFIC is any foreign corporation
if 75 percent or more of its gross income for the taxable year is passive income or the average
percentage of assets held by the corporation during the taxable year which produce passive income or
which are held for the production of passive income is at least 50 percent.

Although banks may earn substantial passive income as a part of their regular banking business, the
PFIC rules were not intended to apply to bona fide banks. Thus, there is a statutory exception to the
term “passive income” for income derived in the active conduct of a banking business by an institution
licensed to do business as a bank in the United States or, to the extent provided in regulations, by any
other corporation (the “active banking exception”). The Internal Revenue Service has previously
provided guidance on the active banking exception, in the form of Notice 89-81 and proposed regulations
issued in 1995 (the “Proposed Regulations”), intended to distinguish bona fide, active foreign banks from
PFICs.

Recent economic conditions have caused many foreign financial institutions to shift assets from one asset
class to another, with the result that certain financial institutions are holding government bonds at higher
than historical levels. These increased levels have raised an issue concerning the treatment of these
financial institutions, and specifically the treatment of government bonds held by such financial
institutions, under the PFIC rules. Specifically, prior to the notice described in more detail below, there
was uncertainty under Notice 89-81 and the Proposed Regulations as to whether government bonds held

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1 See STAFF OF J. COMM. ON TAX’N, 99th Cong., General Explanation of the Tax Reform Act of 1986, at
1023 (J. Comm. Print 1987) (“Blue Book”) (noting as a reason for the enactment of the PFIC rules
that “Congress did not believe that U.S. persons who invest in passive assets should avoid the
economic equivalent of current taxation merely because they invest in those assets indirectly through
a foreign corporation”).

2 Section 1297(a). All “Section” references are to the Internal Revenue Code of 1986, as amended
(the “Code”).

3 H.R. CONF. REP. 99-841 at II-644 (“An exception to the definition of passive income is provided under
the agreement for income derived by bona fide banks . . . . However, the Secretary has regulatory
authority to apply the PFIC provisions to any ‘bank’ where necessary to prevent U.S. individuals from
earning what is essentially portfolio investment income in a tax deferred entity.”).

4 Section 1297(b)(2)(A).

5 1989-2 C.B. 399 (July 6, 1989). Notice 89-81 may be relied upon to the same extent as a revenue
ruling and revenue procedure until final regulations are published. Notice 89-81, Effective Date.

6 60 Federal Register 20922 (April 28, 1995).
The Notice

A notice issued by the Internal Revenue Service on June 28, 2012 (the “Notice”) clarifies the treatment of certain government bonds held by bona fide banks. The Notice provides that, for purposes of the PFIC rules, the income from “Qualifying Government Bonds” held by an “Active Bank” qualifies for the active banking exception. A Qualifying Government Bond means a bond or similar instrument that has been issued by the government (or any political subdivision, agency, instrumentality, or local authority thereof) of the country under the laws of which the Active Bank is created or organized.

The Notice defines an “Active Bank” to be a foreign corporation that:

- would not be a PFIC for such taxable year, and was not in any prior taxable year beginning in the preceding five calendar years a PFIC, in each case as a result of the application of the active banking exception (after taking into account the treatment of Qualifying Government Bonds described in the Notice and, if applicable, a look-through rule); and

- is, and was in each taxable year beginning in the preceding five calendar years, a publicly traded corporation. For this purpose, a corporation will be treated as a publicly traded corporation if (1) one or more classes of stock is regularly traded on a “qualified exchange or other market,” or (2) at least 50 percent of the aggregate vote and value of the shares in the corporation is owned directly or indirectly by a corporation described in (1).

Thus, during the effectiveness of the Notice, under the Notice, government bonds held by a bank meeting the definition of “Active Bank” give rise to non-passive income and are considered non-passive assets if those bonds were issued by the government (or any political subdivision, agency, instrumentality, or local authority thereof) of the country under the laws of which the bank is created or organized.


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7 The look-through rule in Section 1297(c) provides that a foreign corporation that owns (directly or indirectly) at least 25 percent by value of the stock of another corporation will, for the purposes of determining whether the foreign corporation is a PFIC, be treated as holding its proportionate share of the assets of such other corporation, and receiving directly its proportionate share of the income of such other corporation.

8 This phrase is defined in Treasury Regulations Section 1.1296-2.
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