Passive Foreign Investment Companies: Reinterpreting the Active Banking Exception for the Modern Banking Industry

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I. Introduction

The passive foreign investment company ("PFIC") rules generally impose unfavorable tax treatment on certain U.S. shareholders of foreign corporations that generate excess passive income or hold excess passive assets.[1] In January 2021, the Treasury and IRS (the "Treasury") issued final regulations (the "2020 Final Regulations") and re-proposed certain regulations under Code Sec. 1297 (the "2020 Proposed Regulations"),[2] which significantly challenge the ability of a foreign corporation that is carrying on active (in an ordinary sense) financial services and lending business to qualify as a non-PFIC, unless the corporation is licensed as a bank in its charter country and accepts deposits from and lends to unrelated customers as part of its banking business. The 2020 Final Regulations and 2020 Proposed Regulations presented a change of direction from the regulations that the Treasury proposed in 2019 (the "2019 Proposed Regulations"),[3] which, had they been adopted as proposed, would have confirmed that the definition of passive income for PFIC purposes excludes certain active finance income defined under Code Sec. 954(h) (the "active financing exception," or "AFE").[4] The Treasury's reversal was largely unexpected by the market and tax practitioners. Proposed confirmation of the AFE's applicability to the PFIC regime had been met with unified approval of the commentators, and many tax practitioners had already generally shared the interpretation of the statute and legislative history that the Treasury presented as an explanation for its initial proposal, even before the Treasury issued the 2019 Proposed Regulations.[5]

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These recent regulatory developments magnify the difficulties that foreign enterprises in the modern banking industry face in qualifying as non-PFICs. For example, neobanks, fintech, and other firms leveraging various

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technological innovations are commonly not licensed as banks, but nevertheless derive their income from active financial services and lending businesses, activities that are at the essence of a banking business.[6] Although the AFE's applicability to the PFIC regime, and thus the treatment of active financial services and lending income for PFIC determination purposes, was far from clear prior to the 2019 Proposed Regulations, there was sufficient basis for some of these foreign corporations and their U.S. investors to take a position that such income is nonpassive for purposes of PFIC determination.[7] These U.S. investors may now need to re-assess their tax positions in view of the 2020 Final Regulations and the 2020 Proposed Regulations. While, to our knowledge, no information is publicly available on the magnitude of the impact or U.S. investors' market reaction to this tax development, it is reasonable to assume that investment in foreign unregulated or lightly regulated finance companies may become less attractive to some U.S. investors.[8]

This article discusses the current state and the evolution of, and the possible solution for, the PFIC rules defining nonpassive income in the context of the evolving banking industry. While simply incorporating the AFE into the PFIC rules would be a relatively measured approach that the Treasury could have taken, using the rationale it articulated in the preamble to the 2019 Proposed Regulations, this approach may now be foreclosed as the 2020 Final Regulations explicitly provide that the AFE does not apply for PFIC purposes.[9] This article argues that, as an alternative modernized approach in finalizing the 2020 Proposed Regulations, the Treasury may want to exercise the regulatory authority that the plain language of Code Sec. 1297(b)(2)(A), the "active banking exception," provides to exclude active financial services or lending income of foreign corporations not licensed as banks.[10]

Part II reviews the active banking exception's and the AFE's current and historical statutory and regulatory framework to provide context for the 2020 Final Regulations and 2020 Proposed Regulations. Part III summarizes the 2020 Proposed Regulations and 2020 Final Regulations and the reasons why they may not reflect the realities of the modern banking industry. Part IV discusses the evolving banking industry and suggests, as an alternative to incorporating the AFE into the PFIC regime, eliminating the active banking exception's threshold licensing and deposit-taking requirements. Part V argues that the Treasury's interpretation of the legislative history of and interplay between the PFIC and AFE rules is overly restrictive. Part V then analyzes whether any contrary position the Treasury may have taken in the past may preclude it from using its regulatory authority to eliminate licensing and deposit-taking requirements from the active banking exception. Part VI lays out details for potential active banking exception regulations that adopt the principles of the AFE but are tailored to the PFIC regime. Part VII concludes that a reinterpretation by the Treasury of the statutory active banking exception may be the most appropriate way for the Treasury to account for the vast innovation in the banking industry that has arisen since the adoption of the PFIC rules while also following the PFIC regime's spirit and intent.

II. Background

A. Generally

Congress enacted the PFIC rules as part of the Tax Reform Act of 1986 (the "1986 Act")[11] to remove incentives for U.S. investors to invest in passive investment entities outside the United States.[12] U.S. investors passively investing through U.S. investment companies generally are subject only to a shareholder-level tax under the "regulated investment company" passthrough regime, though this regime requires current inclusion of income.[13] By contrast, absent anti-deferral provisions, U.S. investors investing through offshore funds and other offshore investment vehicles treated as corporations for U.S. tax purposes previously would incur taxes only when they received the income as a dividend from the offshore vehicle, or when they sold their interest in the offshore vehicle, as capital gain. Notably, a U.S. taxpayer that is a 10% or more shareholder (a "10% U.S. shareholder") of a foreign corporation in which such 10% U.S. shareholders own more than 50% of the equity by vote or value (a "controlled foreign corporation," or "CFC") is subject to the anti-deferral provisions known as Subpart F (and more recently, the "global intangible low taxed income" or "GILTI" provisions).[14] As Subpart F generally does not apply to investments in foreign corporations not controlled by 10% U.S. shareholders, the PFIC rules were enacted explicitly to close the perceived loophole that permitted a minority U.S. investor, by investing in an offshore passive investment vehicle not controlled by U.S. investors, to avoid current taxation and to convert ordinary income

into capital gains.[15] The PFIC rules make any actual or deemed deferral of tax costly by retrospectively imposing the highest rates of tax and a punitive interest charge on "excess distributions" from a PFIC (including on gain upon sale of PFIC stock), unless the U.S. investor elects into one of the two PFIC current taxation regimes—the "qualified electing fund" ("QEF") or the "mark-to-market" ("MTM") regime.[16] However, in practice, such elections are frequently unavailable. For example, a U.S. shareholder cannot make a QEF election unless the company provides certain information about its ordinary earnings and net capital gain (and its lower-tier PFIC subsidiaries' ordinary earnings and net capital gain) as determined under U.S. federal income tax principles, which may be quite complicated for an operating multinational.[17] In addition, the MTM election generally is available only to publicly traded companies, which in most cases excludes lower-tier PFICs.[18] Furthermore, the compliance cost associated with owning a PFIC may be a deterrent in itself.[19] Therefore, many U.S. investors view PFICs as unattractive.[20]

B. Basic Definitional Framework of the PFIC Rules

A PFIC is any foreign corporation if 75% or more of its gross income for the taxable year consists of passive income, or if 50% or more of the average value of its assets consist of assets that produce, or are held for the production of, passive income.[21] Under Code Sec. 1297(b)(1), the PFIC rules define "passive income" as "any income which is of a kind which would be foreign personal holding company income as defined in section 954(c)."[22] Any asset that produces or is held for the production of passive income, or does not produce any income, is treated as passive. Foreign personal holding company income ("FPHCI") is a subcategory of foreign base company income, which in turn is the general category for Subpart F income that 10% U.S. shareholders of CFCs must include in current income.[23] Under Code Sec. 954(c), FPHCI generally includes income that the Code considers to be passive in nature and, in particular, includes interest, dividends, and certain gains. As a result of this structural framework, as a general rule and notwithstanding exceptions specific to the Subpart F or PFIC regimes, income which is considered passive for purposes of Subpart F will be passive for PFIC purposes, as well.

While the PFIC rules serve primarily as an anti-deferral regime for passive investments, the motivation for Subpart F was twofold: to prevent U.S.-parented multinational companies from deferring inclusion of passive income earned offshore and, more pressingly, to prevent U.S. companies from moving the nominal location of their receipt of highly mobile income into low-tax jurisdictions, without sufficient business need for presence in that jurisdiction.[24] At the time the PFIC rules were enacted, Congress considered it necessary to disincentivize a U.S. corporation or multinational from moving its receipt of banking or insurance business income to a tax haven jurisdiction, so banking and insurance businesses were specifically made subject to Subpart F's anti-deferral provisions.[25] However, Congress also recognized that a minority U.S. investor should be able to invest in traditionally active financial services businesses offshore without suffering current inclusion, just as if the investment had been in any other active line of business. That the income earned was of a similar nature to income that passive investors commonly earned was insufficient reason to subject it to anti-deferral.[26] The narrower scope of the PFIC rules as compared to Subpart F was codified under Code Sec. 1297(b)(2) *via* exceptions to the definition of "passive income" for PFIC purposes, including an exception for income earned in the active conduct of a banking business, known as the "active banking exception."[27]

Consistent with Congress's intent discussed above, the PFIC rules as first enacted in 1986 defined passive income by reference to former Code Sec. 904(d)(2)(A), which described the "passive income basket" for foreign tax credit purposes. Like the PFIC regime, the foreign tax credit regime focuses more on whether income is passive in nature rather than where the income is earned or where the business activities are performed.[28] In 1986, Code Sec. 904(d)(2)(C) described a separate "financial services income basket," which specifically included what otherwise would be passive income had it not been derived in the active conduct of a banking, financing, or similar business by an entity predominantly engaged in such business.[29] The PFIC cross-reference was changed to Code Sec. 954(c) in 1988, when Congress attempted to better reconcile the overlapping Subpart F and PFIC rules by applying the regimes to the same shareholders and, in unrelated amendments, also eliminating the financial services income basket for foreign tax credit purposes.[30] Thus, it may be reasonable to interpret the initial cross-reference to suggest that Congress may have viewed the type of income that would be included in the "financial services income basket" as excluded from the definition of passive income.[31]

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C. The PFIC Active Banking Exception and Previous Treasury Guidance

The active banking exception provides that passive income does not include 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*)" (emphasis added).[32] The Treasury has yet to provide final regulations with respect to what extent a foreign corporation would qualify as conducting an active banking business but has provided other guidance and proposed regulations on multiple occasions, as further described in this Part II.C and in Part III.B below.

1. Notice 89-81

The Treasury first provided guidance on what constitutes income eligible for the active banking exception in Notice 89-81 (the "Notice"), which was intended to be incorporated into the future regulations.[33] Specifically, the Notice provides, among other things, that income derived from the conduct of "bona fide banking activities" offshore by a bank licensed in the United States would qualify for the exception. Furthermore, the Notice laid out the tests that a foreign corporation not licensed as a bank in the United States, which the Notice termed, an "active foreign bank," must satisfy. First, under a "banking activity test," the foreign corporation must be "actively conducting" the banking business that qualifies as a "trade or business," each as defined by reference to rules under former Temporary Reg. §1.367(a)-2T(b).[34] Second, under a "gross income test," at least 60% of the foreign corporation's gross income must be derived from certain enumerated "bona fide banking activities." Third, the foreign corporation must be licensed in the country in which it conducts its principal banking operations to conduct the *bona fide* banking activities and must be subject to the banking regulation of that jurisdiction. Just as for U.S.-licensed banks, only income earned from *bona fide* banking activities by an active foreign bank qualifies for the active banking exception. In addition, income earned from *bona fide* banking activities conducted by certain members of an active foreign bank's group ("qualified affiliates") is eligible for the active banking exception.

The Notice lays out rigid thresholds for the banking activity and gross income tests, as well as rigid requirements for qualified affiliates. To be engaged in a banking business, the foreign corporation must regularly accept deposits and make loans in the ordinary course of its trade or business. The foreign corporation satisfies the deposit-taking requirement only if deposits from unrelated persons comprise at least half the foreign corporation's total liabilities, and only if the foreign corporation averages at least 1,000 unrelated depositors who are citizens or residents of the country in which the bank is licensed to collect deposits. The foreign corporation satisfies the loan-making requirement only if the corporation extends at least half the amount of all loans (measured by principal amount) outstanding during the corporation's taxable year to unrelated persons. The foreign corporation satisfies the gross income test's 60% threshold only with income from certain enumerated activities, generally required to be conducted in the ordinary course of business with unrelated parties, and that include the aforementioned deposit taking and loan making, as well as a number of other activities traditionally associated with banking.[35] Finally, an entity will be a qualified affiliate only if it satisfies extensive requirements: (i) it must regularly conduct a *bona fide* banking activity in the ordinary course of its trade or business; (ii) it must be a member of an affiliated group that earns half of its gross income from *bona fide* banking activities and includes a licensed bank or an active foreign bank, in either case, that earns at least 20% of the group's gross income; and (iii) it generally must have been a member of the group for at least five years.

Accordingly, though no explanation was included in the Notice itself, it appears the Treasury was set on limiting the banking exception only to enumerated activities and, even then, only if conducted by (or within a group that contained) a "bona fide bank": a corporation that, in the Treasury's view, at a threshold is licensed and subject to regulation as a bank in the jurisdiction of its principal operations and that satisfies rigid deposit-taking, loan-making, and banking income requirements. The Notice remains effective and can be relied upon until final regulations are adopted.

2. 1995 Proposed Regulations

In 1995, the Treasury first issued proposed regulations under the active banking exception (the "1995 Proposed Regulations").[36] The 1995 Proposed Regulations adopt the Notice's general structure, including that the exception from passive income applies only to income derived *via* certain enumerated activities and only if the income is earned by a U.S.-licensed bank or other "active bank."[37] The list of enumerated

banking activities largely mirrored that in the Notice.[38] Also as in the Notice, to be an active bank under the 1995 Proposed Regulations a foreign corporation must satisfy deposit-taking and licensing requirements, and also satisfy a lending test. However, as the 1995 Proposed Regulations' preamble explains, the Treasury recognized the need to "accommodate the various types of banks that have developed as a result of different banking systems and regulatory frameworks" by adopting subjective tests instead of the more rigid quantitative standards of the Notice, and by allowing a foreign corporation to qualify as an active bank even if deposits do not constitute its primary funding source.[39] In addition, the 1995 Proposed Regulations dropped entirely the Notice's 60% gross income test for "active foreign bank" qualification. Finally, the Treasury relaxed the affiliated group rules to allow more flexibility for affiliates of banks to have their own banking income treated as eligible for the banking exception. Taken as a whole, the sum of the changes indicates that the Treasury still believed that in order to satisfy the banking exception, income must be earned in the performance of "bona fide banking activities" by an entity (or within a group that contains an entity) that is a "bona fide bank."[40] At the same time, the Treasury recognized that its conception of a "bona fide bank" as used in the Notice had been too rigid in practice and also might require adjustment for the "various types of banks that have developed as a result of different banking systems and regulatory frameworks."[41]

Seemingly due to the concern that foreign corporations that were not "bona fide banks," in the view of the Treasury, would attempt to take advantage of the 1995 Proposed Regulations' enhanced flexibility, a foreign corporation would "in no case" satisfy the licensing requirement if it obtained a banking license opportunistically to satisfy the active banking exception. In the preamble to the 1995 Proposed Regulations, the Treasury noted that it adopted a licensing test to distinguish banks from investment funds, because a bank license "is strong evidence that a corporation is a bank."[42] Interestingly, in explaining the requirement for the deposit-taking test, the Treasury cited a need to distinguish banks from finance companies, which do not accept deposits. To establish that, for the purposes of the active banking exception, a distinction between finance companies and banks is required by Congress, the preamble quotes a 1993 Congressional report (the "1993 Conference Report"), discussed in more detail below, as "noting that the banking, insurance, and securities exemptions 'do not apply to income derived in the conduct of financing and credit services businesses.'"[43]

D. Definitional Framework and History of the AFE

Code Sec. 954(h), the active financing exception or AFE, provides an exception from the Subpart F anti-deferral rules for income of U.S.-parented CFCs operating in the financial services industry.[44] The AFE operates similarly to the active banking exception, but in the context of Subpart F rather than being specific to the PFIC rules. Both the AFE and the active banking exception allow income, which otherwise would be passive due to its classification as FPHCI, to be treated as nonpassive to the extent earned in the active conduct of certain financial businesses.

The AFE currently states that, for purposes of Code Sec. 954(c)(1), FPHCI "shall not include qualified banking or financing income of an eligible controlled foreign corporation."[45] An eligible CFC is (1) "predominantly engaged in the active conduct of a banking, financing, or similar business" and (2) "conducts substantial activity with respect to such business." To be "predominantly engaged" in the active conduct of banking or similar business, a CFC must either (a) derive more than 70% of its gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are not related persons, (b) engage in the "active conduct of a banking business" and be licensed to do business as a bank in the United States "(or be *any other* corporation not so licensed which is specified by the Secretary in regulations)" (emphasis added), or (c) actively conduct a securities business while registered as a securities broker or dealer or government securities broker or dealer under the Securities Exchange Act ("SEA") of 1934 "(or be *any other* corporation not so registered which is specified by the Secretary in regulations)" (emphasis added).[46] CFCs not licensed as banks or broker/dealers in the United States must derive more than 30% of their gross income directly from the active and regular conduct of a lending or finance business from transactions with customers that are not related persons and that are located within such CFC's home country. Further, "qualified banking or financing income" must be derived from one or more transactions with customers located in a country other than the United States, where substantially all of the activities in connection

with the transactions are conducted directly by the CFC in its home country and where the income must be treated as earned by such CFC in its home country for purposes of such country's tax laws. "Qualified banking or financing income" also excludes income from transactions with customers located outside the CFC's home country unless the CFC conducts substantial banking, financing or similar business activity in its home country. For this purpose, activities performed in and conducted by employees of certain related persons located in the same home country as the CFC count as activities of the CFC itself.[47] In turn, "lending or finance business" means the business of making loans; purchasing or discounting accounts receivable, notes, or installment obligations; engaging in leasing (including entering into leases and purchasing, servicing, and disposing of leases and leased assets); issuing letters of credit or providing guarantees; providing charge and credit card services; or rendering services or making facilities available in connection with the foregoing activities, where the activities are conducted by affiliated CFCs. In addition, Code Sec. 954(h)(7) provides anti-abuse rules that would disregard certain items of income, gain, loss, or deduction if a principal purpose of the transactions giving rise to such amounts is to qualify income or gain for the AFE. Finally, the AFE provides that the Treasury shall prescribe such regulations as may be necessary or appropriate to carry out the purposes of the AFE and related rules of Code Sec. 954. To date, no such regulations have been adopted or proposed.

As with the PFIC active banking exception, the AFE is designed to distinguish between passive investment income and income earned in the active conduct of a financing business. However, as the above makes evident, the AFE also contains guardrails to ensure that the foreign corporation has *bona fide* business reasons to locate the receipt of mobile income by virtue of its presence in, and actually earning such income in, the jurisdiction of its incorporation. Additionally, by its literal terms, the AFE addresses only CFCs. These differences from the banking exception arise because Congress enacted the AFE under Subpart F in response to the well-articulated needs of U.S.-parented multinationals.[48] As discussed above in Part II.B, the motivation for Subpart F was not only anti-deferral for passive investment income earned by multinationals, but also the prevention of shifting active business income of U.S.-parented multinationals into more tax-favorable jurisdictions.

III. The 2019 Proposed Regulations, the 2020 Final Regulations, and the 2020 Proposed Regulations

A. The 2019 Proposed Regulations

On July 11, 2019, the Treasury published the 2019 Proposed Regulations that, had they been adopted as drafted, would have incorporated the AFE into the definition of passive income for purposes of the PFIC tests.[49] Noting that the AFE by its terms was an exception to FPHCI, the Treasury reasoned in the preamble that there was no indication that Congress did not intend for the AFE to apply to the PFIC regime.[50] In this regard, the Treasury distinguished the AFE from other exceptions to the general definition of FPHCI in Code Sec. 954(c), in particular the related party and CFC lookthrough rules of Code Secs. 954(c)(3) and (6). Even more relevantly, the Treasury distinguished the AFE from Code Sec. 954(i), which provides an exception from FPHCI for income earned in the active conduct of an insurance business by a "qualifying insurance company." Like the AFE, Code Sec. 954(i) is an exception to FPHCI, similarly situated in Code Sec. 954 but outside of Code Sec. 954(c). However, unlike the AFE, Code Sec. 954(i) by its terms covers only insurance business income and only if earned by a "qualifying insurance company" as defined by Code Sec. 953. These two statutory features align Code Sec. 954(i) with the similar PFIC insurance exception of Code Sec. 1297(b)(2)(B), which by its terms excepts income "derived in the active conduct of an insurance business" by a "qualifying insurance corporation," or "QIC," as separately defined by Code Sec. 1297(f). The Treasury implied that Code Sec. 1297(b)(2)(B) effectively superseded Code Sec. 954(i) in the PFIC context because it covered the same type of business but under a statute that Congress had recently modified specifically for the PFIC rules.[51] Since no recent congressional action under the PFIC rules addressed the types of income, including financing income, that the AFE governs, the Treasury proposed to apply Code Sec. 954(h) in a complementary fashion to the PFIC exception for active banking income. The Treasury requested comments about whether, when regulations are in force under the active banking exception, the "corollary FPHCI exclusion" should also continue to apply.[52] The Treasury also implied that for the AFE to be superseded by the active

banking exception as a "corollary exclusion," the regulations in force under the active banking exception would be expected to cover exceptions for financing income in addition too banking income.[53]

B. The 2020 Final Regulations and the 2020 Proposed Regulations

In January 2021, the Treasury published the 2020 Final Regulations and 2020 Proposed Regulations. As discussed in Part I above, the Treasury reversed its position in the 2019 Proposed Regulations that the AFE should apply in the context of the PFIC rules. In the preamble to the 2020 Final Regulations, the Treasury specifically noted that all comments that it had received regarding the matter supported maintaining and even expanding the application of the AFE to the definition of passive income for purposes of PFIC rules.[54] The Treasury, however, explained the drastic change as rooted in a deeper study of the legislative history of the AFE and its relation to the structure of Code Secs. 1297(b)(1) and 1297(b)(2). The stated rationale was that applying the AFE in the PFIC context would be duplicative of the statutory active banking exception in Code Sec. 1297(b)(2)(A) and have the effect of "narrowing the scope" of the active banking exception without clear congressional authorization in legislative history.[55] Both rationales effectively take a diametrically opposite view to the rationale the 2019 Proposed Regulations presented in favor of the AFE. In place of directly incorporating the AFE into the banking exception, the Treasury stated that "certain principles" of the AFE should be applied to the banking exception.[56]

The 2020 Proposed Regulations contain an entirely new set of rules for the active banking exception, distinct from both the Notice and the 1995 Proposed Regulations. The 2020 Proposed Regulations generally incorporate the principles of the AFE into the PFIC passive income definition, but only for a foreign corporation licensed as a bank, in its jurisdiction of incorporation, to accept deposits from residents of that country and carry out one or more specified banking activities, and only if the foreign corporation regularly accepts deposits and engages in one or more banking activities.[57] These requirements effectively reproduce those required for a "bona fide bank" in the 1995 Proposed Regulations, only slightly relaxed insofar as they no longer include regularly making loans to customers as a requirement. In the preamble to the 2020 Proposed Regulations, the Treasury restated its belief that Congress intended for the active banking exception to be available only to traditional banks, and therefore the exception should cover only regulated banks and not any other type of institution.[58] Aside from applying the new active banking exception to all foreign corporations rather than just CFCs, the Treasury made no attempt to reconcile the restrictions in the AFE designed to prevent multinationals from shifting active business income with the different purpose of the PFIC rules. In particular, substantially all the activities generating the active banking income must be performed in the bank's home country, and each group entity making direct use of the active banking exception must qualify as an active bank on its own, as no relief exists for a banking group's non-bank affiliate members. The rule as drafted also disfavors foreign banks that operate cross-border and would be more naturally inclined to seek investment from U.S. investors. Seemingly recognizing the inadequacy of applying the AFE, with its inherent limitations, to this limited category of traditional banks, the Treasury requested comments on the general approach the 2020 Proposed Regulations took to the active banking exception, including "whether the definition of foreign bank is drafted in a manner that does not exclude bona fide foreign banks and does not include other types of financial institutions."[59]

IV. The Evolution of the Alternative Industry Providing Traditional Banking Services

Over the past 20 years, the share of traditional banks within the financial services system has shrunk significantly.[60] Neobanks, fintech, and other firms leveraging various technological innovations have sprung up not only to capture the market share of the traditional banks, but also to expand the availability of financial services and lending to historically underserved communities and populations. Although the United States has seen this expansion first, the momentum is shifting to jurisdictions outside of the United States. Many companies now take advantage of technological innovation that has made it more profitable and cost effective to provide credit services, access to basic payment, trade finance, and trust services to a variety of customers.[61] These companies have sufficient flexibility to deploy capital to the local points where needed for use in the business of providing financial services and lending. In many jurisdictions, the legal and banking regulatory

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systems have not kept pace with the transformation away from traditional banking. Sometimes, not being regulated or being lightly regulated allows the newer companies to penetrate the market and present an effective alternative to the established banking giants. Sometimes as well, these new players leverage the access of the existing banks to provide certain regulated services, for example, where neobanks provide deposits to customers under agreement with traditional banks.[62] Because of their innovative nature and technological and market share potential, these foreign companies may generate significant investment interest from U.S. investors who may want to make minority investments *via* preferred stock or convertible debt. In addition, as these companies may eventually have the potential to go public, their PFIC status may be an important factor affecting the availability of U.S. investment capital.[63]

Harmonizing the PFIC rules with the banking regulatory landscape that governs these newer financial services and lending enterprises is becoming increasingly important as this growing industry gradually replaces traditional banking. One might take a view as a matter of public policy that all these enterprises should be regulated in a similar fashion to banks, regardless of their size or targeted customers. However, regardless of their current supervision status, it is evident that such companies are engaged in the active conduct of a business that typically is associated with banking and is based on deployment of a mix of financial capital, intellectual property, and human capital similar to that of traditional banks, albeit in a different proportion. In addition, little confusion could exist between such companies and passive investment vehicles, such as investment funds. Therefore, as a matter of both coherent tax policy and implementing the original congressional intent of the active banking exception (as discussed below), the Treasury may want to consider, when finalizing the 2020 Proposed Regulations, how to better accommodate U.S. investment in these newly emerging forms of active financial services and lending business. Appropriate characterization could largely be achieved by the Treasury reversing its decision in the 2020 Final Regulations and explicitly incorporating the AFE into the PFIC rules. However, as discussed above, because the AFE was originally crafted in the context of U.S.-parented multinationals' difficulties with Subpart F, the AFE contains limitations with respect to the location where the income is earned and the business activity performed, and, as a result, is overly restrictive in the context of determining whether income is active for purposes of PFIC rules. The AFE also contains no method for affiliates of banks to utilize the active banking exception. Alternatively, and preferably, the Treasury could craft entirely new active banking exception regulations that shift focus to the active or passive nature of the enterprise's banking activities while eliminating as outdated licensing and deposit-taking threshold requirements. Unlike in 1995, licensing and deposit taking no longer serve as necessary proxies for identifying all companies engaged in what we believe Congress would have viewed at the time as the active conduct of a banking business and thus as not intended to be subject to PFIC treatment.

Several public commentators, including the NYSBA, have made convincing arguments explaining how the legislative history of the AFE works in favor of adopting the AFE into the PFIC rules.[64] We agree with those arguments but believe that the Treasury's authority extends further. Taking an alternative tack, Part V below argues that, contrary to the Treasury's long-standing view, which was again reinforced in the 2020 Proposed Regulations, the legislative history of the active banking exception supports an interpretation that foreign entities not licensed in the United States could benefit from the exception even without being licensed as a bank or accepting substantial deposits in their own jurisdictions.

V. The Legislative History of the Active Banking Exception and the Treasury's Regulatory Authority

A. Legislative History of the Active Banking Income Exception Under PFIC

1. The 1986 Blue Book

No congressional reports associated with the enactment of the PFIC rules exist, but the explanation issued by the Joint Committee on Taxation after the enactment of the 1986 legislation (the "Blue Book") provides insight into the underlying congressional intent.[65] According to the Blue Book, "*[e]xcept as provided in regulations,* passive income … does not include income derived by bona fide banks …" (emphasis added).[66] The Blue Book further states that a foreign bank with a U.S. banking license was a "bona fide bank" for this purpose, and also that the 1986 Act provides regulatory authority to "expand the exception to passive

income for income derived by a foreign bank licensed to do business in the United States to any other foreign corporation engaged in the active conduct of a banking business, as well" and "restrict the exception for income derived by bona fide banks … where it is necessary to prevent U.S. persons from earning what is essentially investment income in a tax deferred entity."[67] The Blue Book states that "[i]t is intended that income derived by foreign banks *and other financial* and insurance businesses that operate as incorporated investment vehicles on behalf of shareholders or other related parties be treated as passive income …" (emphasis added).[68]

These statements suggest that Congress provided regulatory authority to the Treasury both to expand and to limit the active banking income exception to ensure that only active businesses, rather than passive investment vehicles, benefit from the exception. The mention of "bona fide banks" does not in fact limit the scope of the rule's application. Furthermore, the sentence that refers to other financial businesses intended to be excluded if they operate as incorporated investment vehicles suggests that the base rule ought to include some other financial businesses beyond "bona fide banks." Finally, in the context of the contemporaneous changes to the financial services basket of the foreign tax credit, the Blue Book refers to a "bona fide financial services company."[69] Unlike traditional banks, financial services companies often would not be licensed in their jurisdictions and generally do not take deposits directly. The implication is that "bona fide" in the context of the legislative history to the 1986 Act properly refers to the legitimacy of the active business activities from which an enterprise derives its income and should not be used to infer threshold regulatory requirements.

2. Plain Language of the Statute and Original Cross-References

The strongest indication of congressional intent, however, is the plain language of the statute, which allows the active banking exception for the income derived in 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)."[70] The parenthetical does not indicate that such a corporation must be licensed or regulated as a bank anywhere or even be casually referred to as a bank.[71] Because the active banking exception's statutory wording directly contemplates U.S. bank licensing but does not mention non-U.S. licensing in its permissive grant of authority to the Treasury, one may infer that Congress did not intend to impose a general licensing requirement. The statute also does not specify a deposit-taking requirement of any kind. A plain reading of the parenthetical demonstrates that Treasury may apply the exception to any foreign corporation that it can determine is engaged in the active conduct of a banking business. It is also reasonable to assume that, in defining what active banking income meant in 1986, Congress could not have foreseen the exact business developments that occurred since then, but it could have foreseen that fundamental shifts likely would happen and therefore provided the Treasury with sufficient authority to tailor the requirements to the demands of the future.

Furthermore, the original meaning and intent of the statute require interpretation within the structure of the Code as it existed at the time of the provision's enactment, rather than through the lens of subsequent re-alignments. The original cross-reference in Code Sec. 1297(b)(1) to the foreign tax credit limitation passive income basket adds additional support for the view that the parenthetical allows a permissive interpretation. Within that original structure, the financial services income basket's existence as a separate category implies that Congress did not treat financial services income as passive in general, and that the PFIC rules incorporate that view through the cross-reference to the passive income basket. Therefore, within that structure, the active banking income exception requires interpretation as an expansion, rather than a narrowing, of the financial services income definition for it to have a separate meaning. At the least, the subsequent changes to the cross-reference sufficiently obscure the original intent of the active banking exception and thus give the Treasury latitude to exercise its explicit authority under the stature to respond to the needs of the current business environment.

3. The 1993 Conference Report

The Treasury points to the language in the 1993 Conference Report that accompanied the expansion of the PFIC passive income exceptions as evidence that Congress believed the active banking exception was not available to companies not engaged in deposit-taking activities.[72] However, the language of the 1993 Conference Report, which described the then-current active banking income exception as not applying to "income derived in the conduct of financing and

credit services businesses," is quite ambiguous.[73] While the statute clearly requires income to be earned in a banking business, neither the statute nor the 1993 Conference Report requires taking deposits to be a necessary component of a banking business. Furthermore, one may interpret the language as merely affirming that no explicit exception existed under the PFIC statute for financing and credit service business without regulatory action from the Treasury, rather than that income derived from such business was not intended by Congress to qualify for treatment as derived in a banking business. Unlike a statement of intent, one may interpret the language simply as Congress' recognition of the state of law at that moment, because the Treasury had not fully exercised the authority granted it by Code Sec. 1297(b)(2) and the Notice did not express an intent to include financing and credit services businesses into the scope of the exception.

In the 1993 Conference Report, Congress also requested that the Treasury study the tax treatment of income derived in the conduct of financing and credit services businesses, and provide the House Committee on Ways and Means and the Senate Committee on Finance with a report of such study by March 1, 1994.[74] This request indicates, at a minimum, that Congress had interest in providing rules for the businesses that did not qualify as traditional banks and in understanding why the Treasury had not provided more expansive rules under the active banking business exception. No such report has been provided to our knowledge.

It is largely impossible to determine exactly what income Congress intended to make exempt under the active banking exception. The language of the Blue Book and of the 1993 Conference Report is sufficiently ambiguous, and the language of the statute itself is sufficiently broad to allow for discretion by the Treasury. In the preamble to the 1995 Proposed Regulations, the Treasury was clear that it was using the bank licensing and deposit-taking requirements as proxies to identify foreign corporations engaged in the active conduct of a banking business, without implying that Congress intended such requirements.[75] As discussed above, contrary to what the 2020 Final Regulations and the 2020 Proposed Regulations suggest, no clear inference can be made from the existing legislative history that Congress intended such requirements.

What the statute and the legislative history do make clear is that the PFIC rules are intended to apply to income earned from investment in passive foreign companies, that interest earned actively in a banking business will not be considered passive, and that the Treasury has the authority to determine which foreign enterprises deserve treatment as actively conducting a banking business. Thus, it would be warranted for the Treasury to extend the active banking exception to any company that actively deploys any mix of capital, intellectual property and human capital that could reasonably be considered to be a banking business, so long as the income generated by the business is earned actively and not as mere investment returns to its shareholders through passive investment of capital.

An open question exists as to whether the Treasury today envisions its regulatory authority as compatible with allowing unlicensed entities that do not take substantial deposits to benefit from the active banking exception. As discussed in Part I above, just a year after proposing that the PFIC rules should incorporate the AFE, the Treasury abruptly reversed course in the 2020 Final Regulations. It is possible that concern over lack of regulatory authority to incorporate the AFE into the PFIC rules in the first place may have driven this reversal, potentially in view of the *Loving* decision that provided some specific gloss on the long-standing *Chevron* standard by placing additional premium on consistency in the regulatory interpretation of the statute. In the section below, we examine the Treasury's authority under the active banking exception through the lens of the *Loving* case.[76] Although the path of writing a new rule without the threshold bank licensing and deposit-taking requirements would not be without challenge, we argue that it may be possible for the Treasury to meet the *Loving* standard.

B. The Treasury's Regulatory Authority to Provide a New Standard Under *Loving*

As discussed above, the Treasury has historically interpreted the active banking exception to include implicit licensing and deposit-taking threshold requirements. If the Treasury were to depart from its past practice by proposing active banking regulations without these threshold requirements, would the Treasury overstep the regulatory authority granted in the statute specifically because it will have reversed course from past practice?

In *Loving*, the U.S. Court of Appeals provided further guidance on the application of the seminal Supreme Court two-factor *Chevron* test that requires that an agency's authoritative interpretation be given deference

if the interpreted statutory provision is ambiguous and if the agency's interpretation is reasonable.[77] The Court of Appeals analyzed whether the IRS reasonably interpreted a 125-year-old statute to infer a grant of the authority to regulate tax return preparers. In particular, in determining whether a statute is ambiguous and in then determining whether the agency's interpretation is permissible, the Court of Appeals focused on whether a significant change from the IRS's own past approach indicated that the new interpretation was unreasonable.[78] According to the Court of Appeals, a wise policy justification is not on its own sufficient to bypass the usual legislative process if the exercise of the regulatory authority is contrary to the statute.

We believe that, under the *Loving* test, the Treasury has sufficient regulatory authority under the statute to adopt a new rule that departs from the prior approach by permitting a foreign corporation that is not licensed as a bank and does not accept deposits to qualify for the active banking exception. As discussed above, the statute is ambiguous on its face, but the active banking exception explicitly delegates to the IRS the determination of which foreign corporations are eligible for the exception. Neither the statutory language, nor the Blue Book, nor the various statutory developments since the 1986 enactment of the active banking exception provide unequivocal direction on whether the foreign enterprise must be licensed as a bank or accept deposits. The deposit-taking requirement itself may be viewed as an additional refinement to the licensing requirement, added by the Treasury primarily to ensure that the tested company duly operated as a bank and did not simply maintain an opportunistic banking license.[79] Most importantly, the stated purpose for and overall statutory framework of the PFIC rules strongly suggest that the active banking exception should emphasize the active nature of the income a foreign corporation earns in the context of activities typically conducted by a banking business. Congress has not issued further legislation or clear informative action to address the active banking exception since its initial enactment that would change the understanding of its initial emphasis. The Treasury's focus on the label that the regulatory system in the local jurisdiction gives the enterprise (*i.e.*, "licensed" versus "unlicensed") seems misplaced, and the resulting licensing and deposit-taking tests seem unnecessary and overly restrictive, especially for the evolving banking industry. While the Treasury has consistently interpreted the active banking exception to require the company earning such income to be regulated as a bank and to accept deposits, the Court of Appeals in *Loving* did note that the IRS may change its interpretation of the statute as long as the new interpretation is reasonable and consistent with the statute.[80] Finally, the Treasury could eliminate the threshold licensing and deposit-taking requirements without departing from the already-promulgated 2020 Final Regulations, which only addressed the AFE, or from the Treasury's promise that it is prepared to incorporate principles of the AFE into the final active banking exception regulations.

If the Treasury were willing to reconsider its position on the threshold requirements for the active banking exception, the challenge would be to develop a test for "income derived in the active conduct of a banking business" that would appropriately distinguish between, on the one hand, entities performing active financial services and lending income (*i.e.*, the essence of banking activities), and, on the other hand, collective passive investment vehicles that may generate similar income or even mimic some of the same activities. In Part VI, below, we suggest one potential approach to new proposed regulations that could replace the multiple less suitable proposals that are currently available for use by taxpayers.

VI. What Would the Test Look Like?

As discussed above in Part III.B, the existing regulatory proposals under the active banking exception are all insufficiently flexible to be useful for many active enterprises currently engaged in nontraditional banking. Two immediately evident approaches could resolve this deficiency. First, the Treasury could take the relatively measured approach of applying the AFE to the PFIC rules based on the rationale it articulated in the preamble to the 2019 Proposed Regulations. However, that path may already be foreclosed to the Treasury by the 2020 Final Regulations, which made a definitive statement that the AFE would not be applied. Additionally, applying the AFE as written without utilizing a specific PFIC exception would necessarily have the disadvantage of importing the Subpart F guardrails, such as the location of customers, and the location of employees or of their activities, already built into the statutory wording of the AFE, guardrails that appear to be inappropriate and overly restrictive in the PFIC context. In particular, these requirements would disfavor banks that generally operate cross-border, rather than concentrating most of their activities in the jurisdiction

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of their incorporation. Such a bias would, by definition, disadvantage banks that would be more likely to seek U.S. investment as compared to local foreign banks. Furthermore, these Subpart F restrictions would be especially onerous to the technology-driven fintech industry, which operates outside of the brick-and-mortar model and aims to reach more easily customers located in different countries.

Accordingly, we recommend that the Treasury exercise the regulatory authority explicitly granted in the statute to promulgate sensible regulations that would allow the entire modern banking industry to benefit from the active banking exception.

Alternatively and preferably, the Treasury could provide new regulations under the active banking exception that revisit its position on the necessity of the threshold licensing and deposit-taking requirements while at the same time adopting some of the principles of the AFE. Doing so would allow the Treasury to tailor the active banking exception guidance to the specific purpose of the PFIC rules and the evolving banking industry, and it would not be inconsistent with the Treasury's statements in the preamble to the 2020 Proposed Regulations that the final regulations could incorporate at least some principles of the AFE. Accordingly, formulating a rule along the lines suggested below may be a promising approach.

The active banking exception regulations would take their basic framework from the AFE. The regulations would provide that, for purposes of the active banking exception, "income derived in the active conduct of a banking business" will mean "qualified financial services or lending income" of an "eligible foreign corporation" or an "eligible affiliate." An *eligible foreign corporation* would mean a foreign corporation that is "predominantly engaged in the active conduct of a financial services or lending business" and "conducts substantial activity with respect to such business." A foreign corporation would be *predominantly engaged* for these purposes if (i) more than 70% of the gross income of the foreign corporation is derived directly from the active and regular conduct of a financial services or lending business from transactions with customers that are not related persons; (ii) the foreign corporation is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States, or (iii) the foreign corporation is engaged in the active conduct of a securities business and is registered as a securities broker or dealer under Section 15(a) of the SEA of 1934 or is registered as a government securities broker or dealer under Section 15C(a) of the SEA. In that regard, using 70% as the threshold to indicate eligibility as an active business appears to be reasonable and time-tested.

Similar to the 1995 Proposed Regulations, to define the active conduct of a trade or business, the new regulations would import the rules from Reg. §1.367(a)-2(d)(2) and 2(d)(3). Specifically, a *trade or business* would be defined as "a specific unified group of activities that constitute (or would constitute) an independent economic enterprise carried on for profit." To constitute a trade or business, a group of activities must ordinarily include every operation that forms a part of, or a step in, a process by which an enterprise may earn income or profit, which would typically include the collection of income and the payment of expenses. Independent contractors may carry on these activities, so long as they are under the direct control of the corporation. Importantly, the following activities would not alone constitute a trade or business for purposes of the active banking exception: (1) any activity giving rise to expenses that would be deductible only under Code Sec. 212 if the activities were carried on by an individual; or (2) the holding for one's own account of investments in stock, securities, land, or other property, including casual sales thereof. The last two requirements would be particularly important in the context of assuring that the exclusion would not apply to any income that a fund or some other passive investment vehicle would generate. The *active conduct* of a trade or business would require the officers and employees of the corporation or of related entities to carry out substantial managerial and operational activities. A corporation may be engaged in the active conduct of a trade or business even if independent contractors carry out incidental activities of the trade or business on behalf of the corporation.

Also similar to the 1995 Proposed Regulations, the qualified financial services or lending income of eligible

affiliates of eligible foreign corporations could qualify for the exception, provided that both the eligible affiliate and the group containing the eligible foreign corporation meet minimum thresholds for financial services or lending business activity, as measured by income tests. For example, an *eligible affiliate* would be an entity that is a member of a group, all the members of which are related within the meaning of Code Sec. 954(d)(3), where (i) the group contains at least one eligible foreign corporation, (ii) more than 30% of the gross income of the entity is derived directly from the active and regular conduct of a lending or finance business from transactions with customers that are not related persons, and (iii) more than 50% of the gross income of the group (excluding income derived among the members of the group themselves) is derived directly from the active and regular conduct of a lending or finance business from transactions with customers that are not related persons.

Qualified financial services or lending income would be income of an eligible foreign corporation (or eligible affiliate) which is derived in the active conduct of a financial services or lending business by the eligible foreign corporation (or eligible affiliate) with unrelated customers. Finally, *financial services or lending business* would be informed by both the AFE and the 1995 Proposed Regulations and would mean the business of (i) making loans; (ii) purchasing or discounting accounts receivable, notes, or installment obligations; (iii) engaging in leasing (including entering into leases and purchasing, servicing, and disposing of leases and leased assets); (iv) issuing letters of credit or providing guarantees; (v) providing charge and credit card services; (vi) entering into derivatives transactions or hedging transactions; (vii) performing trust services; (viii) arranging foreign exchange transactions; (ix) underwriting issuance of stock, debt instruments, or other securities; (x) providing traveler's check and money order services; (xi) providing correspondent bank services; (xii) providing paying agent and collection agency services; (xiii) maintaining restricted reserves to satisfy a capital or reserve requirement under the laws of a jurisdiction in which the corporation actively conducts a trade or business; and (xiv) rendering services or making facilities available in connection with any of the foregoing activities, where such activities are performed either directly or by another entity which is a member of the same affiliated group (as defined in Code Sec. 1504 but determined without regard to Code Sec. 1504(b)(3)).[81] Anti-abuse rules would be drawn, similar to those that Code Sec. 954(h)(7) prescribes, and would provide that any item of income, gain, loss, or deduction of an entity that is not engaged in regular and continuous transactions with unrelated customers shall be disregarded.

In sum, the rules for the exception for "income derived in the active conduct of a banking business" could track closely the structure and substance of the AFE, while (i) adding more activities that should qualify as financial services or lending; (ii) allowing financial services or lending income of certain affiliates to qualify; and (iii) eliminating any AFE requirements that refer to where the activities are conducted, where the income is earned or where the customers reside. This approach would be more practical and more aligned with the purpose of the PFIC regime than the 2020 Proposed Regulations, which, in addition to making the active banking exception completely unavailable to institutions that are not licensed and accept deposits, fall short on all three points above. Adopting sensible regulations such as suggested in this Part VI would align the active banking exception with the purpose and overall framework of the PFIC rules while modernizing the interpretation of the exception to reflect the reality of the evolving banking industry.

VII. Conclusion

As we discuss in this article, the Treasury faces a significant challenge in finalizing the regulatory guidance for the active banking exception under the PFIC regime. The Treasury could choose to take the more predictable approach and follow the historic trajectory of past guidance to limit the exclusion only to foreign corporations that operate under a bank license and accept deposits. Alternatively, the Treasury could modernize its interpretation of the active banking exception by recognizing that a significant sector of the financial industry now operates outside of the traditional bank regulatory framework and may continue to do so for the foreseeable future. Many of those foreign corporations are clearly active business enterprises that generate active services and lending income that would be viewed as "banking" income under any colloquial or commonsense usage of the term. Treating these corporations as PFICs due to categorizing income earned in the active conduct of their business as "passive" would be contrary to original intent of the active banking exception. Accordingly, we recommend that the Treasury exercise the regulatory authority explicitly granted in the statute to promulgate sensible regulations that would allow the entire modern banking industry to benefit from the active banking exception.

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ENDNOTES

* The authors wish to thank Ted Gkoo for his assistance on this article.

1 Code Sec. 1297(a). For the PFIC rules generally, *see* Sections 1291 through 1298 of the Internal Revenue Code (the "Code") and associated regulations thereunder.

Unless otherwise indicated, all section numbers refer to sections of the Code and Treasury Regulations thereunder.

2 86 FR 4516 (Jan. 15, 2021) [hereinafter 2020 Final Regulations]; 86 FR 4582 (Jan. 15, 2021) [hereinafter 2020 Proposed Regulations]. The Treasury released these regulations to the public in November 2020 and published them in the Federal Register in January 2021.

3 84 FR 33120 (July 11, 2019).

4 Code Sec. 954(h). *See also* former Proposed Reg. §1.1297-1(c)(i)(A).

5 *See*, *e.g.*, 2020 Final Regulations, at 4518–4520; 2020 Proposed Regulations, at 4585–4586; New York State Bar Association Tax Section, Report No. 1422, Report on the Proposed "PFIC" Regulations Under Sections 1291, 1297 and 1298 (2019); Lee Sheppard, *Toward a Unitary Definition of Active Financing Business*, 21 Tax Notes Int'l 430 (July 31, 2000).

6 *See infra*, Part IV for a further description of this emerging industry.

7 *See*, *e.g.*, New York State Bar Association Tax Section, Report No. 1207, Report Commenting on Select Issues with Respect to the Passive Foreign Investment Company Rules (2010), at 23; Paul Crispino, *Active Financing Made Permanent, but Questions Remain*, Tax Notes 1501 (June 13, 2016). In addition, some examples of publicly available equity offering documents and annual filings on Forms 20-F may be located on the U.S. Securities and Exchange Commission site Edgar, available at *www.sec.gov/edgar.shtml*.

8 The 2020 Proposed Regulations will be effective after their finalization, although taxpayers may rely on them for prior years if the taxpayer consistently applies each applicable rule for each year. The Treasury and the IRS permit taxpayers to rely on the 2019 Proposed Regulations with respect to applying the AFE for purposes of PFIC rules for years ending on or before December 31, 2020, without the consistency requirement.

9 Interestingly, while the Treasury states explicitly in the 2020 Final Regulations' preamble its position that the AFE does not apply for purposes of Code Sec. 1297(b)(1), Reg. §1.1297-1 does not refer to the AFE. Reg. §1.1297-1(c)(i)(B) does identify the other exceptions to foreign personal holding company income that do not apply for PFIC purposes.

10 Code Sec. 1297(b)(2)(A) applies to 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)."

11 Tax Reform Act of 1986, P.L. 99-514, 100 Stat. 2085.

12 *See* Joint Comm. on Taxation, 99th Cong., General Explanation of the Tax Reform Act of 1986 (1987) [hereinafter Blue Book].

13 Code Secs. 851–855, 4982.

14 Code Secs. 951 to 965, known as "Subpart F," predate the PFIC rules' advent in 1986. The GILTI rules were added to the Internal Revenue Code in 2017. Code Sec. 951A.

15 Blue Book, at 1023.

16 Code Secs. 1295 & 1296.

17 *See* Reg. §1.1295-1(g).

18 *See* Code Sec. 1296(k); Reg. §1.1296-2.

19 The investor has annual reporting requirements on IRS Form 8621, as described under Reg. §1.1298-1. In some cases, compliance may be virtually impossible for a U.S. investor due to lack of access to the necessary information, although the U.S. investor remains subject to hefty penalties without regard to how impractical it would be to comply.

20 A limited exception to this rule may be exempt entities, including pension funds, which generally are not subject to the PFIC rules, as well as mutual funds that could benefit from a more relaxed rule on marking to market PFIC stocks. *See* Reg. §1.1291-1(e) (providing that Code Sec. 1291 applies to a shareholder that is an exempt organization only if a dividend from the PFIC would be taxable to the organization under subchapter F); Code Sec. 1296 (2018) (allowing mutual funds to mark-to-market a stock that is not otherwise treated as marketable).

21 Code Sec. 1297(a).

22 Code Sec. 1297(b)(1). The definition of active or passive income is not only relevant for the income test, but also for the asset test, because the assets that generate passive income are treated as passive assets.

23 Code Sec. 954(a).

24 President's 1961 Tax Recommendations: Hearings Before the House Committee on Ways and Means, Doc. No. 140, 87th Cong., 1st Sess. 8–10 (1961).

25 Tax Reform Act of 1986, *supra* note 11, Code Sec. 1221(a)(1) (redefining FPHCI without reference to banking or insurance income exceptions). *See also* Blue Book, at 865. Congress later enacted the AFE in response to U.S. financial services industry arguments that U.S. taxation of unrepatriated foreign earnings created a competitive disadvantage for U.S. financial institutions as compared to foreign financial institutions operating in the same foreign jurisdictions, which were subject only to lower foreign taxes. *See*, *e.g.*, Testimony of Michael Gaffney, First Vice President, Co-Head, Global Tax, Merrill Lynch & Co. on behalf of the Securities Industry Association before the Committee on Finance United States Senate, *An Examination of U.S. Tax Policy and Its Effect on the Domestic and International Competitiveness of U.S.—Based Operations*, July 15, 2003, published in Tax Notes Int'l on July 17, 2003 (providing an overview of the AFE's history and the financial industry arguments for the AFE's importance to the international competitiveness of U.S. financial institutions).

26 Blue Book, at 1023.

27 Code Sec. 1297(b)(2) today contains four exceptions to the definition of passive income for PFIC purposes, as otherwise imported from Subpart F *via* Code Sec. 1297(b)(1): income derived in the conduct of active banking business, income derived in the active conduct of insurance business, certain income received from a related person, and export trade income. The active banking exception is Code Sec. 1297(b)(2)(A).

28 The foreign tax credit regime alleviates the double taxation of income earned by U.S. taxpayers offshore that results from the worldwide taxation system in the United States. The separate basket for passive income arose because the offshore tax rate for passive income was often higher than for non-passive income, and Congress believed blending the rates allowed an excessive amount of passive income to be creditable.

29 Enacted by P.L. 99-514: Law Sec. 1201 (1986) and eliminated in 1988. The language of former Code Sec. 904(d)(2)(C) read as follows:

> FINANCIAL SERVICES INCOME.—
>
> (i) IN GENERAL.—Except as otherwise provided in this subparagraph, the term "financial services income" means income received or accrued by any person which is not passive income (determined without regard to subparagraph (A)(iii)(I)) and which-
>
> (I) is derived in the active conduct of a banking, financing, or similar business, or derivedfrom the investment by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, …
>
> (ii) SPECIAL RULE IF ENTITY PREDOMINANTLY ENGAGED IN BANKING, ETC., BUSINESS.—If, for any taxable year, an entity is predominantly engaged in the active conduct of a banking, insurance, financing, or similar business, the term "financial services income" includes any passive income (determined without regard to subparagraph (A)(iii)(I)) of such corporation for such taxable year …

30 Technical and Miscellaneous Revenue Act of 1988, P.L. No. 100-647, §1012(p)(5), 102 Stat. 3342 (1988).

31 As discussed in Part V below, the change to the cross-reference at minimum adds ambiguity in determining how to interpret the PFIC rules.

32 Code Sec. 1297(b)(2)(A).

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[33] Notice 89-81. 1989-2 CB 399.

[34] A trade or business must be a group of activities that could be an independent enterprise carried on for profit and contain every part of the profit-generating profit, including the collection of income and the payment of expenses. Specifically, the definition excludes any investment activities for the corporation's own account. Active conduct requires officers and employees of the corporation to carry out substantial managerial and operational activities with respect to the trade or business, and independent contractors are permitted to carry out only incidental activities.

[35] The "bona fide banking activities" include: accepting deposits from unrelated persons, lending in the ordinary course of business to unrelated persons, factoring for unrelated persons, negotiating evidences of indebtedness, issuing letters of credit, performing trust services, arranging foreign exchange transactions, entering into interest rate swaps and other hedging transactions, underwriting securities, providing credit card services or factoring credit card receivables, providing traveler's check and money order services, providing correspondent bank services, providing agency paying and collection agency services (in each case for or with unrelated persons) and any other activity that the Commissioner determines to be a commercial banking activity generally conducted by active foreign banks in the ordinary course of their banking business.

[36] Proposed Reg. §1.1296-4, 60 FR 20922 (Apr. 28, 1995).

[37] The 1995 Proposed Regulations were proposed to be effective for taxable years beginning after 1994, although taxpayers could apply the rules for any year after 1986. Because both the Notice and the 1995 Proposed Regulations are currently effective, they provide taxpayers with some flexibility to choose the most favorable test available. For a description of differences between the Notice and the 1995 Proposed Regulations, *see*, generally, New York State Bar Association Tax Section, Report No. 1207, *supra* note 7.

[38] The 1995 Proposed Regulations added finance leasing as a new category of banking income. Additionally, it was necessary to add maintaining restricted reserves as an enumerated activity, because unlike the Notice, the 1995 Proposed Regulations limited banking activities to income earned *via* activities with customers. Consistent with the Notice, the banking activities list contains a catchall for "any other activity that the Commissioner determines, through a revenue ruling or other formal published guidance … to be a banking activity generally conducted by active banks in the ordinary course of their banking business." Proposed Reg. §§1.1296-4(f)(2)(ix), (xiv), and (xv).

[39] 1995 Proposed Regulations, at 20923.

[40] The preamble to the 1995 Proposed Regulations states that the "enhanced flexibility of the proposed rules should permit all foreign corporations actively conducting a licensed banking business (whether directly or through affiliates) to qualify for the bank exception." *Id.*

[41] *Id.*

[42] *Id.*

[43] *Id.* (citing H.R. Rep. No. 103-213, *Budget Reconciliation Act of 1993*, at 641 (1993) (Conf. Rep.).

[44] Definitionally, the Subpart F rules apply to CFCs or qualified business units, but for purposes of the PFIC rules, the distinction is largely irrelevant.

[45] Code Sec. 954(h)(1).

[46] Code Sec. 954(h)(2).

[47] In addition, the related person must be compensated on an arm's length basis for the performance of the activity by its employees, with such compensation treated as earned by such related person in its home country for purposes of the home country's tax laws.

[48] *See supra*, note 25. *See also* Securities Industry and Financial Markets Association, *SIFMA Views on Tax Reform* (2017) (articulating its continued advocacy for the AFE).

[49] Proposed Reg. §1.1297-1(c)(i)(A).

[50] 2019 Proposed Regulations, at 33123.

[51] The preamble to the 2019 Proposed Regulations stated: "Congress recently amended the exclusion for income derived in the active conduct of an insurance business in section 1297(b)(2)(B) to require that income be earned by a QIC …. Given this statutory change and the tests contained in the definition of QIC in section 1297(f), the Treasury Department and the IRS have determined that the exception for insurance income in section 954(i) should not apply in addition to the newly modified exception in section 1297(b)(2)(B)." *Id.*

[52] *Id.*

[53] The preamble to the 2019 Proposed Regulations also stated: "By contrast, given that no final regulations under the PFIC regime provide rules concerning an exclusion of active banking *and financing* income, these proposed regulations provide that the FPHCI exception for banking and financing income under section 954(h) applies for purposes of determining PFIC status." (emphasis added). *Id.*

[54] 2020 Final Regulations, at 4519.

[55] *Id.*

[56] *Id.*

[57] Proposed Reg. §§1.1297-1(c)(2)(i) & (ii).

[58] 2020 Proposed Regulations, at 4585. In support of this proposition, the Treasury cited the same 1993 Conference Report it had earlier cited in the 1995 Proposed Regulations, discussed *infra* Part V.

[59] 2020 Proposed Regulations, at 4586.

[60] *See*, *e.g.*, John Tamny, *As U.S. Banks Shrink, So Does the Power of the Federal Reserve*, FORBES (Nov. 20, 2016).

[61] *See*, *e.g.*, Karen Kwok, *Buy-Now-Pay-Later Exposes Regulation Blind Spot*, REUTERS (Dec. 8, 2020); Bryan Cave Leighton Paisner LLP, *Changing "Buy Now Pay Later" Regulations & Considerations for Retailers*, JD SUPRA (Mar. 4, 2021).

[62] *See*, *e.g.*, Rhys Thomas, *Fintech and Banks: Competing Through Collaboration*, FINTECH MAGAZINE (Dec. 1, 2020).

[63] In addition, if a foreign corporation that is classified as a PFIC has a U.S. subsidiary, a U.S. investor in the PFIC would indirectly be taxed on such subsidiary's income under the punitive PFIC rules, even though the income is already taxed at the corporate level in the United States and forms a part of an active multinational enterprise.

[64] *See*, *e.g.*, Miller & Chevalier, *Firm Seeks Changes to 3 Issues Under Proposed PFIC Regs*, TAX NOTES (Apr. 13, 2021); New York State Bar Association Tax Section, Report No. 1207, *supra* note 7, at 21–24.

[65] Blue Book, at 1021–1026.

[66] *Id.*, at 1025.

[67] *Id.*

[68] *Id.*

[69] Blue Book, at 883 ("[A] bona fide financial services company generally should be able to obtain the benefits of foreign tax rate averaging with respect to its active business income to the same extent that, for example, a manufacturing or service enterprise can."). *See also supra* note 30 and associated text (describing the financial services income basket as it existed in 1986).

[70] Code Sec. 1297(b)(2)(A).

[71] In contrast, the qualified insurance company exception of Code Sec. 1297(b)(2)(B) only applies to a foreign corporation "which would be subject to tax under subchapter L if such corporation were a domestic corporation, and … the applicable insurance liabilities of which constitute more than 25 percent of its total assets, determined on the basis of such liabilities and assets as reported on the corporation's applicable financial statement for the last year ending with or within the taxable year." Code Sec. 1297(f).

[72] 2020 Proposed Regulations, at 4585 ("Furthermore, the 1993 legislative history to the expansion of section 1297(b)'s passive income exceptions makes clear that the PFIC rules as in effect at that time did not apply to finance companies, that is, entities that did not engage in the deposit-taking activities characteristic of banks.").

[73] *See* H.R. Rep. No. 103-213, *supra* note 43, at 641 ("These rules [the banking exception and the securities dealer exception], however, do not apply to income derived in the conduct of financing and credit services businesses.").

[74] *Id.*

[75] The one activity that distinguishes institutions that operate under a banking license is deposit taking. Deposit taking is a method of raising funds, so it generates liabilities rather than income. It is unclear why deposit taking

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should be the distinguishing feature of a banking business for purposes of PFIC rules.

[76] *S. Loving*, CA-DC, 2014-1 USTC ¶50,175, 742 F3d 1013 (2014).

[77] *Id.* (relying on the framework of *Chevron U.S.A. Inc. v. NRDC*, 467 US 837 (1984)).

[78] The Court of Appeals distilled the following six considerations for analysis: (1) the common meaning of the terms used in the statute and the IRS's previous and contemporaneous interpretation of such terms forming common usage used to decipher congressional intent; (2) the plain meaning of the words cannot be sidestepped with a labored interpretation; (3) the context of enactment of the underlying statute and its place in the overall statutory scheme; (4) Congress's later actions, while not dispositive, used as evidence of congressional understanding of how the statute operates; (5) the magnitude of the impact that could be caused by the IRS's regulatory action as related to Congress's imputed intent to delegate regulatory power to the IRS; and (6) a significant change from the IRS's own past approach to the issue as informing the reasonableness of its new interpretation.

[79] *See* 1995 Proposed Regulations, at 20923 (discussing the reasons for the existence of the deposit-taking test).

[80] *Loving*, *supra* note 76 (citing *FCC v. Fox Television Stations, Inc.*, 556 US 502, 515, 129 SCt 1800, 173 L.Ed.2d 738 (2009)).

[81] The activities list could also be broadened to include customer transactions with crypto currencies or crypto assets or similar categories.

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