

U.S.-licensed banks from similar related-party transactions would not have been banking income. Because the proposed regulations generally do not differentiate between related party and non-related party transactions in the same way as the Notice, the only effect of the rule would have been to treat, in the case of U.S. licensed banks only, as banking income the income earned on transactions with related parties who are not customers and income earned from activities (such as securities activities) that are not banking activities described in § 1.1296-4(f). The IRS and Treasury believe that the standards for determining whether income is derived in the active conduct of a banking business should be the same for all corporations that are either active banks or qualified bank affiliates.

The IRS and Treasury are aware that many bank activities may also be considered securities activities. Under the proposed regulations, an entity that performs an activity that is both a banking activity and a securities activity must satisfy only the requirements of the bank rules to treat income from such activity as nonpassive. For example, an entity that derives income from dealing in foreign exchange may treat such income as nonpassive if it is an active bank (or a qualified bank affiliate) even though it is not a controlled foreign corporation.

Dealing in securities, however, is not included as both a banking activity and a securities activity. The IRS and Treasury believe that Congress intended that income from dealing in securities should be nonpassive only if it is earned by a controlled foreign corporation that actively conducts a securities business and meets the other requirements of section 1296(b)(3)(A).

The IRS and Treasury have become aware that certain developing country economies impose high deposit reserve requirements as a tool for implementing monetary policy. Because the central banks of these countries require the maintenance of such reserves as a prerequisite to conducting a banking business, the earnings on such assets, if any, should appropriately be excluded from passive income.

F. Customer Relationship

Under the proposed regulations, a bank satisfies the deposit and lending tests only if it carries on such activities with customers. Moreover, only the income from its banking activities (and those of its qualified bank affiliates) conducted with, or for, customers will produce nonpassive income. This is a change from the Notice requirement, under which activities qualified only if

they were conducted with unrelated parties. Under the proposed regulations, a customer may be any person, related or unrelated, if that person has a customer relationship with the bank. Whether such a relationship exists depends on all the facts and circumstances. However, persons who are related to, or who are shareholders, officers, directors, or other employees of, the corporation will not be treated as customers of the corporation if one of the principal purposes for the corporation's transacting business with such persons was to qualify the corporation as an active bank or qualified bank affiliate.

G. Affiliates of Active Banks

The IRS and Treasury recognize that many active banks conduct one or more banking activities through separately incorporated affiliates that may not individually qualify as active banks. Accordingly, the proposed regulations provide rules under which income from banking activities may be treated as nonpassive if earned by a corporation that does not qualify as an active bank but is a member of a related group of which an active bank is also a member. However, such income is nonpassive only for purposes of determining whether any member of the related group is a passive foreign investment company or for purposes of applying the excess passive asset rules of section 956A(c)(2)(A). In addition, such income remains passive with respect to persons who own stock in the affiliate but who are not members of the related group of which the affiliate is a member.

For purposes of these rules, a related group is any group of persons related within the meaning of section 954(d)(3), substituting person for controlled foreign corporation. This definition is a departure from the affiliated group definition of the Notice because it permits noncorporate entities (such as partnerships) to count as members of the group for purposes of satisfying the groupwide gross income test.

Section 1.1296-4(i)(2) requires the bank affiliate to generate more than 60 percent of its income from banking, insurance and securities activities (but not other financial services). For purposes of this test, the look-through rules of sections 1296(c) and 1296(b)(2)(C) do not apply. This requirement ensures that a bank affiliate's eligibility for the bank exception depends upon the business activities conducted directly by the affiliate, and is not influenced by activities conducted by related persons. However, a bank affiliate may nevertheless apply sections 1296(c) and

1296(b)(2)(A) to determine whether it is a PFIC under the income or asset tests of section 1296(a).

In addition, the related group must meet two gross income tests for the exception to apply. First, under § 1.1296-4(i)(3)(i), income from banking activities derived by active banks must constitute at least 30 percent of the financial services income earned by group members. Second, under § 1.1296-4(i)(3)(ii), income earned by group members from banking activities, securities activities, and insurance activities must constitute at least 70 percent of the financial services income earned by group members that are financial services entities. The regulations adopt the definition of financial services income contained in § 1.904-4(e), which includes only income earned by financial services entities.

These affiliate rules are structurally similar to the affiliate rules contained in the Notice, but have been modified in several respects to respond to taxpayer comments. For example, the 80 percent stock ownership threshold of the Notice caused many corporations to be treated as PFICs solely because the gross income of subsidiaries in which the group owned less than an 80 percent interest was excluded for purposes of the Notice's gross income tests, even though the group had voting control of such subsidiaries. The adoption of a lower 50 percent ownership threshold for group membership in the proposed regulations recognizes that international groups are not organized to meet the 80 percent threshold required for consolidation under U.S. tax law.

In addition, the gross income tests were changed in several ways to deal with problems encountered by diversified affiliated groups. First, the denominators of the fractions now include only financial services income, which by its terms includes only income earned by financial services entities. This change prevents foreign corporations that are part of a banking group from being disqualified solely because the group is a subgroup of a larger group that does not perform solely financial services.

Second, the numerator of the fraction for the groupwide gross income test now includes gross income from securities and insurance activities in addition to banking activities. This change prevents a foreign corporation engaged in banking activities that is part of a banking subgroup from being disqualified solely because it is part of a larger group that provides a broad range of financial services.