

Regulation, or the Division of Investment Management.”

§ 201.430 [Corrected]

3. On page 32814, in the first column, last line, in § 201.430(a) the reference to “200.30-17” is corrected to read “200.30-18”.

4. On page 32814, in the second column, in § 201.430(c) the reference to “200.30-17” is corrected to read “200.30-18”.

§ 201.431 [Corrected]

5. On page 32814, in the second column, in the sixth line of § 201.431(a) “200.30-17” is corrected to read “200.30-18”.

Dated: August 31, 1995.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

[FR Doc. 95-22110 Filed 9-6-95; 8:45 am]

BILLING CODE 8010-01-P

INTERNATIONAL TRADE COMMISSION

19 CFR Part 206

Implementing Rules for the Uruguay Round Agreements Act

AGENCY: International Trade Commission.

ACTION: Adoption of interim rules as final rules.

SUMMARY: The Commission has adopted as final rules, without change, interim rules that amend part 206 of the Commission’s rules to conform its rules of practice and procedure with amendments made to sections 201-204 of the Trade Act of 1974 (19 U.S.C. 2251-2254) by the Uruguay Round Agreements Act (URAA) (Pub. L. 103-465, 108 Stat. 4809 (1994)). The URAA, among other things, amended sections 201-204 of the Trade Act to bring U.S. law into conformity with the Uruguay Round Agreement on Safeguards.

EFFECTIVE DATE: September 7, 1995.

FOR FURTHER INFORMATION CONTACT: William Gearhart (202-205-3091), Office of the General Counsel, U.S. International Trade Commission. Hearing impaired individuals are advised that information on this matter can be obtained by contacting the Commission’s TDD terminal on 202-205-1810.

SUPPLEMENTARY INFORMATION:

Background

The interim rules were published in the **Federal Register** on January 3, 1995

(60 FR 10). The interim amendment to section 206.17 was effective January 3, 1995; all other amendments were effective January 1, 1995. Comments on the interim rules were required to be received on or before April 3, 1995. No comments were received.

Accordingly, the Commission has adopted as final rules, without change, the interim rules amending 19 CFR part 206 that were published at 60 FR 10 on January 3, 1995.

List of Subjects in 19 CFR Part 206

Administrative practice and procedure, Investigations, Imports.

Authority: 19 U.S.C. 1335; 19 U.S.C. 2251-2254, 3351-3382; secs. 103, 301-302, Pub. L. 103-465, 108 Stat. 4809.

By order of the Commission.

Issued: August 30, 1995.

Donna R. Koehnke,

Secretary.

[FR Doc. 95-22235 Filed 9-6-95; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1, 4 and 602

[TD 8618]

RIN 1545-AM15

Definition of a Controlled Foreign Corporation, Foreign Base Company Income and Foreign Personal Holding Company Income of a Controlled Foreign Corporation

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final Income Tax Regulations governing the definition of a controlled foreign corporation and the definitions of foreign base company income and foreign personal holding company income of a controlled foreign corporation. These regulations are necessary because of changes made to the prior law by the Tax Reform Act of 1986, the Technical and Miscellaneous Revenue Act of 1988, the Revenue Reconciliation Act of 1989, and the Omnibus Budget Reconciliation Act of 1993. Certain conforming changes in the regulations were necessary because of changes made by the Deficit Reduction Act of 1984. The regulations will provide the public with the guidance to comply with those acts and will affect United States shareholders of controlled foreign corporations.

DATES: These regulations are effective September 7, 1995.

For dates of applicability, see § 1.954-0(a).

FOR FURTHER INFORMATION CONTACT: Valerie Mark of the Office of Associate Chief Counsel (International), within the Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (Attention CC:INTL:2 (INTL-0362-88)). Telephone (202) 622-3840 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget (OMB) in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)) under control number 1545-1068. The estimated average burden per respondent associated with the collection of information in this regulation is one hour.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, PC:FP, Washington, DC 20224, and to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503.

Background

This document contains final regulations amending the Income Tax Regulations (26 CFR Part 1) under sections 954(b), 954(c) and 957(a) of the Internal Revenue Code (Code). Sections 954 and 957 were amended by sections 1201, 1221, 1222 and 1223 of the Tax Reform Act of 1986 (Pub. L. 99-514), by section 1012 of the Technical and Miscellaneous Revenue Act of 1988 (Pub. L. 100-647), by section 7811 of the Revenue Reconciliation Act of 1989 (Pub. L. 101-239) and by section 13233 of the Omnibus Budget Reconciliation Act of 1993 (Pub. L. 103-66). These regulations are also issued under authority contained in section 7805 of the Code.

Temporary regulations (TD 8216) and a cross-referenced notice of proposed rulemaking (INTL-362-88) under sections 954 and 957 of the Code were published in the **Federal Register** on July 21, 1988 (53 FR 27489 and 53 FR 27532, respectively). Numerous written comments on the proposed and temporary regulations were received from the public. As explained below,

the comments were considered in the drafting of the final regulations.

Discussion of Major Comments and Changes to the Regulations

Section 1.954-1: Foreign Base Company Income

Section 1.954-1T(a)(3) and (5) (temporary regulations) apply the de minimis and full inclusion tests of section 954(b)(3) before the high tax exception of section 954(b)(4). Commenters have expressed concern that, in certain cases, the only amounts required to be included in the gross income of the United States shareholders of a controlled foreign corporation may be full inclusion income. This result may occur when subpart F income, other than full inclusion foreign base company income, qualifies for the high tax exception. In response to these comments, § 1.954-1(d)(6) provides that an amount that otherwise would be included as full inclusion foreign base company income, pursuant to the operation of the full inclusion test of section 954(b)(3)(B), will be excluded from full inclusion foreign base company income if more than 90 percent of the adjusted gross foreign base company and adjusted gross insurance income qualifies for the high tax exception described in section 954(b)(4) and the high tax election is actually made.

Section 1.954-1T(a)(4) provides that in computing net foreign base company income, foreign personal holding company income is reduced by related person interest expense before allocating and apportioning other expenses in accordance with § 1.904(d)-5(c)(2). Commenters understood this rule to be at variance with § 1.904(d)-5(c)(2), which requires related person interest expense to be allocated to passive foreign personal holding company income after the allocation of directly related expenses. In response to this comment, the rule regarding allocation of related person interest expense was removed from § 1.954-1T(a)(4) and (c) was amended to clarify that foreign base company income is reduced by directly related expenses before passive foreign personal holding company income is reduced by related person interest expense.

Section 1.954-1T(a)(7) treats amounts recharacterized as foreign base company income or insurance income under section 952(c) as adjusted net foreign base company income or adjusted net insurance income. Thus, these amounts are not included in net foreign base company income or net insurance income for purposes of applying the

high tax exception. Commenters argued that the rules of paragraph (a)(7) should be amended to provide that amounts that are recharacterized under section 952(c)(2) should not be treated as adjusted net foreign base company income or adjusted net insurance income if the amounts would have qualified for the high tax exception. This comment was rejected because section 952(c)(2) does not incorporate the exclusions and special rules of section 954(b)(4). Additional rules regarding the coordination of sections 952(c) and 954 are being proposed under section 952 in a separate document published elsewhere in this issue of the **Federal Register**.

Several comments were made concerning the anti-abuse rules of § 1.954-1T(b)(4), which require aggregation of gross income of related controlled foreign corporations for purposes of the de minimis and full inclusion tests. One comment suggested that the aggregation rules of paragraph (b)(4) should be applied only if a purpose of first importance (as opposed to a principal purpose) is to avoid the application of the de minimis or full inclusion tests described in section 954(b)(3). This comment was rejected because the standard suggested is significantly more subjective than that of the regulations and is therefore unadministrable. However, it was determined that it was unnecessary to make the aggregation rules of paragraph (b)(4) applicable to the full inclusion test, for which there is not the same opportunity for tax avoidance.

One commenter suggested that the anti-abuse rules of § 1.954-1T(b)(4) should be amended to provide that the gross income of separate controlled foreign corporations is aggregated only if a substantial portion of the activities of the separate corporations would comprise a single branch, and that the presumptions described in paragraph (b)(4)(ii) should be eliminated. The commenter also suggested that the definition of related person for purposes of these rules should refer to the provisions of section 954(d)(3), rather than the broader provisions of section 267. These comments were rejected because the suggested amendments would unduly restrict the application of the anti-abuse rules. The presumptions described in paragraph (b)(4)(ii) may be rebutted, for example, by establishing reliance on the requirements of foreign law. The anti-abuse rules are necessary to prevent the misuse of the de minimis rule of section 954(b)(3), and do not impose a significant limitation or burden on the activities of controlled foreign corporations.

Section 1.954-1T(c) provides that in computing net foreign base company income, the gross amount in each category of foreign base company income may not be reduced below zero. Section 1.954-2T(e) provides that the excess of losses over gains from the sale or exchange of certain property may not be allocated to any other category of foreign personal holding company income. Section 1.954-2T(f) and (g) contain similar provisions with regard to excess losses from commodities and foreign currency transactions, respectively. Because the categories of foreign base company income described in section 954(a) and the categories of foreign personal holding company income described in section 954(c)(1)(B), (C) and (D) are defined in terms of net income, the temporary regulations interpreted the statutory scheme as generally precluding the allocation of excess losses from categories of foreign personal holding company income described in paragraph (e), (f), or (g) against other foreign personal holding company income categories. Commenters contended that by preventing any category of subpart F income from being reduced below zero, paragraph (c) caused inappropriate tax credit results and failed to harmonize the subpart F provisions with section 904(f)(5). Commentators stated that paragraphs (e), (f) and (g) should be amended to allow excess losses described in those paragraphs to be allocated to other categories of foreign personal holding company income.

Paragraph (c) has been amended to clarify that, in determining net income, if the amount in any category of foreign base company income (including any category of foreign personal holding company income) is less than zero, the loss may not reduce any other categories of foreign base company income (or foreign personal holding company income) except by operation of the earnings and profits limitation. Proposed regulations published elsewhere in this issue of the **Federal Register** will provide rules concerning the application of the earnings and profits limitation.

Section 1.954-1T(d) provides that the effective rate of foreign income tax on an item of income is determined in a manner consistent with the existing foreign tax credit regime under sections 904 and 960. In some cases, the amount of an item of income for foreign law purposes with respect to which foreign income tax is paid will be different from the amount for United States tax purposes. As a result, the effective rate of tax with respect to the item of income may be affected. In addition, because

pursuant to section 960 the foreign income taxes of a controlled foreign corporation more than three tiers below a United States shareholder are not considered, the high tax exception will never apply to items of income of such corporations.

Commenters suggested that certain foreign law accounting practices should be considered in determining the effective rate of tax on an item of income, for purposes of applying the high tax exception of section 954(b)(4) and paragraph (d) of the regulations. Commenters also contended that it is inappropriate to use section 960 to determine the effective rate of foreign tax and thus prevent consideration of taxes paid by controlled foreign corporations more than three tiers below the United States shareholder.

The comment that the high tax exception should not be limited to creditable taxes under section 960 was rejected. The high tax exception is not intended to apply to the extent that an item of income would be subject to residual United States tax if such item were included in the gross income of the United States shareholder. The taxes paid with respect to such item of income should be considered for purposes of the high tax exception only to the extent they are otherwise considered for United States taxing purposes. See Joint Committee on Taxation Staff, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 970-71 (1986).

The comment that foreign law accounting practices should be considered in determining the effective rate of tax on an item of income, for purposes of applying the high tax exception, was also rejected. Such a rule would impose a significant burden on the IRS. It would require the IRS to monitor and apply foreign tax and accounting principles, and to reconcile their application with United States tax and accounting principles, both in the current tax year and in later tax years to prevent an item of income, deduction, credit, gain or loss from being duplicated or omitted. Further, the IRS would have to consider and identify the particular foreign tax and accounting principles that could be taken into account for purposes of these rules.

Section 1.954-1T(d)(4) defines the term *item of income* for purposes of the high tax exception by reference to the foreign tax credit and subpart F income categories to which the income relates. Thus, it is possible that amounts attributable to separate transactions may be included in the same item of income. If the income from the separate transactions were subject to foreign

income tax at different rates, the effective rate of tax for the income item would reflect an average of the two (or more) rates of tax. One commenter has suggested that additional categories of income be created within the existing foreign tax credit and subpart F income groups to limit the effect of this tax rate blending.

The regulations rely on existing guidance under the foreign tax credit and subpart F provisions generally to define *item of income* for purposes of section 954(b)(4). To identify items of income on a transaction-by-transaction basis is inconsistent with the separate limitation categories of income described in section 904, and adds complexity by requiring different computations for purposes of these rules and the rules under the foreign tax credit provisions of the Code. Moreover, there is no bias in the existing rules toward a particular result.

Commenters suggested that the consistency rule of § 1.954-1T(d)(4)(ii)(B) be eliminated, to allow taxpayers to apply the high tax exception on an item-by-item basis. The consistency rule prohibits a taxpayer from selectively applying the high tax exception with respect to foreign personal holding company income that is passive income under section 904(d). Elimination of the consistency rule would provide a result that is incompatible with the foreign tax credit provisions of the Code, and thus the comment was rejected.

The final regulations clarify how the rules of paragraph (d) coordinate with the earnings and profits limitation of section 952(c)(1). Under § 1.954-1(d)(4)(ii), if the amount of income included in subpart F income for the taxable year is reduced by the earnings and profits limitation, the amount of income that is an item of income, for purposes of paragraph (d), is determined after the application of the rules of section 952(c)(1). An example was added to illustrate this rule.

Section 1.954-1T(d)(5) provides that the election to apply the high tax exception must be made by the controlling United States shareholders and is binding on all United States shareholders of the controlled foreign corporation. Commenters argued that the Secretary does not have the authority to bind all United States shareholders to a single election. This comment was rejected because it was determined that section 954(b)(4) provides the authority. Further, allowing each United States shareholder to separately elect the high tax exception would add undue complexity

to the operation of the foreign tax credit rules.

Section 1.954-1(f) provides guidance on the definition of related person under section 954(d)(3).

Section 1.954-2: Foreign Personal Holding Company Income

Section 1.954-2T(a)(2)(i) provides that amounts that fall within the definition of income equivalent to interest, under paragraph (h), will be so treated though such amounts may also fall within the definition of gain from certain property transactions under paragraph (e), gain from a commodities transaction under paragraph (f) or foreign currency gain under paragraph (g). Paragraph (a)(2)(i) provides that amounts will be treated as income equivalent to interest even if these amounts are excluded from the computation of foreign personal holding company income under paragraphs (e), (f), or (g) because they are derived from certain qualifying business transactions. A commenter suggested that paragraph (a)(2)(i) should not treat income from qualifying business transactions excluded under paragraphs (e), (f), or (g) as income equivalent to interest. This comment was rejected. The rules regarding qualifying business transactions in paragraphs (e), (f) and (g) do not operate to exclude interest income from characterization as foreign personal holding company income. Income equivalent to interest within the meaning of section 954(c)(1)(E) and paragraph (h) generally should be treated like interest for purposes of subpart F.

Several commenters suggested that the test described in § 1.954-2T(a)(3) to determine the use for which property is held (for purposes of determining the character of the income, gain or loss realized from a disposition of such property) should not focus solely on the use of the property immediately prior to its disposition, but instead should consider the predominant use for which the property was held. This comment was accepted. Section 1.954-2(a)(3) provides that the use for which property is held is the use for which it was held for more than one-half of the period during which the controlled foreign corporation held the property. If there has been a change in use, however, and a principal purpose for such change in use was to avoid characterizing income or gain attributable to the property as foreign personal holding company income, then the change in use will be disregarded.

Section 1.954-2T(a)(3)(ii), *Examples 2 and 3* illustrate the rules regarding change in use for which property is

held. The final regulations delete these examples because *Example 1* sufficiently illustrated the rules of this paragraph. *Examples 4* and 5 of paragraph (a)(3)(ii) illustrate the change in use rules with respect to hedging transactions. The final regulations delete these examples because the rules governing hedging transactions are now generally contained in paragraph (a)(4)(ii).

Section 1.954-2T(a)(4)(i) lists some of the types of income that are included in the term *interest*. To clarify that this list was not meant to be exclusive, paragraph (a)(4)(i) has been amended to provide that the term *interest* includes all amounts that are treated as interest (including tax-exempt interest) under the Code and regulations or any other provision of law. A new sentence illustrates the types of income that would be treated as interest.

Section 1.954-2T(a)(4)(ii) provides that certain hedging transactions that reduce the risk of price changes in the cost of inventory and similar property are included within the definition of *inventory and similar property* if certain requirements are met and if they are so identified by the fifth day after which they are entered into. Paragraphs (f)(4) and (g)(4) of the temporary regulations contain definitions of the term *qualified hedging transaction* that have similar five-day identification requirements. These several definitions of a hedging transaction have been consolidated in § 1.954-2(a)(4)(ii) which contains a definition of *bona fide hedging transaction* and new identification requirements for bona fide hedging transactions that apply for purposes of computing foreign personal holding company income under § 1.954-2.

Section 1.954-2(a)(4)(ii)(A) generally defines a bona fide hedging transaction as a transaction that meets the requirements of § 1.1221-2 (a) through (c) with two exceptions. First, the risk being hedged may be with respect to ordinary property, section 1231 property or a section 988 transaction. Second, a transaction that hedges the liabilities, inventory or other assets of a related person, or that is entered into to assume or reduce risks of a related person, will not be treated as a bona fide hedging transaction. Several commenters had sought to expand the definition of qualified hedging transactions to include hedging transactions conducted by a controlled foreign corporation that is a currency coordination center, i.e., a controlled foreign corporation that aggregates the currency exposures of related controlled foreign corporations and hedges such exposures. The statute provides,

however, that a transaction must satisfy the business needs of the particular controlled foreign corporation. See also Joint Committee on Taxation Staff, *General Explanation of the Tax Reform Act of 1986*, 99th Cong., 2d Sess. 976 (1986).

Section 1.954-2(a)(4)(ii)(B) provides identification requirements for a bona fide hedging transaction. The same-day identification and the recordkeeping requirements of § 1.1221-2 apply for transactions entered on or after March 7, 1996. For bona fide hedging transactions entered into prior to this date and after July 22, 1988, the transaction must be identified by the close of the fifth day after the day on which it is entered into. For bona fide hedging transactions entered into prior to July 22, 1988, the transaction must be identified reasonably contemporaneously with the date it is entered into but no later than within the normal period prescribed under the method of accounting of the controlled foreign corporation used for financial reporting purposes.

Section 1.954-2(a)(4)(ii)(C) describes the treatment of transactions that are misidentified as hedging transactions, and hedging transactions that the taxpayer fails to identify as such. Paragraph (a)(4)(ii)(C) also provides relief for taxpayers that have identified, or failed to identify, a hedging transaction due to inadvertent error. These misidentification rules are substantially similar to the rules in § 1.1221-2(f), modified for purposes of the subpart F regime.

Section 1.954-2T(a)(4)(iii) defines regular dealer, and states that, "purchasing and selling property through a regulated exchange or off-exchange market (for example, engaging in futures transactions) is not actively engaging as a merchant" for purposes of these rules. This provision was intended to mean that such purchasing and selling activity alone, in the absence of other activities, will not qualify a controlled foreign corporation as a regular dealer within the meaning of paragraph (a)(4)(iii). Because commenters indicated that this reference to purchasing and selling through a regular exchange or off-exchange market was confusing, this provision was removed. Further, the definition of regular dealer was amended. Section 1.954-2(a)(4)(iv) provides that a controlled foreign corporation will be a regular dealer if it regularly and actively offers to, and in fact does, engage in certain specified activities with customers who are not related persons (as defined in section 954(d)(3)) with respect to the CFC. Examples were added to clarify that a

controlled foreign corporation that qualifies as a dealer under § 1.954-2(a)(4)(iv) will not be disqualified from being treated as a regular dealer because it also engages in transactions with related persons.

The temporary regulations define *dealer property* as property held by a controlled foreign corporation that is a regular dealer in property of such kind in its capacity as a dealer. The temporary regulations also state that property held for investment or speculation is not dealer property. A commenter suggested that property should be considered dealer property within the meaning of § 1.954-2T(a)(4)(iv) if the controlled foreign corporation holding the property is a regular dealer in such property. This comment was rejected because it proposes an unduly expansive definition of dealer property. Paragraph (a)(4), therefore, generally continues to define dealer property in the same manner as the temporary regulations.

The final regulations do clarify, however, that if a controlled foreign corporation qualifies as a regular dealer, all of the property held in a dealer capacity by that corporation is treated as dealer property. Thus, dealer property includes property arising from a transaction entered into with a related person, as long as the controlled foreign corporation is a regular dealer and holds the property in its capacity as a dealer, and not for investment or speculation. The examples of § 1.954-2(a)(4)(vi) illustrate this rule. A rule has been added for licensed securities dealers under which only securities identified as held for investment under section 475(b) or 1236 will be treated as held for investment or speculation. Also, to conform to amendments to section 954(c)(1)(B) made by the Technical and Miscellaneous Revenue Act of 1988, § 1.954-2(a)(4)(v)(C) provides that a bona fide hedging transaction with respect to dealer property is treated as a transaction in dealer property.

Section 954(c)(2)(B) and § 1.954-2T(b)(2) exclude from foreign personal holding company income export financing interest that is derived in the active conduct of a banking business. A commenter suggested that paragraph (b)(2) should treat a controlled foreign corporation as engaged in the conduct of a banking business even if it transfers the servicing of loans to related or unrelated parties. This comment was rejected because servicing of loans is a fundamental element of banking activity that gives rise to export financing interest for which an exception from foreign personal holding company income is intended.

Section 1.954-2T(b)(2) references the definition of export financing interest contained in section 904(d)(2)(G). Under section 904(d)(2)(G), the property that is financed must be manufactured, produced, grown or extracted in the United States by the taxpayer or a related person. Section 1.954-2(b)(2) clarifies that § 1.927(a)-1T(c)(1) applies for purposes of determining whether property is manufactured, produced, grown or extracted in the United States.

Section 1.954-2T(b)(2) also provides that the term *export financing interest* does not include income from related party factoring that is treated as interest under section 864(d)(1) or (6). The final regulations contain examples that clarify that if amounts are not treated as interest under section 864(d)(1) or (6) because the exception under section 864(d)(7) applies, these amounts may be export financing interest under paragraph (b)(2).

Section 954(c)(3)(A) and § 1.954-2T(b)(3) and (4) provide that certain dividend, interest, rent or royalty income received from related corporate payors is not included in foreign personal holding company income. To reflect amendments to section 954(c)(3)(A) by the Revenue Reconciliation Act of 1989, the final regulations provide that if a partnership with one or more corporate partners makes a payment of interest, rent or royalties, the interest, rent or royalty payment will be treated as paid by a corporate partner to the extent the payment gives rise to a partnership item of deduction that is allocable to the corporate partner or to the extent that a partnership item reasonably related to the payment would be allocated to the corporate partner under an existing allocation under the partnership agreement. To the extent the payment is treated as made by the corporate partner, it will be excluded from the foreign personal holding company income of the recipient if the corporate partner otherwise satisfies the conditions of section 954(c)(3)(A).

Under § 1.954-2T(b)(3)(ii), interest may not be excluded from foreign personal holding company income of the recipient to the extent the deduction for interest is allocated to the payor's subpart F income. To clarify how this rule is to be applied when a controlled foreign corporation is both the recipient and payor of interest, § 1.954-2(b)(4)(ii)(B)(2) was added, which parallels the rule contained in § 1.904-5(k)(2).

Section 1.954-2T(b)(3) provides that, to exclude dividends and interest received from related corporate payors from foreign personal holding company

income, a substantial part of the payor's assets must be used in a trade or business in the payor's country of incorporation. Section 1.954-2T(b)(3)(iv) provides that a substantial part of the payor's assets will be considered to be used in a trade or business in the payor's country of incorporation if, for each quarter of the taxable year, the average value of its assets which are so used is over 50 percent of the average value of all of its assets (determined as of the beginning and end of the quarter). To simplify the application of this rule, § 1.954-2(b)(4)(iv) provides that the average value of assets is to be determined on a yearly rather than a quarterly basis by averaging the values of assets as of the close of each quarter.

Section 1.954-2T(b)(3)(vi)(A) provides that for purposes of the substantial assets test, tangible property (other than inventory) is generally considered located where it is physically located. Paragraph (b)(3)(vi)(B) contains an exception for property temporarily located elsewhere for inspection or repair. A commenter suggested that, in addition to this exception, the regulations should restore the exception contained in prior regulations that treated purchased property located abroad and intended for prompt shipment to the country of incorporation as property located in the country of incorporation. This comment was rejected because this provision would have been inconsistent with the rule that property purchased for use in a trade or business is not considered used in a trade or business until it is placed in service.

Section 1.954-2T(b)(3)(vii)(A) provides that for purposes of the substantial assets test, the location of intangible property is determined based on the site of the activities conducted by the payor during the taxable year in connection with the use or exploitation of the property. The country in which services are performed is determined under the principles of section 954(e) and § 1.954-4(c). This rule was amended to provide more comprehensive guidance to determine the situs of activities in connection with the use or exploitation of intangible property. Section 1.954-2(b)(4)(vii)(B) provides that the country in which the activities connected to the use or exploitation of property are conducted is the country in which the expenses associated with these activities are incurred by the payor or its agent or an independent contractor.

Section 1.954-2T(b)(3)(vii)(A) provides that the intangible property is considered located in the payor's

country of incorporation during each quarter of the taxable year if the activities connected with its use or exploitation are conducted in its country of incorporation during the entire taxable year. A commenter argued that this test is inconsistent with the quarterly determination required by the substantial assets test of § 1.954-2T(b)(3)(iv). Changes were made to the location of property rules (§ 1.954-2(b)(4)(vi) through (ix)) so that relevant determinations are made for each quarter separately.

The final regulations continue to reserve on the provision of special rules regarding the location of assets of banks and insurance companies for purposes of the same-country exception. Comments are invited regarding the need for special guidance on this issue.

Several comments questioned the application of the rules of § 1.954-2T(b)(6), pursuant to which interest income of a controlled foreign corporation that is described in section 103 is included in foreign personal holding company income but is characterized as tax-exempt interest when included in the gross income of the United States shareholders. The purpose of this rule was to prevent a person from avoiding the consequences of the alternative minimum tax provisions by investing in tax-exempt obligations described in section 103 through a controlled foreign corporation.

The final regulations reserve on the treatment of tax-exempt interest. The administrative complexity of applying the rule described in the temporary regulations, and the potential for double taxation that it creates, argue against its continued application. Proposed regulations, published elsewhere in this issue of the **Federal Register**, will provide rules regarding the treatment of tax-exempt interest. In the interim, the rules of the temporary regulations continue to apply.

Section 1.954-2T(b)(5) provides that the determination whether rents and royalties are derived from the active conduct of a trade or business is made under the facts and circumstances of each case, and refers to paragraphs (c) and (d) for the application of its provisions. Commenters have asked whether only the facts and circumstances described in paragraphs (c) and (d) may be considered. The final regulations are clarified to reflect that whether rents or royalties are derived in the active conduct of a trade or business is determined solely under the provisions of paragraphs (c) and (d).

Section 1.954-2T(c)(2)(iii) defines *active leasing expenses* for purposes of

determining whether rental income is derived in the active conduct of a trade or business. A commenter suggested that paragraph (c)(2)(iii) be amended to state that if a corporation sells property of the same type as the property that is leased, the corporation's expenses that are of the type described in that paragraph may be pro-rated on any reasonable basis between the leasing and the sales function. It was determined that the change requested by this commenter was unnecessary because paragraph (c)(2)(iii) already defines active leasing expenses as deductions properly allocable to rental income.

A commenter suggested that an example be added to § 1.954-2T(c) to illustrate that expenses such as payments to third parties for insurance, utilities and repairs are considered active leasing expenses and not amounts paid to agents or independent contractors. The regulations were amended in response to this comment. Section 1.954-2(c)(2)(iii)(D) provides that the term *active leasing expenses* does not include payments to agents or independent contractors other than payments for insurance, utilities and other expenses for like services or capitalized property. A similar change was made to the definition of the term *adjusted leasing profit*.

Section 954(c)(1)(B) and § 1.954-2T(e) include in foreign personal holding company income the excess of gains over losses from certain property transactions. Section 1.954-2T(e)(1)(i) provides that gain or loss that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss but rather gain or loss from a property transaction under paragraph (e). A commenter contended that gain or loss from transactions described in section 988(a)(1)(B) should be characterized as gain or loss described in section 954(c)(1)(C) and § 1.954-2T(f) rather than in section 954(c)(1)(B) and paragraph (e). This comment was rejected, because the capital transactions described in section 988(a)(1)(B) are more appropriately subject to the provisions of section 954(c)(1)(B) and paragraph (e). This provision is now contained in § 1.954-2(g)(5).

A commenter asked that gain from a disposition of stock of a subsidiary be excluded from foreign personal holding company income to the extent that gain from the subsidiary's disposition of its assets would be so excluded. There is no statutory authority for the position recommended by the commenter, however. In addition, the look-through treatment proposed by the commenter is

inconsistent with the treatment prescribed for dispositions of interests in a partnership or trust under section 954(c)(1)(B)(ii). For these reasons, the comment was rejected.

Pursuant to § 1.954-2T(e)(3)(vi), gain from a disposition of non-depreciable intangible property or goodwill is characterized as foreign personal holding company income unless the intangible property is disposed of in connection with a disposition of the entire trade or business of the controlled foreign corporation. Commenters have argued that the gain should be excluded from foreign personal holding company income if such property is used in the trade or business of the controlled foreign corporation, without regard to whether an entire trade or business of the controlled foreign corporation is sold.

The regulations were modified in response to this comment. Section 1.952-2(e)(3)(iv) excludes from foreign personal holding company income any gain or loss of a controlled foreign corporation from a disposition of intangible property, goodwill or going concern value to the extent used or held for use in the trade or business of the controlled foreign corporation.

Section 1.954-2T(e)(4) provides that gain or loss from the sale, exchange or retirement of a debt instrument is included in the computation of foreign personal holding company income under paragraph (e) with certain exceptions. However, a loss on a debt instrument taken in consideration for the sale or exchange of property is excluded from foreign personal holding company income if the gain or loss from that underlying sale or exchange is not includible in foreign base company income. This rule was eliminated from the final regulations because it was inconsistent to prevent a controlled foreign corporation from using these losses to offset subpart F income when gain from such debt instruments was not excepted from the general inclusion rule.

Section 1.954-2T(e)(5) provides that rights to acquire property, other than certain property that is dealer property or inventory property, are characterized as property that does not give rise to income for purposes of section 954(c)(1)(B). One commenter has suggested that such rights should not be characterized as property that does not give rise to income. This comment was rejected because any gain that may arise upon a disposition of an option, warrant, or other right to acquire property, other than gain from a disposition of inventory or dealer property, is income of the type intended

to be characterized as foreign personal holding company income for purposes of section 954(c)(1)(B). The provisions of § 1.954-2T(e)(5) are now incorporated into the definition of property that does not give rise to income under § 1.954-2(e)(3). However, the final regulations clarify that notional principal contracts are excluded from the definition of property that does not give rise to income. (But see § 1.954-2 (f), (g) and (h).)

Section 954(c)(1)(C) and § 1.954-2T(f) provide rules for including the excess of gains over losses from commodities transactions in foreign personal holding company income. Several commenters argued that § 1.954-2T(f)(2)(i) defines *commodity* too broadly, and that, like sections 553 and 864, the regulations should apply only to commodities that are actively traded on a regulated exchange. This comment was rejected because the statute and its legislative history make clear that section 954(c)(1)(C) is intended to apply broadly to any commodity of a kind that is actively traded. Thus, there is no reason to distinguish income from a disposition of a commodity actively traded on a regulated exchange from income from a disposition of a commodity of a kind that is otherwise actively traded.

Although § 1.954-2(f)(2)(i) no longer explicitly provides that nonfunctional currency is a commodity, nonfunctional currency continues to fall within the general definition of *commodity*. Consequently, foreign currency is still treated as a commodity if the currency is actively traded or if contractual interests in the currency are actively traded. Under the ordering rules of paragraph (a)(2), however, paragraph (g) (foreign currency transactions) continues to apply before paragraph (f). Thus, unless an election is made under section 988(c)(1)(D)(ii), a currency futures contract is treated as a commodities transaction, while a currency forward contract is generally treated as a foreign currency transaction.

Section 1.954-2T(f)(1) excludes gains and losses from qualified active sales and qualified hedging transactions from the computation of foreign personal holding company income under paragraph (f). In defining *qualified active sale*, paragraph (f)(3) requires substantially all of the controlled foreign corporation's business to be as an active producer, processor, merchant or handler of commodities of like kind. Commenters argued that by using the phrase "of like kind," § 1.954-2T(f)(3) defines *qualified active sales* too narrowly. The "of like kind" language was not intended to require that all of the commodities be of one kind, but

rather than the controlled foreign corporation must be an active producer, etc., with respect to each kind of commodity. To avoid confusion, the "of like kind" language has been eliminated from the definition of the term *qualified active sale*.

Section 1.954-2T(f)(3)(ii) defines the term *sale of commodities*. Commenters questioned the requirement, incorporated in the definition of this term, that the corporation hold the commodity in physical form. This comment was accepted. The final regulations no longer require the controlled foreign corporation to hold the commodity in physical form. Section 1.954-2(f)(2)(iii)(B) requires only that the controlled foreign corporation hold the commodity directly and not through an independent contractor. The retention of this requirement is consistent with the legislative history of section 954(c)(1)(C), which makes clear that the exclusion from foreign personal holding company income was intended to apply only with respect to commodities for which controlled foreign corporations are active producers, processors, handlers or merchants. Section 1.954-2(f)(2)(iii)(D) provides that activities of employees of entities related to the controlled foreign corporation may be treated as activities directly engaged in by the controlled foreign corporation if the employees are paid and supervised by the controlled foreign corporation.

Section 1.954-2(f)(2)(iii)(B) also amends the definition of the term *active conduct of a commodities business* by clarifying that the requirements specified in that paragraph must be satisfied with respect to each commodity and that property may be held either as dealer property or as inventory or similar property.

Section 954(c)(1)(C)(ii) and § 1.954-2T(f)(1) and (3) exclude income attributable to commodities transactions from foreign personal holding company income if substantially all of the business of a controlled foreign corporation is as an active producer, processor, merchant or handler of commodities. Section 1.954-2T(f)(3)(iv) provides that the controlled foreign corporation will satisfy the substantially all requirement if 85 percent of its taxable income for the taxable year is attributable to qualified active sales and qualified hedging transactions. Several commenters argued that this test could fail to reflect the nature of the controlled foreign corporation's business accurately in some years because of the volatility of certain commodities markets.

To accommodate this concern, § 1.954-2(f)(2)(iii)(C) modifies the definition of the term *substantially all* by applying the 85 percent test to gross receipts rather than taxable income. To prevent manipulation of this modified test, a provision was added under which the District Director may disregard any sale or hedging transaction that has as a principal purpose manipulation of the 85 percent test.

Section 1.954-2T(f)(4) defines the term *qualified hedging transaction* as a bona fide hedging transaction that is entered into primarily to reduce the risk of price change with respect to commodities sold or to be sold in qualified active sales. A commenter argued that a bona fide hedging transaction should not be required to relate to a qualified active sale to be treated as a qualified hedging transaction. This comment was rejected because this provision is based on the statutory requirement that qualified hedging transactions must arise out of the business of the controlled foreign corporation as an active producer, processor, merchant or handler of commodities. Thus, the rule of the temporary regulations is retained.

Section 954(c)(1)(D) and § 1.954-2T(g) include in foreign personal holding company income the net foreign currency gains attributable to section 988 transactions. The rules in § 1.954-2T(g)(2)(i) governing the treatment of gain or loss attributable to foreign currency transactions in hyperinflationary currencies have been removed. Section 1.954-2(g)(5)(iii) provides that the applicable rules of section 985 will apply to such transactions.

Section 1.954-2T(g)(2)(ii) excludes from foreign personal holding company income gain or loss from qualified business transactions that are separately identified, and gain or loss from qualified hedging transactions that are identified with, or traced to, a qualified business transaction. Many commenters argued that these rules are too cumbersome to apply. They contended that a controlled foreign corporation that has a large number of qualified business transactions may not hedge such transactions individually, and that it is difficult or impossible in such cases to relate a hedge to one or even several qualified business transactions. The commenters also argued that the alternative election to treat all currency gain (or loss) as foreign personal holding company income (or loss allocable to foreign personal holding company income) does not provide adequate relief for controlled foreign corporations whose hedging activities relate to

qualified business transactions on a net basis but give rise to foreign currency gain that is treated as foreign personal holding company income.

The regulations are modified in response to those comments. Section 1.954-2(g)(2)(ii) excludes from foreign personal holding company income foreign currency gain or loss directly related to the business needs of the controlled foreign corporation. Foreign currency gain or loss is directly related to the business needs of the corporation, first, if it can be clearly determined that it arises from a transaction entered into or property used in the normal course of the corporation's trade or business and the transaction or property does not itself give rise to subpart F income (other than foreign currency gain or loss), or, second, if it arises from a bona fide hedging transaction with respect to such a transaction or property. To exclude gain or loss from a hedging transaction from foreign personal holding company income under this rule, corporations need not trace a hedging transaction to a specific transaction or property if all (or all but a de minimis amount) of the aggregate risks being hedged are within the business needs exception and the hedging transaction otherwise satisfies the requirements of section 1221, as modified for this purpose.

Section 1.954-2(g)(2)(ii)(C) provides a specific dealer exception under which transactions described in section 988(c)(1)(B)(iii) and (C) that are entered into by a regular dealer, in its capacity as a dealer, are treated as directly related to its business needs for purposes of the exclusion under § 1.954-2(g)(2)(ii). Because a corporation's borrowings support all of its activities, paragraph (g)(2)(iii) provides that foreign currency gain or loss attributable to an interest-bearing liability that is not covered by paragraph (g)(5)(iv) is characterized as subpart F income and non-subpart F income on the same basis as interest expense is allocated and apportioned. Thus, for example, exchange gain or loss from an unhedged interest-bearing liability may fall under this rule.

Section 1.954-2T(g)(3) provides that a transaction will not be treated as a qualified business transaction if the foreign currency gain or loss from the transaction is attributable to property or an activity of a kind that gives rise to subpart F income. Commenters have argued that this requirement is too restrictive because it may cause the gain or loss from the underlying transaction, and the foreign currency gain or loss attributable to the transaction, to be in

different separate categories for foreign tax credit purposes.

In response to this comment, a new election was added to paragraph (g). Under § 1.954-2(g)(3), the controlling United States shareholders may elect to have the controlled foreign corporation include foreign currency gain or loss that would otherwise be included in foreign personal holding company income under paragraph (g) in the category of subpart F income to which such gain or loss relates. This election works in conjunction with the general rules of paragraph (g)(2). Thus, for example, this election may apply to currency gain or loss that would otherwise be treated as foreign personal holding company income under paragraph (g) even if other currency gain or loss is excluded under the business needs exception of paragraph (g)(2)(ii).

As described above, the temporary regulations permit taxpayers to elect to treat all foreign currency gain or loss as foreign personal holding company income. The final regulations retain this election, with modifications. Under § 1.954-2(g)(4), the controlling United States shareholders of the controlled foreign corporation may elect to include in the computation of foreign personal holding company income net foreign currency gains or losses attributable to any section 988 transaction and any section 1256 contract that would be a section 988 transaction but for section 988(c)(1)(D). Shareholders are not permitted to make separate elections for section 1256 contracts and section 988 transactions. An election under paragraph (g)(4) supersedes an election under paragraph (g)(3).

Section 1.954-2(g)(5)(iv) reserves on the treatment of gain or loss allocated under § 1.861-9. It is anticipated that when § 1.861-9 is finalized, a provision will be added to this paragraph to indicate that gain or loss that is allocated or apportioned under section 861 in the same manner as interest expense is not foreign currency gain or loss under paragraph (g).

Section 954(c)(1)(E) and § 1.954-2T(h) include income equivalent to interest in foreign personal holding company income. A commenter argued that the term *income equivalent to interest* might be read to include income from a wide range of interest rate sensitive transactions entered into by a securities dealer or commodities producer, processor, merchant or handler in the ordinary course of its business. The commenter suggested that the regulations should be modified to confirm that such income is not income equivalent to interest.

The final regulations do not contain a general dealer exception that applies to all income equivalent to interest because income equivalent to interest is generally treated like interest, for which no general dealer exception is provided. However, consistent with Notice 89-90 (1989-2 C.B. 407), § 1.954-2(h)(3)(ii) provides a specific dealer exception for income from notional principal contracts.

Section 1.954-2T(h)(1) provides that income equivalent to interest does not include income attributable to notional principal contracts except to the extent that such contracts are part of an integrated transaction that gives rise to income equivalent to interest. Notice 89-90 stated, however, that final regulations would provide that income equivalent to interest would include income from notional principal contracts regardless of whether the notional principal contract is integrated with an investment, because notional principal contracts generally affect the all-in cost of interest-bearing liabilities or the return on interest-bearing assets. Accordingly, § 1.954-2(h)(3) provides that income from notional principal contracts based solely on interest rates or interest rate indices is income equivalent to interest, and paragraph (h)(1)(ii) provides that income from a notional principal contract covered by § 1.861-9T is not income equivalent to interest. Paragraph (f) continues to apply to notional principal contracts based on commodities (or a commodities index), and paragraph (g) continues to apply to notional principal contracts covered by section 988.

Section 1.954-2T(h)(3) treats factoring income as income equivalent to interest, with certain exceptions. Commenters have argued that income realized by a credit card company from factoring its receivables (which is attributable to the discount at which it acquires the receivables from the business establishments honoring its credit card) does not represent an interest equivalent amount, but instead represents other types of income, such as compensation for services.

This comment was rejected. It is true that the income attributable to the discount at which a controlled foreign corporation acquires a receivable reflects not only the time value of money, but also certain other elements (for example, collection risk and cost). However, the factoring income derived by the controlled foreign corporation is analogous to interest income derived from a loan made by a bank, which reflects not only the time value of money, but also the other elements of the discount income received in the

factoring transaction described above. The Tax Reform Act of 1986 repealed the exclusion from foreign personal holding company income of such interest income derived by a bank. The repeal of this provision indicates that interest income is not intended to be excluded from foreign personal holding company income merely because it may reflect more than the time value of money. Income equivalent to interest should not be treated differently.

Some of the rules described in the final regulations are inconsistent with provisions of §§ 1.954-3 through 1.954-8, as well as the regulations under other provisions of subpart F. In such cases, these final regulations are intended to apply instead of the regulations under other provisions of section 954 and of subpart F generally. Section 1.952-3 is removed because the rules of that section are replaced by § 1.954-1. Other conforming changes are being considered in a separate regulations project.

Many nonsubstantive structural and editorial changes were made to these final regulations for clarity.

Drafting Information

The principal authors of these regulations are Valerie Mark and, with respect to financial products, Elissa Shendelman of the Office of the Associate Chief Counsel (International), IRS. However, personnel from other offices of the IRS and Treasury Department participated in developing the regulations.

List of Subjects

26 CFR Parts 1 and 4

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1, 4 and 602 are amended to read as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority for part 1 is amended by removing the authority citation for “Section 1.954-0T, 1.954-1T, 1.954-2T and 1.957-1T” and adding the following citations in numerical order to read as follows:

Authority: 26 U.S.C. 7805. * * *

Section 1.954-0 also issued under 26 U.S.C. 954 (b) and (c).

Section 1.954-1 also issued under 26 U.S.C. 954 (b) and (c).

Section 1.954-2 also issued under 26 U.S.C. 954 (b) and (c).

* * * * *

Section 1.957-1 also issued under 26 U.S.C. 957. * * *

§ 1.952-3 [Removed]

Par. 2. Section 1.952-3 is removed.

Par. 3. Sections 1.954-0, 1.954-1 and 1.954-2 are added to read as follows:

§ 1.954-0 Introduction.

(a) *Effective dates*—(1) *Final regulations*—(i) *In general.* Except as otherwise specifically provided, the provisions of §§ 1.954-1 and 1.954-2 apply to taxable years of a controlled foreign corporation beginning after November 6, 1995. If any of the rules described in §§ 1.954-1 and 1.954-2 are inconsistent with provisions of other regulations under subpart F, these final regulations are intended to apply instead of such other regulations.

(ii) *Election to apply final regulations retroactively*—(A) *Scope of election.* An election may be made to apply the final regulations retroactively with respect to any taxable year of the controlled foreign corporation beginning on or after January 1, 1987. If such an election is made, these final regulations must be applied in their entirety for such taxable year and all subsequent taxable years. All references to section 11 in the final regulations shall be deemed to include section 15, where applicable.

(B) *Manner of making election.* An election under this paragraph (a)(1)(ii) is binding on all United States shareholders of the controlled foreign corporation and must be made—

(1) By the controlling United States shareholders, as defined in § 1.964-1(c)(5), by attaching a statement to such effect with their original or amended income tax returns for the taxable year of such United States shareholders in which or with which the taxable year of the CFC ends, and including any additional information required by applicable administrative pronouncements, or

(2) In such other manner as may be prescribed in applicable administrative pronouncements.

(C) *Time for making election.* An election may be made under this paragraph (a)(1)(ii) with respect to a taxable year of the controlled foreign corporation beginning on or after January 1, 1987 only if the time for filing a return or claim for refund has not expired for the taxable year of any United States shareholder of the controlled foreign corporation in which or with which such taxable year of the controlled foreign corporation ends.

(D) *Revocation of election.* An election made under this paragraph (a)(1)(ii) may not be revoked.

(2) *Temporary regulations.* The provisions of §§ 4.954-1 and 4.954-2 of this chapter apply to taxable years of a controlled foreign corporation beginning after December 31, 1986 and on or before November 6, 1995. However, the provisions of § 4.954-2(b)(6) of this chapter continue to apply. For transactions entered into on or before October 10, 1995, taxpayers may rely on Notice 89-90, 1989-2 C.B. 407, in applying the temporary regulations.

(3) *§§ 1.954A-1 and 1.954A-2.* The provisions of §§ 1.954A-1 and 1.954A-2 (as contained in 26 CFR part 1 edition revised April 1, 1995) apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

(b) *Outline of regulation provisions for sections 954(b)(3), 954(b)(4), 954(b)(5) and 954(c) of the Internal Revenue Code.*

§ 1.954-0 Introduction.

(a) Effective dates.

(1) Final regulations.

(i) In general.

(ii) Election to apply final regulations retroactively.

(A) Scope of election.

(B) Manner of making election.

(C) Time for making election.

(D) Revocation of election.

(2) Temporary regulations.

(3) §§ 1.954A-1 and 1.954A-2.

(b) Outline of regulation provisions for sections 954(b)(3), 954(b)(4), 954(b)(5) and 954(c) of the Internal Revenue Code.

§ 1.954-1 Foreign base company income.

(a) In general.

(1) Purpose and scope.

(2) Gross foreign base company income.

(3) Adjusted gross foreign base company income.

(4) Net foreign base company income.

(5) Adjusted net foreign base company income.

(6) Insurance income.

(7) Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).

(b) Computation of adjusted gross foreign base company income and adjusted gross insurance income.

(1) De minimis and full inclusion tests.

(i) De minimis test.

(A) In general.

(B) Currency translation.

(C) Coordination with sections 864(d) and 881(c).

(ii) Seventy percent full inclusion test.

(2) Character of gross income included in adjusted gross foreign base company income.

(3) Coordination with section 952(c).

(4) Anti-abuse rule.

(i) In general.

(ii) Presumption.

(iii) Related persons.

(iv) Example.

(c) Computation of net foreign base company income.

(1) General rule.

(i) Deductions against gross foreign base company income.

(ii) Losses reduce subpart F income by operation of earnings and profits limitation.

(iii) Items of income.

(A) Income other than passive foreign personal holding company income.

(B) Passive foreign personal holding company income.

(2) Computation of net foreign base company income derived from same country insurance income.

(d) Computation of adjusted net foreign base company income or adjusted net insurance income.

(1) Application of high tax exception.

(2) Effective rate at which taxes are imposed.

(3) Taxes paid or accrued with respect to an item of income.

(i) Income other than passive foreign personal holding company income.

(ii) Passive foreign personal holding company income.

(4) Special rules.

(i) Consistency rule.

(ii) Coordination with earnings and profits limitation.

(iii) Example.

(5) Procedure.

(6) Coordination of full inclusion and high tax exception rules.

(7) Examples.

(e) Character of income.

(1) Substance of the transaction.

(2) Separable character.

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(4) Coordination of categories of gross foreign base company income or gross insurance income.

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(ii) Income excluded from other categories of gross foreign base company income.

(f) Definition of related person.

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(i) Individuals.

(ii) Other persons.

(2) Control.

(i) Corporations.

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(iii) Trusts and estates.

(iv) Direct or indirect ownership.

§ 1.954-2 Foreign personal holding company income.

(a) Computation of foreign personal holding company income.

(1) Categories of foreign personal holding company income.

(2) Coordination of overlapping categories under foreign personal holding company provisions.

(i) In general.

(ii) Priority of categories.

(3) Changes in the use or purpose for which property is held.

(i) In general.

(ii) Special rules.

- (A) Anti-abuse rule.
- (B) Hedging transactions.
- (iii) Example.
- (4) Definitions and special rules.
- (i) Interest.
- (ii) Bona fide hedging transaction.
- (A) Definition.
- (B) Identification.
- (C) Effect of identification and non-identification.
- (1) Transactions identified.
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- (iii) Inventory and similar property.
- (A) Definition.
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- (iv) Regular dealer.
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- (A) Definition.
- (B) Securities dealers.
- (C) Hedging transactions.
- (vi) Examples.
- (vii) Debt instrument.
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- (3) Treatment of tax-exempt interest. [RESERVED.]
- (4) Exclusion of dividends or interest from related persons.
- (i) In general.
- (A) Corporate payor.
- (B) Payment by a partnership.
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- (C) Coordination with sections 864(d) and 881(c).
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- (v) Valuation of assets.
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- (B) Exception for property located in part in the payor's country of incorporation.
- (viii) Location of inventory and dealer property.
- (A) In general.
- (B) Inventory and dealer property located in part in the payor's country of incorporation.
- (ix) Location of debt instruments.
- (x) Treatment of certain stock interests.
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- (5) Exclusion of rents and royalties derived from related persons.
- (i) In general.
- (A) Corporate payor.
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- (ii) Exceptions.
- (A) Rents or royalties paid out of adjusted foreign base company income or insurance income.
- (B) Property used in part in the controlled foreign corporation's country of incorporation.
- (6) Exclusion of rents and royalties derived in the active conduct of a trade or business.
- (c) Excluded rents.
- (1) Active conduct of a trade or business.
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- (3) Examples.
- (d) Excluded royalties.
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- (iii) Treatment of losses.
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- (i) In general.
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- (ii) Regular dealers.
- (4) Income equivalent to interest from factoring.
- (i) General rule.
- (ii) Exceptions.
- (iii) Factored receivable.
- (iv) Examples.
- (5) Receivables arising from performance of services.
- (6) Examples.

§ 1.954-1 Foreign base company income.

(a) *In general*—(1) *Purpose and scope.* Section 954 and §§ 1.954-1 and 1.954-2 provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952. Subpart F income is included in the gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and thus is subject to current taxation under section 1, 11 or 55 of the Internal Revenue Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957.

(2) *Gross foreign base company income.* The gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income (determined after the application of section 952(b))—

- (i) Foreign personal holding company income, as defined in section 954(c);

(ii) Foreign base company sales income, as defined in section 954(d);

(iii) Foreign base company services income, as defined in section 954(e);

(iv) Foreign base company shipping income, as defined in section 954(f); and

(v) Foreign base company oil related income, as defined in section 954(g).

(3) *Adjusted gross foreign base company income.* The term *adjusted gross foreign base company income* means the gross foreign base company income of a controlled foreign corporation as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section.

(4) *Net foreign base company income.* The term *net foreign base company income* means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions (including taxes) properly allocable or apportionable to such income under the rules of section 954(b)(5) and paragraph (c) of this section.

(5) *Adjusted net foreign base company income.* The term *adjusted net foreign base company income* means the net foreign base company income of a controlled foreign corporation reduced, first, by any items of net foreign base company income excluded from subpart F income pursuant to section 952(c) and, second, by any items excluded from subpart F income pursuant to the high tax exception of section 954(b). See paragraph (d)(4)(ii) of this section. The term *foreign base company income* as used in the Internal Revenue Code and elsewhere in the Income Tax Regulations means adjusted net foreign base company income, unless otherwise provided.

(6) *Insurance income.* The term *gross insurance income* includes all gross income taken into account in determining insurance income under section 953. The term *adjusted gross insurance income* means gross insurance income as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section. The term *net insurance income* means adjusted gross insurance income reduced under section 953 so as to take into account deductions (including taxes) properly allocable or apportionable to such income. The term *adjusted net insurance income* means net insurance income reduced by any items of net insurance income that are excluded from subpart F income pursuant to section 952(b) or pursuant to the high tax exception of section 954(b). The term *insurance income* as used in subpart F of the Internal Revenue Code and in the regulations under that

subpart means adjusted net insurance income, unless otherwise provided.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income, respectively. Amounts subject to recharacterization under section 952(c) are determined after adjusted net foreign base company income and adjusted net insurance income are otherwise determined under subpart F and are not again subject to any exceptions or special rules that would affect the amount of subpart F income. Thus, for example, items of gross foreign base company income or gross insurance income that are excluded from adjusted gross foreign base company income or adjusted gross insurance income because the de minimis test is met are subject to recharacterization under section 952(c). Further, the de minimis and full inclusion tests of paragraph (b) of this section, and the high tax exception of paragraph (d) of this section, for example, do not apply to such amounts.

(b) *Computation of adjusted gross foreign base company income and adjusted gross insurance income—*(1) *De minimis and full inclusion tests—*(i) *De minimis test—*(A) *In general.* Except as provided in paragraph (b)(1)(i)(C) of this section, adjusted gross foreign base company income and adjusted gross insurance income are equal to zero if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—

(1) 5 percent of gross income; or

(2) \$1,000,000.

(B) *Currency translation.* Controlled foreign corporations having a functional currency other than the United States dollar shall translate the \$1,000,000 threshold using the exchange rate provided under section 989(b)(3) for amounts included in income under section 951(a).

(C) *Coordination with sections 864(d) and 881(c).* Adjusted gross foreign base company income or adjusted gross insurance income of a controlled foreign corporation always includes income from trade or service receivables described in section 864(d) (1) or (6), and portfolio interest described in section 881(c), even if the de minimis test of this paragraph (b)(1)(i) is otherwise satisfied.

(ii) *Seventy percent full inclusion test.* Except as provided in section 953, adjusted gross foreign base company income consists of all gross income of the controlled foreign corporation other than gross insurance income and amounts described in section 952(b), and adjusted gross insurance income consists of all gross insurance income other than amounts described in section 952(b), if the sum of the gross foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income. See paragraph (d)(6) of this section, under which certain items of full inclusion foreign base company income may nevertheless be excluded from subpart F income.

(2) *Character of gross income included in adjusted gross foreign base company income.* The gross income included in the adjusted gross foreign base company income of a controlled foreign corporation generally retains its character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. However, gross income included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(ii) of this section is met is termed *full inclusion foreign base company income*, and constitutes a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Income that is included in subpart F income because the full inclusion test of paragraph (b)(1)(ii) of this section is met does not reduce amounts that, under section 952(c), are subject to recharacterization.

(4) *Anti-abuse rule—*(i) *In general.* For purposes of applying the de minimis test of paragraph (b)(1)(i) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if a principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to prevent income from being treated as foreign base company income or insurance income under the de minimis test. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to prevent income from being treated as foreign

base company income or insurance income under the de minimis test of paragraph (b)(1)(i) of this section if the corporations are related persons, as defined in paragraph (b)(4)(iii) of this section, and the corporations are described in paragraph (b)(4)(ii)(A), (B), or (C) of this section. This presumption may be rebutted by proof to the contrary.

(A) The activities carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were previously carried on, or assets that were previously held, by a single controlled foreign corporation. Further, the United States shareholders of the controlled foreign corporations or related persons (as determined under paragraph (b)(4)(iii) of this section) are substantially the same as the United States shareholders of the one controlled foreign corporation in a prior taxable year. A presumption made in connection with the requirements of this paragraph (b)(4)(ii)(A) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of

§ 1.367(a)-6T(g)(2) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership (as defined in section 7701(a)(2) and § 301.7701-3 of this chapter) that is a related person (as defined in paragraph (b)(4)(iii) of this section) with respect to each such controlled foreign corporation.

(C) The activities carried on by the controlled foreign corporations would constitute a single branch operation under § 1.367(a)-6T(g)(2) if carried on directly by a United States person.

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). In determining for purposes of this

paragraph (b) whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Example.* The following example illustrates the application of this paragraph (b)(4).

Example. (i)(1) *USP* is the sole United States shareholder of three controlled foreign corporations: *CFC1*, *CFC2* and *CFC3*. The three controlled foreign corporations all have the same taxable year. The three controlled foreign corporations are partners in *FP*, a foreign entity classified as a partnership under section 7701(a)(2) and § 301.7701-3 of the regulations. For their current taxable years, each of the controlled foreign corporations derives all of its income other than foreign base company income from activities conducted through *FP*, and its foreign base company income from activities conducted both jointly through *FP* and separately without *FP*. Based on the facts in the table below, the foreign base company income derived by each controlled foreign corporation for its current taxable year, including income derived from *FP*, is less than five percent of the gross income of each controlled foreign corporation and is less than \$1,000,000:

	CFC1	CFC2	CFC3
Gross income	\$4,000,000	\$8,000,000	\$12,000,000
Five percent of gross income	200,000	400,000	600,000
Foreign base company income	199,000	398,000	597,000

(2) Thus, without the application of the anti-abuse rule of this paragraph (b)(4), each controlled foreign corporation would be treated as having no foreign base company income after the application of the de minimis test of section 954(b)(3)(A) and paragraph (b)(1)(i) of this section.

(ii) However, under these facts, the requirements of paragraph (b)(4)(i) of this section are met unless the presumption of paragraph (b)(4)(ii) of this section is successfully rebutted. The sum of the foreign base company income of the controlled foreign corporations is \$1,194,000. Thus, the amount of gross foreign base company income of each controlled foreign corporation will not be reduced by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(c) *Computation of net foreign base company income*—(1) *General rule.* The net foreign base company income of a controlled foreign corporation (as defined in paragraph (a)(4) of this section) is computed under the rules of this paragraph (c)(1). The principles of § 1.904-5(k) shall apply where payments are made between controlled foreign corporations that are related persons (within the meaning of section 954(d)(3)). Consistent with these

principles, only payments described in § 1.954-2(b)(4)(ii)(B)(2) may be offset as provided in § 1.904-5(k)(2).

(i) *Deductions against gross foreign base company income.* The net foreign base company income of a controlled foreign corporation is computed first by taking into account deductions in the following manner:

(A) First, the gross amount of each item of income described in paragraph (c)(1)(iii) of this section is determined.

(B) Second, any expenses definitely related to less than all gross income as a class shall be allocated and apportioned under the principles of sections 861, 864 and 904(d) to the gross income described in paragraph (c)(1)(i)(A) of this section.

(C) Third, foreign personal holding company income that is passive within the meaning of section 904 (determined before the application of the high-taxed income rule of § 1.904-4(c)) is reduced by related person interest expense allocable to passive income under § 1.904-5(c)(2); such interest must be further allocated and apportioned to

items described in paragraph (c)(1)(iii)(B) of this section.

(D) Fourth, the amount of each item of income described in paragraph (c)(1)(iii) of this section is reduced by other expenses allocable and apportionable to such income under the principles of sections 861, 864 and 904(d).

(ii) *Losses reduce subpart F income by operation of earnings and profits limitation.* Except as otherwise provided in § 1.954-2(g)(4), if after applying the rules of paragraph (c)(1)(i) of this section, the amount remaining in any category of foreign base company income or foreign personal holding company income is less than zero, the loss in that category may not reduce any other category of foreign base company income or foreign personal holding company income except by operation of the earnings and profits limitation of section 952(c)(1).

(iii) *Items of income*—(A) *Income other than passive foreign personal holding company income.* A single item of income (other than foreign personal holding company income that is

passive) is the aggregate amount from all transactions that falls within a single separate category (as defined in § 1.904-5(a)(1)), and either—

(1) Falls within a single category of foreign personal holding company income as—

(i) Dividends, interest, rents, royalties and annuities;

(ii) Gain from certain property transactions;

(iii) Gain from commodities transactions;

(iv) Foreign currency gain; or

(v) Income equivalent to interest; or

(2) Falls within a single category of foreign base company income, other than foreign personal holding company income, as—

(i) Foreign base company sales income;

(ii) Foreign base company services income;

(iii) Foreign base company shipping income;

(iv) Foreign base company oil related income; or

(v) Full inclusion foreign base company income.

(B) *Passive foreign personal holding company income.* A single item of foreign personal holding company income that is passive is an amount of income that falls within a single group of passive income under the grouping rules of § 1.904-4(c) (3), (4) and (5) and a single category of foreign personal holding company income described in paragraphs (c)(1)(iii)(A)(1) (i) through (v).

(2) *Computation of net foreign base company income derived from same country insurance income.* Deductions relating to foreign base company income attributable to the issuing (or reinsuring) of any insurance or annuity contract in connection with risks located in the country under the laws of which the controlled foreign corporation is created or organized shall be allocated and apportioned in accordance with the rules set forth in section 953.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income—(1) Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any net item of such income that qualifies for the high tax exception provided by section 954(b)(4) and this paragraph (d). Any item of income that is foreign base company oil related income, as defined in section 954(g), or portfolio interest, as described in section 881(c), does not

qualify for the high tax exception. See paragraph (c)(1)(iii) of this section for the definition of the term *item of income*. For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see § 1.904-4(c). A net item of income qualifies for the high tax exception only if—

(i) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income; and

(ii) It is established that the net item of income was subject to foreign income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 for the taxable year of the controlled foreign corporation.

(2) *Effective rate at which taxes are imposed.* The effective rate with respect to a net item of income shall be determined separately for each controlled foreign corporation in a chain of corporations through which a distribution is made. The effective rate at which taxes are imposed on a net item of income is—

(i) The United States dollar amount of foreign income taxes paid or accrued (or deemed paid or accrued) with respect to the net item of income, determined under paragraph (d)(3) of this section; divided by

(ii) The United States dollar amount of the net item of foreign base company income or insurance income, described in paragraph (c)(1)(iii) of this section, increased by the amount of foreign income taxes referred to in paragraph (d)(2)(i) of this section.

(3) *Taxes paid or accrued with respect to an item of income—(i) Income other than passive foreign personal holding company income.* The amount of foreign income taxes paid or accrued with respect to a net item of income (other than an item of foreign personal holding company income that is passive) for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a United States shareholder under section 951(a)(1)(A) (determined, in the case of a United States shareholder that is an individual, as if an election under section 962 has been made, whether or not such election is actually made). For this purpose, in accordance with the regulations under section 960, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and

without regard to the limitation applicable under section 904(a). The amount of foreign income taxes paid or accrued with respect to a net item of income, determined in the manner provided in this paragraph (d), will not be affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholders of all or part of such income.

(ii) *Passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to a net item of foreign personal holding company income that is passive for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 and that would be taken into account for purposes applying the provisions of § 1.904-4(c) with respect to that net item of income.

(4) *Special rules—(i) Consistency rule.* An election to exclude income from the computation of subpart F income for a taxable year must be made consistently with respect to all items of passive foreign personal holding company income eligible to be excluded for the taxable year. Thus, high-taxed passive foreign personal holding company income of a controlled foreign corporation must either be excluded in its entirety, or remain subject to subpart F in its entirety.

(ii) *Coordination with earnings and profits limitation.* If the amount of income included in subpart F income for the taxable year is reduced by the earnings and profits limitation of section 952(c)(1), the amount of income that is a net item of income, within the meaning of paragraph (c)(1)(iii) of this section, is determined after the application of the rules of section 952(c)(1).

(iii) *Example.* The following example illustrates the provisions of paragraph (d)(4)(ii) of this section. All of the taxes referred to in the following example are foreign income taxes. For simplicity, this example assumes that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, this example does not separately illustrate the deduction for taxes and gross-up.

Example. During its 1995 taxable year, *CFC*, a controlled foreign corporation, earns \$100 of royalty income that is foreign personal holding company income. *CFC* has no expenses associated with this royalty income. *CFC* pays \$20 of foreign income taxes with respect to the royalty income. For 1995, *CFC* has current earnings and profits of \$50. *CFC*'s subpart F income, as determined

prior to the application of this paragraph (d), exceeds its current earnings and profits. Thus, under paragraph (d)(4)(ii) of this section, the amount of *CFC's* only net item of income, the royalty income, will be limited to \$50. The remaining \$50 will be subject to recharacterization in a subsequent taxable year under section 952(c)(2). Because the amount of foreign income taxes paid with respect to this net item of income is \$20, the effective rate of tax on the item, for purposes of this paragraph (d), is 40 percent. Accordingly, an election under paragraph (d)(5) of this section may be made to exclude the item of income from the computation of subpart F income.

(5) *Procedure.* An election made under the procedure provided by this paragraph (d)(5) is binding on all United States shareholders of the controlled foreign corporation and must be made—

(i) By the controlling United States shareholders, as defined in § 1.964-1(c)(5), by attaching a statement to such effect with their original or amended income tax returns, and including any additional information required by applicable administrative pronouncements; or

(ii) In such other manner as may be prescribed in applicable administrative pronouncements.

(6) *Coordination of full inclusion and high tax exception rules.*

Notwithstanding paragraph (b)(1)(ii) of this section, full inclusion foreign base company income will be excluded from subpart F income if more than 90 percent of the adjusted gross foreign base company income and adjusted gross insurance company income of a controlled foreign corporation (determined without regard to the full inclusion test of paragraph (b)(1) of this section) is attributable to net amounts excluded from subpart F income pursuant to an election to have the high tax exception described in section 954(b)(4) and this paragraph (d) apply.

(7) *Examples.* (i) The following examples illustrate the rules of this paragraph (d). All of the taxes referred to in the following examples are foreign income taxes. For simplicity, these examples assume that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, these examples do not separately illustrate the deduction for taxes and gross-up. Except as otherwise stated, these examples assume there are no earnings, deficits, or foreign income taxes in the post-1986 pools of earnings and profits or foreign income taxes.

Example 1. (i) *Items of income.* During its 1995 taxable year, controlled foreign corporation *CFC* earns from outside its country of operation portfolio dividend

income of \$100 and interest income, net of taxes, of \$100 (consisting of a gross payment of \$150 reduced by a third-country withholding tax of \$50). For purposes of illustration, assume that *CFC* incurs no expenses. None of the income is taxed in *CFC's* country of operation. The dividend income was not subject to third-country withholding taxes. Pursuant to the operation of section 904, the interest income is high withholding tax interest and the dividend income is passive income. Accordingly, pursuant to paragraph (c)(1)(iii) of this section, *CFC* has two net items of income—

(1) \$100 of foreign personal holding company (FPHC)/passive income (the dividends); and

(2) \$100 of FPHC/high withholding tax income (the interest).

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(1) of this *Example 1*. Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F under the rules of this paragraph (d). Foreign tax of \$50 would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(2) of this *Example 1*. Therefore, the effective rate of foreign tax is 33 percent (\$50 of creditable taxes paid, divided by \$150, consisting of the net item of foreign base company income (\$100) plus creditable taxes paid thereon (\$50)). The highest rate of tax specified in section 11 for the 1995 taxable year is 34 percent. Accordingly, the net item of income described in paragraph (i)(2) of this *Example 1* may be excluded from subpart F income if an election under paragraph (d)(5) of this section is made, since it is subject to foreign tax at an effective rate that is greater than 30.6 percent (90 percent of 34 percent). However, for purposes of section 904(d), it remains high withholding tax interest.

Example 2. (i) The facts are the same as in *Example 1*, except that *CFC's* country of operation imposes a tax of \$50 with respect to *CFC's* dividend income (and thus *CFC* earns portfolio dividend income, net of taxes, of only \$50). The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, *CFC* has two items of income for purposes of this paragraph (d)—

(1) \$50 of FPHC/passive income (net of the \$50 foreign tax); and

(2) \$100 of FPHC/high withholding tax interest income.

(ii) Each item is taxed at an effective rate greater than 30.6 percent. The net item of income described in paragraph (i)(1) of this *Example 2*: foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 2*: foreign tax (\$50) divided by sum (\$150) of income item (\$100) plus creditable tax thereon (\$50) equals 33 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either or both of the net items of income described in paragraphs (i)

(1) and (2) of this *Example 2* from subpart F income. If no election is made the items would be included in the subpart F income of *CFC*.

Example 3. (i) The facts are the same as in *Example 1*, except that the \$100 of portfolio dividend income is subject to a third-country withholding tax of \$50, and the \$150 of interest income is from sources within *CFC's* country of operation, is subject to a \$10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (c)(1)(iii)(B) of this section they constitute separate items of income pursuant to the application of the grouping rules of § 1.904-4(c). Accordingly, *CFC* has two net items of income for purposes of this paragraph (d)—

(1) \$50 (net of \$50 tax) of FPHC/non-country of operation/greater than 15 percent withholding tax income; and

(2) \$140 (net of \$10 tax) of FPHC/country of operation income.

(ii) The item described in paragraph (i)(1) of this *Example 3* is taxed at an effective rate greater than 30.6 percent, but Item 2 is not. The net item of income described in paragraph (i)(1) of this *Example 3*: Foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 3*: Foreign tax (\$10) divided by sum (\$150) of net item of income (\$140) plus creditable tax thereon (\$10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude the net item of income described in paragraph (i)(1) of this *Example 3* but not the net item of income described in paragraph (i)(2) of this *Example 3* from subpart F income.

Example 4. The facts are the same as in *Example 3*, except that the \$150 of interest income is subject to an income tax of \$50 in *CFC's* country of operation. Accordingly, *CFC's* items of income are the same as in *Example 3*, but both items are taxed at an effective rate greater than 30.6 percent. The net item of income described in paragraph (i)(1) of *Example 3*: Foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of *Example 3*: Foreign tax (\$50) divided by sum (\$150) of net item of income (\$100) plus creditable tax thereon (\$50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(i) of this section, an election made by *CFC's* controlling United States shareholders must exclude from subpart F income both items of FPHC income under the high tax exception of section 954(b)(4) and this paragraph (d). The election may not be made only with respect to one item.

Example 5. The facts are the same as in *Example 1*, except that *CFC* earns \$5 of portfolio dividend income and \$150 of interest income. In addition, *CFC* earns \$45 for performing consulting services within its country of operation for unrelated persons. *CFC's* gross foreign base company income for 1995 of \$155 (\$150 of gross interest income and \$5 of portfolio dividend income) is

greater than 70 percent of its gross income of \$200. Therefore, under the full inclusion test of paragraph (b)(1)(ii) of this section, CFC's adjusted gross foreign base company income is \$200, and under paragraph (b)(2) of this section, the \$45 of consulting income is full inclusion foreign base company income. If CFC elects, under paragraph (d)(5) of this section, to exclude the interest income from subpart F income pursuant to the high tax exception, the \$45 of full inclusion foreign base company income will be excluded from subpart F income under paragraph (d)(6) of this section because the \$150 of gross interest income excluded under the high tax exception is more than 90 percent of CFC's adjusted gross foreign base company income of \$155.

(ii) The following examples generally illustrate the application of paragraph (c) of this section and this paragraph (d). Example 1 illustrates the order of computations. Example 2 illustrates the computations required by sections 952 and 954 and this § 1.954-1 if the full inclusion test of paragraph (b)(1)(ii) of this section is met and the income is not excluded from subpart F income under section 952(b). Computations in these examples involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section. For simplicity, these examples assume that the amount of taxes that are taken into account as a deduction under section 954(b)(5) and the amount of the gross-up required under sections 960 and 78 are equal. Therefore, these examples do not separately illustrate the deduction for taxes and gross-up.

Example 1. (i) *Gross income.* CFC, a controlled foreign corporation, has gross income of \$1000 for the current taxable year. Of that \$1000 of income, \$100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954-2(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 952(b) or section 954(c). Another \$50 is foreign base company sales income under section 954(d). The remaining \$850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954 (c), (d), (e), (f) or (g) or 953, and is foreign source general limitation income described in section 904(d)(1)(I).

(ii) *Expenses.* For the current taxable year, CFC has expenses of \$500. This amount includes \$8 of interest paid to a related person that is allocable to foreign personal holding company income under section 904, and \$2 of other expense that is directly related to foreign personal holding company income. Another \$20 of expense is directly related to foreign base company sales. The

remaining \$470 of expenses is allocable to general limitation income that is not foreign base company income or insurance income.

(iii) *Earnings and losses.* CFC has earnings and profits for the current taxable year of \$500. In the prior taxable year, CFC had losses with respect to income other than gross foreign base company income or gross insurance income. By reason of the limitation provided under section 952(c)(1)(A), those losses reduced the subpart F income (consisting entirely of foreign source general limitation income) of CFC by \$600 for the prior taxable year.

(iv) *Taxes.* Foreign income tax of \$30 is considered imposed on the interest income under the rules of section 954(b)(4), this paragraph (d), and § 1.904-6. Foreign income tax of \$14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904-6. Foreign income tax of \$177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4), this paragraph (d), and § 1.904-6. For the taxable year of CFC, the maximum United States rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if CFC elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and this paragraph (d), it will have \$500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows:

Step 1—Determine gross income:

(1) Gross income	\$1000
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Step 2—Determine gross foreign base company income and gross insurance income:

(2) Interest income included in gross foreign personal holding company income under section 954(c)	100
(3) Gross foreign base company sales income under section 954(d)	50
(4) Total gross foreign base company income and gross insurance income as defined in sections 954 (c), (d), (e), (f) and (g) and 953 (line (2) plus line (3))	150

Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:

(5) Five percent of gross income (.05 × line (1))	50
(6) Seventy percent of gross income (.70 × line (1))	700
(7) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the de minimis test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or \$1,000,000) (if the amount on this line 7 is zero, proceed to Step 8)	150

(8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6))	150
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Step 4—Compute net foreign base company income:

(9) Expenses directly related to adjusted gross foreign base company sales income	20
(10) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income	2
(11) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904	8
(12) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by lines (10) and (11))	90
(13) Net foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (3) reduced by line (9))	30
(14) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (12) plus line (13))	120

Step 5—Compute net insurance income:

(15) Net insurance income under section 953	0
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Step 6—Compute adjusted net foreign base company income:

(16) Foreign income tax imposed on net foreign personal holding company income (as determined under section 954(b)(4) and this paragraph (d))	30
(17) Foreign income tax imposed on net foreign base company sales income (as determined under section 954(b)(4) and this paragraph (d))	14
(18) Ninety percent of the maximum United States corporate tax rate	30.6%
(19) Effective rate of foreign income tax imposed on net foreign personal holding company income (\$90 of interest) under section 954(b)(4) and this paragraph (d) (line (16) divided by line (12))	33%
(20) Effective rate of foreign income tax imposed on \$30 of net foreign base company sales income under section 954(b)(4) and this paragraph (d) (line (17) divided by line (13))	47%

(21) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (12) if line (19) is greater than line (18)) ... 90

(22) Net foreign base company sales income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (13) if line (20) is greater than line (18)) ... 30

(23) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (14), reduced by the sum of line (21) and line (22)) 0

Step 7—Compute adjusted net insurance income:

(24) Adjusted net insurance income 0

Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):

(25) Earnings and profits for the current year 500

(26) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (25) over the sum of lines (23) and (24)); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year 500

(27) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) 600

(28) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (23), line (24), and the lesser of line (26) or line (27)) 500

(29) Amount of prior year's deficit to be recharacterized as subpart F income in later years under section 952(c) (excess of line (27) over line (26)) 100

Example 2. (i) *Gross income.* CFC, a controlled foreign corporation, has gross income of \$1000 for the current taxable year. Of that \$1000 of income, \$720 is interest income that is included in the definition of foreign personal holding company income under section 954(c) (1)(A) and § 1.954-2(b)(1)(ii), is not income from trade or service receivables described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 954(c) and § 1.954-2 or section 952(b). The remaining \$280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954 (c), (d), (e), (f), or (g) or 953, and is foreign source general limitation income for purposes of section 904(d)(1)(i).

(ii) *Expenses.* For the current taxable year, CFC has expenses of \$650. This amount includes \$350 of interest paid to related persons that is allocable to foreign personal holding company income under section 904,

and \$50 of other expense that is directly related to foreign personal holding company income. The remaining \$250 of expenses is allocable to services income other than foreign base company income or insurance income.

(iii) *Earnings and losses.* CFC has earnings and profits for the current taxable year of \$350. In the prior taxable year, CFC had losses with respect to income other than foreign base company income or insurance income. By reason of the limitation provided under section 952(c)(1)(A), those losses reduced the subpart F income of CFC (consisting entirely of foreign source general limitation income) by \$600 for the prior taxable year.

(iv) *Taxes.* Foreign income tax of \$120 is considered imposed on the \$720 of interest income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904-6. Foreign income tax of \$2 is considered imposed on the services income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904-6. For the taxable year of CFC, the maximum United States rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if CFC elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and this paragraph (d), it will have \$350 of subpart F income as defined in section 952(a), determined as follows.

Step 1—Determine gross income:

(1) Gross income \$1000

Step 2—Determine gross foreign base company income and gross insurance income:

(2) Gross foreign base company income and gross insurance income as defined in sections 954 (c), (d), (e), (f) and (g) and 953 (interest income) 720

Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:

(3) Seventy percent of gross income (.70 × line (1)) 700

(4) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3)) 1000

(5) Full inclusion foreign base company income under paragraph (b)(1)(ii) (line (4) minus line (2)) 280

Step 4—Compute net foreign base company income:

(6) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income 50

(7) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904 350

(8) Deductions allocable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c) of this section 250

(9) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by line (6) and line (7)) 320

(10) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (5) reduced by line (8)) 30

(11) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (9) plus line (10)) 350

Step 5—Compute net insurance income:

(12) Net insurance income under section 953 0

Step 6—Compute adjusted net foreign base company income:

(13) Foreign income tax imposed on net foreign personal holding company income (interest) 120

(14) Foreign income tax imposed on net full inclusion foreign base company income 2

(15) Ninety percent of the maximum United States corporate tax rate 30.6%

(16) Effective rate of foreign income tax imposed on \$320 of net foreign personal holding company income under section 954(b)(4) and this paragraph (d) (line (13) divided by line (9)) 38%

(17) Effective rate of foreign income tax imposed on \$30 of net full inclusion foreign base company income under section 954(b)(4) and this paragraph (d) (line (14) divided by line (10)) 7%

(18) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (9) if line (16) is greater than line (15)) 320

(19) Net full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (10) if line (17) is greater than line (15)) 0

(20) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (11) reduced by the sum of line (18) and line (19)) 30

Step 7—Compute adjusted net insurance income:

(21) Adjusted net insurance income 0

Step 8—Reduction of adjusted net foreign base company income or adjusted net insurance income by reason of paragraph (d)(6) of this section:

- (22) Adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1) of this section) (line (4) reduced by line (5)) 720
- (23) Ninety percent of adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1)(ii) of this section) (90% of the amount on line (22)) 648
- (24) Net foreign base company income and net insurance income excluded from subpart F income under section 954(b)(4), increased by the amount of expenses that reduced this income under section 954(b)(5) and paragraph (c) of this section (line (18) increased by the sum of line (6) and line (7)) 720
- (25) Adjusted net full inclusion foreign base company income excluded from subpart F income under paragraph (d)(6) of this section (zero, or line (10) reduced by line (19) if line (24) is greater than line (23)) 30
- (26) Adjusted net foreign base company income after application of paragraph (d)(6) of this section (line (20) reduced by line (25)) 0

Step 9—Additions to or reduction of subpart F income by reason of section 952(c):

- (27) Earnings and profits for the current year 350
- (28) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (27) over the sum of line (21) and line (26)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year 350
- (29) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) 600
- (30) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), and (5) do not apply (the sum of line (21) and line (26) plus the lesser of line (28) or line (29)) 350
- (31) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years under section 952(c) (excess of line (29) over line (28)) 250

(e) Character of income—(1)

Substance of the transaction. For purposes of section 954, income shall be

characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount that is designated as rent by the taxpayer but actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as rent but shall be characterized as income from the sale of property, royalties or income from services, as the case may be. Local law shall not be controlling in characterizing income.

(2) *Separable character.* To the extent the definitional provisions of section 953 or 954 describe the income or gain derived from a transaction, or any portion or portions thereof, that income or gain, or portion or portions thereof, is so characterized for purposes of subpart F. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing personal property and selling it to related persons outside its country of incorporation, also performs services outside its country of incorporation with respect to the property it sells, the sales income will be treated as foreign base company sales income and the services income will be treated as foreign base company services income for purposes of these rules.

(3) *Predominant character.* The portion of income or gain derived from a transaction that is included in the computation of foreign personal holding company income is always separately determinable and thus must always be segregated from other income and separately classified under paragraph (e)(2) of this section. However, the portion of income or gain derived from a transaction that would meet a particular definitional provision under section 954 or 953 (other than the definition of foreign personal holding company income) in unusual circumstances may not be separately determinable. If such portion is not separately determinable, it must be classified in accordance with the predominant character of the transaction. For example, if a controlled foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction, and the portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise not separately determinable, then the classification of income from the transaction shall be made in accordance

with the predominant character of the arrangement.

(4) *Coordination of categories of gross foreign base company income or gross insurance income—(i) In general.* The computations of gross foreign base company income and gross insurance income are limited by the following rules:

(A) If income is foreign base company shipping income, pursuant to section 954(f), it shall not be considered insurance income or income in any other category of foreign base company income.

(B) If income is foreign base company oil related income, pursuant to section 954(g), it shall not be considered insurance income or income in any other category of foreign base company income, except as provided in paragraph (e)(4)(i)(A) of this section.

(C) If income is insurance income, pursuant to section 953, it shall not be considered income in any category of foreign base company income except as provided in paragraph (e)(4)(i) (A) or (B) of this section.

(D) If income is foreign personal holding company income, pursuant to section 954(c), it shall not be considered income in any other category of foreign base company income, other than as provided in paragraph (e)(4)(i) (A), (B) or (C) of this section.

(ii) *Income excluded from other categories of gross foreign base company income.* Income shall not be excluded from a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in another category of gross foreign base company income or gross insurance income, if the income is excluded from that other category by a more specific provision of section 953 or 954. For example, income derived from a commodity transaction that is excluded from foreign personal holding company income under § 1.954-2(f) as income from a qualified active sale may be included in gross foreign base company income if it also meets the definition of foreign base company sales income. See § 1.954-2(a)(2) for the coordination of overlapping categories within the definition of foreign personal holding company income.

(f) *Definition of related person—(1) Persons related to controlled foreign corporation.* Unless otherwise provided, for purposes of section 954 and §§ 1.954-1 through 1.954-8 inclusive, the following persons are considered under section 954(d)(3) to be related persons with respect to a controlled foreign corporation:

(i) *Individuals.* An individual, whether or not a citizen or resident of the United States, who controls the controlled foreign corporation.

(ii) *Other persons.* A foreign or domestic corporation, partnership, trust or estate that controls or is controlled by the controlled foreign corporation, or is controlled by the same person or persons that control the controlled foreign corporation.

(2) *Control*—(i) *Corporations.* With respect to a corporation, control means the ownership, directly or indirectly, of stock possessing more than 50 percent of the total voting power of all classes of stock entitled to vote or of the total value of the stock of the corporation.

(ii) *Partnerships.* With respect to a partnership, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the capital or profits interest in the partnership.

(iii) *Trusts and estates.* With respect to a trust or estate, control means the ownership, directly or indirectly, of more than 50 percent (by value) of the beneficial interest in the trust or estate.

(iv) *Direct or indirect ownership.* For purposes of this paragraph (f), to determine direct or indirect ownership, the principles of section 958(a) shall be applied without regard to whether a corporation, partnership, trust or estate is foreign or domestic or whether or not an individual is a citizen or resident of the United States.

§ 1.954-2 Foreign personal holding company income.

(a) *Computation of foreign personal holding company income*—(1) *Categories of foreign personal holding company income.* For purposes of subpart F and the regulations under that subpart, foreign personal holding company income consists of the following categories of income—

(i) Dividends, interest, rents, royalties, and annuities as described in paragraph (b) of this section;

(ii) Gain from certain property transactions as described in paragraph (e) of this section;

(iii) Gain from commodities transactions as described in paragraph (f) of this section;

(iv) Foreign currency gain as described in paragraph (g) of this section; and

(v) Income equivalent to interest as described in paragraph (h) of this section.

(2) *Coordination of overlapping categories under foreign personal holding company provisions*—(i) *In general.* If any portion of income, gain or loss from a transaction is described

in more than one category of foreign personal holding company income (as described in paragraph (a)(2)(ii) of this section), that portion of income, gain or loss is treated solely as income, gain or loss from the category of foreign personal holding company income with the highest priority.

(ii) *Priority of categories.* The categories of foreign personal holding company income, listed from highest priority (paragraph (a)(2)(ii)(A) of this section) to lowest priority (paragraph (a)(2)(ii)(E) of this section), are—

(A) Dividends, interest, rents, royalties, and annuities, as described in paragraph (b) of this section;

(B) Income equivalent to interest, as described in paragraph (h) of this section without regard to the exceptions in paragraph (h)(1)(ii)(A) of this section;

(C) Foreign currency gain or loss, as described in paragraph (g) of this section without regard to the exclusion in paragraph (g)(2)(ii) of this section;

(D) Gain or loss from commodities transactions, as described in paragraph (f) of this section without regard to the exclusion in paragraph (f)(1)(ii) of this section; and

(E) Gain or loss from certain property transactions, as described in paragraph (e) of this section without regard to the exceptions in paragraph (e)(1)(ii) of this section.

(3) *Changes in the use or purpose for which property is held*—(i) *In general.* Under paragraphs (e), (f), (g) and (h) of this section, transactions in certain property give rise to gain or loss included in the computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. The use or purpose for which property is held is that use or purpose for which it was held for more than one-half of the period during which the controlled foreign corporation held the property prior to the disposition.

(ii) *Special rules*—(A) *Anti-abuse rule.* If a principal purpose of a change in use or purpose of property was to avoid including gain or loss in the computation of foreign personal holding company income, all the gain or loss from the disposition of the property is treated as foreign personal holding company income. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(B) *Hedging transactions.* The provisions of paragraph (a)(3)(i) of this section shall not apply to bona fide hedging transactions, as defined in paragraph (a)(4)(ii) of this section. A transaction will be treated as a bona fide hedging transaction only so long as it

satisfies the requirements of paragraph (a)(4)(ii) of this section.

(iii) *Example.* The following example illustrates the application of this paragraph (a)(3).

Example. At the beginning of taxable year 1, *CFC*, a controlled foreign corporation, purchases a building for investment. During taxable years 1 and 2, *CFC* derives rents from the building that are included in the computation of foreign personal holding company income under paragraph (b)(1)(iii) of this section. At the beginning of taxable year 3, *CFC* changes the use of the building by terminating all leases and using it in an active trade or business. At the beginning of taxable year 4, *CFC* sells the building at a gain. The building was not used in an active trade or business of *CFC* for more than one-half of the period during which it was held by *CFC*. Therefore, the building is considered to be property that gives rise to rents, as described in paragraph (e)(2) of this section, and gain from the sale is included in the computation of *CFC*'s foreign personal holding company income under paragraph (e) of this section.

(4) *Definitions and special rules.* The following definitions and special rules apply for purposes of computing foreign personal holding company income under this section.

(i) *Interest.* The term *interest* includes all amounts that are treated as interest income (including interest on a tax-exempt obligation) by reason of the Internal Revenue Code or Income Tax Regulations or any other provision of law. For example, interest includes stated interest, acquisition discount, original issue discount, de minimis original issue discount, market discount, de minimis market discount, and unstated interest, as adjusted by any amortizable bond premium or acquisition premium.

(ii) *Bona fide hedging transaction*—(A) *Definition.* The term *bona fide hedging transaction* means a transaction that meets the requirements of § 1.1221-2 (a) through (c) and that is identified in accordance with the requirements of paragraph (a)(4)(ii)(B) of this section, except that in applying § 1.1221-2(b)(1), the risk being hedged may be with respect to ordinary property, section 1231 property, or a section 988 transaction. A transaction that hedges the liabilities, inventory or other assets of a related person (as defined in section 954(d)(3)), that is entered into to assume or reduce risks of a related person, or that is entered into by a person other than a person acting in its capacity as a regular dealer (as defined in paragraph (a)(4)(iv) of this section) to reduce risks assumed from a related person, will not be treated as a bona fide hedging transaction. For an illustration of how this rule applies with respect to foreign

currency transactions, see paragraph (g)(2)(ii)(D) of this section.

(B) *Identification.* The identification requirements of this section shall be satisfied if the taxpayer meets the identification and recordkeeping requirements of § 1.1221-2(e). However, for bona fide hedging transactions entered into prior to March 7, 1996 the identification and recordkeeping requirements of § 1.1221-2 shall not apply. Rather, for bona fide hedging transactions entered into on or after July 22, 1988 and prior to March 7, 1996 the identification and recordkeeping requirements shall be satisfied if such transactions are identified by the close of the fifth day after the day on which they are entered into. For bona fide hedging transactions entered into prior to July 22, 1988, the identification and recordkeeping requirements shall be satisfied if such transactions are identified reasonably contemporaneously with the date they are entered into, but no later than within the normal period prescribed under the method of accounting of the controlled foreign corporation used for financial reporting purposes.

(C) *Effect of identification and non-identification—(1) Transactions identified.* If a taxpayer identifies a transaction as a bona fide hedging transaction for purposes of this section, the identification is binding with respect to any loss arising from such transaction whether or not all of the requirements of paragraph (a)(4)(ii)(A) of this section are satisfied. Accordingly, such loss will be allocated against income that is not subpart F income (or, in the case of an election under paragraph (g)(3) of this section, against the category of subpart F income to which it relates) and apportioned among the categories of income described in section 904(d)(1). If the transaction is not in fact a bona fide hedging transaction described in paragraph (a)(4)(ii)(A) of this section, however, then any gain realized with respect to such transaction shall not be considered as gain from a bona fide hedging transaction. Accordingly, such gain shall be treated as gain from the appropriate category of foreign personal holding company income. Thus, the taxpayer's identification of the transaction as a hedging transaction does not itself operate to exclude gain from the appropriate category of foreign personal holding company income.

(2) *Inadvertent identification.* Notwithstanding paragraph (a)(4)(ii)(C)(1) of this section, if the taxpayer identifies a transaction as a bona fide hedging transaction for purposes of this section, the

characterization of the loss is determined as if the transaction had not been identified as a bona fide hedging transaction if—

- (i) The transaction is not a bona fide hedging transaction (as defined in paragraph (a)(4)(ii)(A) of this section);
- (ii) The identification of the transaction as a bona fide hedging transaction was due to inadvertent error; and
- (iii) All of the taxpayer's transactions in all open years are being treated on either original or, if necessary, amended returns in a manner consistent with the principles of this section.

(3) *Transactions not identified.* Except as provided in paragraphs (a)(4)(ii)(C)(4) and (5) of this section, the absence of an identification that satisfies the requirements of paragraph (a)(4)(ii)(B) of this section is binding and establishes that a transaction is not a bona fide hedging transaction. Thus, subject to the exceptions, the characterization of gain or loss is determined without reference to whether the transaction is a bona fide hedging transaction.

(4) *Inadvertent error.* If a taxpayer does not make an identification that satisfies the requirements of paragraph (a)(4)(ii)(B) of this section, the taxpayer may treat gain or loss from the transaction as gain or loss from a bona fide hedging transaction if—

- (i) The transaction is a bona fide hedging transaction (as defined in paragraph (a)(4)(ii)(A) of this section);
- (ii) The failure to identify the transaction was due to inadvertent error; and
- (iii) All of the taxpayer's bona fide hedging transactions in all open years are being treated on either original or, if necessary, amended returns as bona fide hedging transactions in accordance with the rules of this section.

(5) *Anti-abuse rule.* If a taxpayer does not make an identification that satisfies all the requirements of paragraph (a)(4)(ii)(B) of this section but the taxpayer has no reasonable grounds for treating the transaction as other than a bona fide hedging transaction, then loss from the transaction shall be treated as realized with respect to a bona fide hedging transaction. Thus, a taxpayer may not elect to exclude loss from its proper characterization as a bona fide hedging transaction. The reasonableness of the taxpayer's failure to identify a transaction is determined by taking into consideration not only the requirements of paragraph (a)(4)(ii)(A) of this section but also the taxpayer's treatment of the transaction for financial accounting or other purposes and the taxpayer's identification of similar transactions as hedging transactions.

(iii) *Inventory and similar property—(A) Definition.* The term *inventory and similar property* (or *inventory or similar property*) means property that is stock in trade of the controlled foreign corporation or other property of a kind that would properly be included in the inventory of the controlled foreign corporation if on hand at the close of the taxable year (if the controlled foreign corporation were a domestic corporation), or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of its trade or business.

(B) *Hedging transactions.* A bona fide hedging transaction with respect to inventory or similar property (other than a transaction described in section 988(c)(1) without regard to section 988(c)(1)(D)(i)) shall be treated as a transaction in inventory or similar property.

(iv) *Regular dealer.* The term *regular dealer* means a controlled foreign corporation that—

(A) Regularly and actively offers to, and in fact does, purchase property from and sell property to customers who are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation in the ordinary course of a trade or business; or

(B) Regularly and actively offers to, and in fact does, enter into, assume, offset, assign or otherwise terminate positions in property with customers who are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation in the ordinary course of a trade or business.

(v) *Dealer property—(A) Definition.* Property held by a controlled foreign corporation is *dealer property* if—

(1) The controlled foreign corporation is a regular dealer in property of such kind (determined under paragraph (a)(4)(iv) of this section); and

(2) The property is held by the controlled foreign corporation in its capacity as a dealer in property of such kind without regard to whether the property arises from a transaction with a related person (as defined in section 954(d)(3)) with respect to the controlled foreign corporation. The property is not held by the controlled foreign corporation in its capacity as a dealer if the property is held for investment or speculation on its own behalf or on behalf of a related person (as defined in section 954(d)(3)).

(B) *Securities dealers.* If a controlled foreign corporation is a licensed securities dealer, only the securities that it has identified as held for investment in accordance with the provisions of section 475(b) or section 1236 will be

considered to be property held for investment or speculation under this section. A licensed securities dealer is a controlled foreign corporation that is both a securities dealer, as defined in section 475, and a regular dealer, as defined in paragraph (a)(4)(iv) of this section, and that is either—

(1) registered as a securities dealer under section 15(a) of the Securities Exchange Act of 1934 or as a Government securities dealer under section 15C(a) of such Act; or

(2) licensed or authorized in the country in which it is chartered, incorporated, or organized to purchase and sell securities from or to customers who are residents of that country. The conduct of such securities activities must be subject to bona fide regulation, including appropriate reporting, monitoring, and prudential (including capital adequacy) requirements, by a securities regulatory authority in that country that regularly enforces compliance with such requirements and prudential standards.

(C) *Hedging transactions.* A bona fide hedging transaction with respect to dealer property shall be treated as a transaction in dealer property.

(vi) *Examples.* The following examples illustrate the application of paragraphs (a)(4)(ii), (iv) and (v) of this section.

Example 1. (i) *CFC1* and *CFC2* are related controlled foreign corporations (within the meaning of section 954(d)(3)) located in Countries F and G, respectively. *CFC1* and *CFC2* regularly purchase securities from and sell securities to customers who are not related persons with respect to *CFC1* or *CFC2* (within the meaning of section 954(d)(3)) in the ordinary course of their businesses and regularly and actively hold themselves out as being willing to, and in fact do, enter into either side of options, forward contracts, or other financial instruments. *CFC1* uses securities that are traded in securities markets in Country G to hedge positions that it enters into with customers located in Country F. *CFC1* is not a member of a securities exchange in Country G, so it purchases such securities from *CFC2* and unrelated persons that are registered as securities dealers in Country G and that are members of Country G securities exchanges. Such hedging transactions qualify as bona fide hedging transactions under paragraph (a)(4)(ii) of this section.

(ii) Transactions that *CFC1* and *CFC2* enter into with each other do not affect the determination of whether they are regular dealers. Because *CFC1* and *CFC2* regularly purchase securities from and sell securities to customers who are not related persons within the meaning of section 954(d)(3) in the ordinary course of their businesses and regularly and actively hold themselves out as being willing to, and in fact do, enter into either side of options, forward contracts, or other financial instruments, however, they

qualify as regular dealers in such property within the meaning of paragraph (a)(4)(iv) of this section. Moreover, because *CFC1* purchases securities from *CFC2* as bona fide hedging transactions with respect to dealer property, the securities are dealer property under paragraph (a)(4)(v)(C) of this section. Similarly, because *CFC2* sells securities to *CFC1* in the ordinary course of its business as a dealer, the securities are dealer property under paragraph (a)(4)(v)(A) of this section.

Example 2. (i) *CFC* is a controlled foreign corporation located in Country B. *CFC* serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks outside of the group. *CFC* regularly and actively holds itself out as being willing to, and in fact does, enter into either side of options, forward contracts, or other financial instruments with other members of the same controlled group. *CFC* hedges risks arising from such transactions by entering into transactions with persons who are not related persons (within the meaning of section 954(d)(3)) with respect to *CFC*. However, *CFC* does not regularly and actively hold itself out as being willing to, and does not, enter into either side of transactions with unrelated persons.

(ii) *CFC* is not a regular dealer in property under paragraph (a)(4)(iv) of this section and its options, forwards, and other financial instruments are not dealer property within the meaning of paragraph (a)(4)(v) of this section.

(vii) *Debt instrument.* The term *debt instrument* includes bonds, debentures, notes, certificates, accounts receivable, and other evidences of indebtedness.

(b) *Dividends, interest, rents, royalties, and annuities—(1) In general.* Foreign personal holding company income includes—

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(4) of this section and distributions of previously taxed income under section 959(b);

(ii) Interest, except export financing interest as defined in paragraph (b)(2) of this section and certain interest received from related persons as described in paragraph (b)(4) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in paragraph (b)(5) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(6) of this section; and

(iv) Annuities.

(2) *Exclusion of certain export financing interest—(i) In general.* Foreign personal holding company income does not include interest that is export financing interest. The term *export financing interest* means interest that is derived in the conduct of a banking business and is export

financing interest as defined in section 904(d)(2)(G). Solely for purposes of determining whether interest is export financing interest, property is treated as manufactured, produced, grown, or extracted in the United States if it is so treated under § 1.927(a)-1T(c).

(ii) *Exceptions.* Export financing interest does not include income from related party factoring that is treated as interest under section 864(d)(1) or (6) after the application of section 864(d)(7).

(iii) *Conduct of a banking business.* For purposes of this section, export financing interest is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.

(iv) *Examples.* The following examples illustrate the application of this paragraph (b)(2).

Example 1. (i) *DS*, a domestic corporation, manufactures property in the United States. In addition to selling inventory (property described in section 1221(1)), *DS* occasionally sells depreciable equipment it manufactures for use in its trade or business, which is property described in section 1221(2). Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G), of each item of inventory or equipment sold by *DS* is attributable to products imported into the United States. *CFC*, a controlled foreign corporation with respect to which *DS* is a related person (within the meaning of section 954(d)(3)), provides loans described in section 864(d)(6) to unrelated persons for the purchase of property from *DS*. This property is purchased exclusively for use or consumption outside the United States and outside *CFC*'s country of incorporation.

(ii) If, in issuing and servicing loans made with respect to purchases from *DS* of depreciable equipment used in its trade or business, which is property described in section 1221(2) in the hands of *DS*, *CFC* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of this paragraph (b)(2) and, thus, not included in foreign personal holding company income. However, interest from the loans made with respect to purchases from *DS* of property that is inventory in the hands of *DS* cannot be export financing interest because it is treated as income from a trade or service receivable under section 864(d)(6) and the exception under section 864(d)(7) does not apply. Thus the interest from loans made with respect to this inventory is included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

Example 2. (i) *DS*, a domestic corporation manufactures property in the United States. *DS* wholly owns two controlled foreign

corporations organized in Country A. *CFC1* and *CFC2*. *CFC1* has a substantial part of its assets used in its trade or business in Country A. *CFC1* purchases the property that *DS* manufactures and sells it without further manufacture for use or consumption within Country A. This property is inventory property, as described in section 1221(1), in the hands of *CFC1*. Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G), of each item of inventory sold by *CFC1* is attributable to products imported into the United States. *CFC2* provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property from *CFC1*.

(i) If, in issuing and servicing loans made with respect to purchases from *CFC1* of the inventory property, *CFC2* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of paragraph (b)(2) of this section. It is not treated as income from a trade or service receivable under section 864(d)(6) because the exception under section 864(d)(7) applies. Thus the interest is excluded from foreign personal holding company income.

Example 3. The facts are the same as in *Example 2* except that the property sold by *CFC1* is manufactured by *CFC1* in Country A from component parts that were manufactured by *DS* in the United States. The interest accrued from the loans by *CFC2* is not export financing interest as defined in section 904(d)(2)(G) because the property is not manufactured in the United States under § 1.927(a)-1T(c). No portion of the interest is export financing interest as defined in this paragraph (b)(2). The full amount of the interest is, therefore, included in foreign personal holding company income under paragraph (b)(1)(ii) of this section.

(3) *Treatment of tax-exempt interest.* [Reserved] For guidance, see § 4.954-2(b)(6) of this chapter.

(4) *Exclusion of dividends or interest from related persons—(i) In general—(A) Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include dividends or interest if the payor—

(1) Is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3);

(2) Is created or organized under the laws of the same foreign country (the *country of incorporation*) as is the controlled foreign corporation; and

(3) Uses a substantial part of its assets in a trade or business in its country of incorporation, as determined under this paragraph (b)(4).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(4), if a partnership with one or more corporate partners makes a payment of interest, a corporate partner will be treated as the payor of the interest—

(1) If the interest payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that the item of deduction is allocable to the corporate partner under section 704(b); or

(2) If the interest payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions—(A) Dividends.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(4) only to the extent that they are paid out of earnings and profits that are earned or accumulated during a period in which—

(1) The stock on which dividends are paid with respect to which the exclusion is claimed was owned by the recipient controlled foreign corporation directly, or indirectly through a chain of one or more subsidiaries each of which meets the requirements of paragraph (b)(4)(i)(A) of this section; and

(2) Each of the requirements of paragraph (b)(4)(i)(A) of this section is satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962, during a period in which the payor was a related corporation as to the controlled foreign corporation and the other requirements of paragraph (b)(4)(i)(A) of this section were substantially satisfied.

(3) This paragraph (b)(4)(ii)(A) is illustrated by the following example:

Example. A, a domestic corporation, owns all of the stock of B, a corporation created and organized under the laws of Country Y, and C, a corporation created and organized under the laws of Country X. The taxable year of each of the corporations is the calendar year. In Year 1, B earns \$100 of income from the sale of products in Country Y that it manufactured in Country Y. C had no earnings and profits in Year 1. On January 1 of Year 2, A contributes all of the stock of B and C to Newco, a Country Y corporation, in exchange for all of the stock of Newco. Neither B nor C earns any income in Year 2, but at the end of Year 2 B distributes the \$100 accumulated earnings and profits to Newco. Newco's income from the distribution, \$100, is foreign personal holding company income because the earnings and profits distributed by B were not earned or accumulated during a period in which the stock of B was owned by Newco and in which each of the requirements of paragraph (b)(4)(i)(A) of this section was satisfied.

(B) *Interest paid out of adjusted foreign base company income or*

insurance income—(1) In general. Interest may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(4) to the extent that the deduction for the interest is allocated under § 1.954-1(a)(4) and (c) to the payor's adjusted gross foreign base company income (as defined in § 1.954-1(a)(3)), adjusted gross insurance income (as defined in § 1.954-1(a)(6)), or any other category of income included in the computation of subpart F income under section 952(a).

(2) *Rule for corporations that are both recipients and payors of interest.* If a controlled foreign corporation is both a recipient and payor of interest, the interest that is received will be characterized before the interest that is paid. In addition, the amount of interest paid or accrued, directly or indirectly, by the controlled foreign corporation to a related person (as defined in section 954(d)(3)) shall be offset against and eliminate any interest received or accrued, directly or indirectly, by the controlled foreign corporation from that related person. In a case in which the controlled foreign corporation pays or accrues interest to a related person, as defined in section 954(d)(3), and also receives or accrues interest indirectly from the related person, the smallest interest payment is eliminated and the amounts of all other interest payments are reduced by the amount of the smallest interest payment.

(C) *Coordination with sections 864(d) and 881(c).* Income of a controlled foreign corporation that is treated as interest under section 864(d) (1) or (6), or that is portfolio interest, as defined by section 881(c), is not excluded from foreign personal holding company income under section 954(c)(3)(A)(i) and this paragraph (b)(4).

(iii) *Trade or business requirement.* Except as otherwise provided under this paragraph (b)(4), the principles of section 367(a) apply for purposes of determining whether the payor has a trade or business in its country of incorporation and whether its assets are used in that trade or business. Property purchased or produced for use in a trade or business is not considered used in a trade or business before it is placed in service or after it is retired from service as determined in accordance with the principles of sections 167 and 168.

(iv) *Substantial assets test.* A substantial part of the assets of the payor will be considered to be used in a trade or business located in the payor's country of incorporation for a taxable year only if the average value of the payor's assets for such year that are used in the trade or business and are

located in such country equals more than 50 percent of the average value of all the assets of the payor (including assets not used in a trade or business). The average value of assets for the taxable year is determined by averaging the values of assets at the close of each quarter of the taxable year. The value of assets is determined under paragraph (b)(4)(v) of this section, and the location of assets used in a trade or business of the payor is determined under paragraphs (b)(4)(vi) through (xi) of this section.

(v) *Valuation of assets.* For purposes of determining whether a substantial part of the assets of the payor are used in a trade or business in its country of incorporation, the value of assets shall be their fair market value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their adjusted basis.

(vi) *Location of tangible property—(A) In general.* Tangible property (other than inventory and similar property as defined in paragraph (a)(4)(iii) of this section, and dealer property as defined in paragraph (a)(4)(v) of this section) used in a trade or business is considered located in the country in which it is physically located.

(B) *Exception.* An item of tangible personal property that is used in the trade or business of a payor in the payor's country of incorporation is considered located within the payor's country of incorporation while it is temporarily located elsewhere for inspection or repair if the property is not placed in service in a country other than the payor's country of incorporation and is not to be so placed in service following the inspection or repair.

(vii) *Location of intangible property—(A) In general.* Intangible property (other than inventory and similar property as defined in paragraph (a)(4)(iii) of this section, dealer property as defined in paragraph (a)(4)(v) of this section, and debt instruments) is considered located entirely in the payor's country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the use or exploitation of the property in that country during that entire quarter. For this purpose, the country in which the activities connected to the use or exploitation of the property are conducted is the country in which the expenses associated with these activities are incurred. Expenses incurred in connection with the use or exploitation of an item of intangible property are included in the computation provided by this paragraph (b)(4) if they would be

deductible under section 162 or includible in inventory costs or the cost of goods sold if the payor were a domestic corporation. If the payor conducts such activities through an agent or independent contractor, then the expenses incurred by the payor with respect to the agent or independent contractor shall be deemed to be incurred by the payor in the country in which the expenses of the agent or independent contractor were incurred by the agent or independent contractor.

(B) *Exception for property located in part in the payor's country of incorporation.* If the payor conducts its activities in connection with the use or exploitation of an item of intangible property, including goodwill (other than inventory and similar property, dealer property and debt instruments) during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the intangible considered located in the payor's country of incorporation during that quarter is a percentage of the value of the item as of the close of the quarter. That percentage equals the ratio that the expenses incurred by the payor (described in paragraph (b)(4)(vii)(A) of this section) during the entire quarter by reason of activities that are connected with the use or exploitation of the item of intangible property and are conducted in the payor's country of incorporation bear to all expenses incurred by the payor during the entire quarter by reason of all such activities worldwide.

(viii) *Location of inventory and dealer property—(A) In general.* Inventory and similar property, as defined in paragraph (a)(4)(iii) of this section, and dealer property, as defined in paragraph (a)(4)(v) of this section, are considered located entirely in the payor's country of incorporation for a quarter of the taxable year only if the payor conducts all of its activities in connection with the production and sale, or purchase and resale, of such property in its country of incorporation during that entire quarter. If the payor conducts such activities through an agent or independent contractor, then the location of such activities is the place in which they are conducted by the agent or independent contractor.

(B) *Inventory and dealer property located in part in the payor's country of incorporation.* If the payor conducts its activities in connection with the production and sale, or purchase and resale, of inventory or similar property or dealer property during a quarter of the taxable year both in its country of incorporation and elsewhere, then the value of the inventory or similar

property or dealer property considered located in the payor's country of incorporation during each quarter is a percentage of the value of the inventory or similar property or dealer property as of the close of the quarter. That percentage equals the ratio that the costs and expenses incurred by the payor during the entire quarter by reason of activities connected with the production and sale, or purchase and resale, of inventory or similar property or dealer property that are conducted in the payor's country of incorporation bear to all costs or expenses incurred by the payor during the entire quarter by reason of all such activities worldwide. A cost incurred in connection with the production and sale or purchase and resale of inventory or similar property or dealer property is included in this computation if it—

(1) Would be included in inventory costs or otherwise capitalized with respect to inventory or similar property or dealer property under section 61, 263A, 471, or 472 if the payor were a domestic corporation; or

(2) Would be deductible under section 162 if the payor were a domestic corporation and is definitely related to gross income derived from such property (but not to all classes of gross income derived by the payor) under the principles of § 1.861-8.

(ix) *Location of debt instruments.* For purposes of this paragraph (b)(4), debt instruments, other than debt instruments that are inventory or similar property (as defined in paragraph (a)(4)(iii) of this section) or dealer property (as defined in paragraph (a)(4)(v) of this section) are considered to be used in a trade or business only if they arise from the sale of inventory or similar property or dealer property by the payor or from the rendition of services by the payor in the ordinary course of a trade or business of the payor, and only until such time as interest is required to be charged under section 482. Debt instruments that arise from the sale of inventory or similar property or dealer property during a quarter are treated as having the same location, proportionately, as the inventory or similar property or dealer property held during that quarter. Debt instruments arising from the rendition of services in the ordinary course of a trade or business are considered located on a proportionate basis in the countries in which the services to which they relate are performed.

(x) *Treatment of certain stock interests.* Stock in a controlled foreign corporation (lower-tier corporation) that is incorporated in the same country as the payor and related to the payor

within the meaning of section 954(d)(3) shall be considered located in the payor's country of incorporation in proportion to the value of the assets of the lower-tier corporation. The location of assets used in a trade or business of the lower-tier corporation shall be determined under the rules of this paragraph (b)(4).

(xi) *Treatment of banks and insurance companies.* [Reserved]

(5) *Exclusion of rents and royalties derived from related persons—(i) In general—(A) Corporate payor.* Foreign personal holding company income received by a controlled foreign corporation does not include rents or royalties if—

(1) The payor is a corporation that is a related person with respect to the controlled foreign corporation, as defined in section 954(d)(3); and

(2) The rents or royalties are for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation receiving the payments is created or organized (the country of incorporation).

(B) *Payment by a partnership.* For purposes of this paragraph (b)(5), if a partnership with one or more corporate partners makes a payment of rents or royalties, a corporate partner will be treated as the payor of the rents or royalties—

(1) If the rent or royalty payment gives rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent the item of deduction is allocable to the corporate partner under section 704(b); or

(2) If the rent or royalty payment does not give rise to a partnership item of deduction under the Internal Revenue Code or Income Tax Regulations, to the extent that a partnership item reasonably related to the payment would be allocated to that partner under an existing allocation under the partnership agreement (made pursuant to section 704(b)).

(ii) *Exceptions—(A) Rents or royalties paid out of adjusted foreign base company income or insurance income.* Rents or royalties may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(5) to the extent that deductions for the payments are allocated under section 954(b)(5) and § 1.954-1(a)(4) and (c) to the payor's adjusted gross foreign base company income (as defined in § 1.954-1(a)(3)), adjusted gross insurance income (as defined in § 1.954-1(a)(6)), or any other category of income included in the

computation of subpart F income under section 952(a).

(B) *Property used in part in the controlled foreign corporation's country of incorporation.* If the payor uses the property both in the controlled foreign corporation's country of incorporation and elsewhere, the part of the rent or royalty attributable (determined under the principles of section 482) to the use of, or the privilege of using, the property outside such country of incorporation is included in the computation of foreign personal holding company income under this paragraph (b).

(6) *Exclusion of rents and royalties derived in the active conduct of a trade or business.* Foreign personal holding company income shall not include rents or royalties that are derived in the active conduct of a trade or business and received from a person that is not a related person (as defined in section 954(d)(3)) with respect to the controlled foreign corporation. For purposes of this section, rents or royalties are derived in the active conduct of a trade or business only if the provisions of paragraph (c) or (d) of this section are satisfied.

(c) *Excluded rents—(1) Active conduct of a trade or business.* Rents will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following—

(i) Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;

(ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;

(iii) Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or

(iv) Property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

(2) *Special rules—(i) Adding substantial value.* For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* For purposes of paragraph (c)(1)(iv) of this section, whether an organization in a foreign country is substantial in relation to the amount of rents is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of rents if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.

(iii) *Active leasing expenses.* The term *active leasing expenses* means the deductions incurred by an organization of the lessor in a foreign country that are properly allocable to rental income and that would be allowable under section 162 to the lessor if it were a domestic corporation, other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons (as defined in section 954(d)(3)) with respect to, the lessor;

(B) Deductions for rents paid or accrued;

(C) Deductions that, although generally allowable under section 162, would be specifically allowable to the lessor (if the lessor were a domestic corporation) under any section of the Internal Revenue Code other than section 162; and

(D) Deductions for payments made to agents or independent contractors with respect to the leased property other than payments for insurance, utilities and other expenses for like services, or for capitalized repairs.

(iv) *Adjusted leasing profit.* The term *adjusted leasing profit* means the gross income of the lessor from rents, reduced by the sum of—

(A) The rents paid or incurred by the lessor with respect to such rental income;

(B) The amounts that would be allowable to such lessor (if the lessor were a domestic corporation) as deductions under sections 167 or 168 with respect to such rental income; and

(C) The amounts paid by the lessor to agents or independent contractors with respect to such rental income other than payments for insurance, utilities and other expenses for like services, or for capitalized repairs.

(3) *Examples.* The application of this paragraph (c) is illustrated by the following examples.

Example 1. Controlled foreign corporation A is regularly engaged in the production of office machines which it sells or leases to others and services. Under paragraph (c)(1)(i) of this section, the rental income of Corporation A from these leases is derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 2. Controlled foreign corporation D purchases motor vehicles which it leases to others. In the conduct of its short-term leasing of such vehicles in foreign country X, Corporation D owns a large number of motor vehicles in country X which it services and repairs, leases motor vehicles to customers on an hourly, daily, or weekly basis, maintains offices and service facilities in country X from which to lease and service such vehicles, and maintains therein a sizable staff of its own administrative, sales, and service personnel. Corporation D also leases in country X on a long-term basis, generally for a term of one year, motor vehicles that it owns. Under the terms of the long-term leases, Corporation D is required to repair and service, during the term of the lease, the leased motor vehicles without cost to the lessee. By the maintenance in country X of office, sales, and service facilities and its complete staff of administrative, sales, and service personnel, Corporation D maintains and operates an organization therein that is regularly engaged in the business of marketing and servicing the motor vehicles that are leased. The deductions incurred by such organization satisfy the 25-percent test of paragraph (c)(2)(ii) of this section; thus, such organization is substantial in relation to the rents Corporation D receives from leasing the motor vehicles. Therefore, under paragraph (c)(1)(iv) of this section, such rents are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 3. Controlled foreign corporation E owns a complex of apartment buildings that it has acquired by purchase. Corporation E engages a real estate management firm to lease the apartments, manage the buildings and pay over the net rents to Corporation E. The rental income of Corporation E from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 4. Controlled foreign corporation F acquired by purchase a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation F acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. Under paragraph (c)(1)(ii) of this section, the rents received by Corporation F from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 5. Controlled foreign corporation G owns equipment that it ordinarily uses to perform contracts in foreign countries to drill oil wells. For occasional brief and irregular periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration

of such temporary leasing of the property, Corporation G continues the use of such equipment in the performance of its own drilling contracts. Under paragraph (c)(1)(iii) of this section, rents Corporation G receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Active conduct of a trade or business.* Royalties will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (the licensor) from licensing—

(i) Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind; or

(ii) Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.

(2) *Special rules*—(i) *Adding substantial value.* For purposes of paragraph (d)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* For purposes of paragraph (d)(1)(ii) of this section, whether an organization in a foreign country is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of royalties if active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(iii) *Active licensing expenses.* The term *active licensing expenses* means the deductions incurred by an organization of the licensor in a foreign country that are properly allocable to royalty income and that would be allowable under section 162 to the licensor if it were a domestic corporation, other than—

(A) Deductions for compensation for personal services rendered by

shareholders of, or related persons (as defined in section 954(d)(3)) with respect to, the licensor;

(B) Deductions for royalties paid or incurred;

(C) Deductions that, although generally allowable under section 162, would be specifically allowable to the licensor (if the controlled foreign corporation were a domestic corporation) under any section of the Internal Revenue Code other than section 162; and

(D) Deductions for payments made to agents or independent contractors with respect to the licensed property.

(iv) *Adjusted licensing profit.* The term *adjusted licensing profit* means the gross income of the licensor from royalties, reduced by the sum of—

(A) The royalties paid or incurred by the licensor with respect to such royalty income;

(B) The amounts that would be allowable to such licensor as deductions under section 167 or 197 (if the licensor were a domestic corporation) with respect to such royalty income; and

(C) The amounts paid by the licensor to agents or independent contractors with respect to such royalty income.

(3) *Examples.* The application of this paragraph (d) is illustrated by the following examples.

Example 1. Controlled foreign corporation A, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility employees of Corporation A who are scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, that ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation A for the privilege of using patented rights that it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A), but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind.

Example 2. Assume that Corporation A in Example 1, in addition to receiving royalties for the use of patents that it develops, receives royalties for the use of patents that it acquires by purchase and licenses to others without adding any value thereto. Corporation A generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of Corporation A, that Corporation A has acquired rights under a patent and is interested in licensing its rights. Corporation A does not, however, maintain and operate

an organization in a foreign country that is regularly engaged in the business of marketing the purchased patents. The royalties received by Corporation A for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 3. Controlled foreign corporation B receives royalties for the use of patents that it acquires by purchase. The primary business of Corporation B, operated on a regular basis, consists of licensing patents that it has purchased raw from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation B, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation B from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 4. Controlled foreign corporation C receives royalties for the use of a patent that it developed through its own staff of employees at its facility in country X. Corporation C has developed no other patents. It does not regularly employ a staff of scientists, engineers or technicians to create new products to be patented. Further, it does not purchase and license patents developed by others to which it has added substantial value. The royalties received by Corporation C are not derived from the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 5. Controlled foreign corporation D finances independent persons in the development of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation D also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice that is intended to promote the use of the patented property. Corporation D does not, however, maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the patents. Royalties received by Corporation D for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(e) *Certain property transactions*—(1) *In general*—(i) *Inclusions*. Gain from certain property transactions described in section 954(c)(1)(B) includes the excess of gains over losses from the sale or exchange of—

(A) Property that gives rise to dividends, interest, rents, royalties or annuities, as described in paragraph (e)(2) of this section;

(B) Property that is an interest in a partnership, trust or REMIC; and

(C) Property that does not give rise to income, as described in paragraph (e)(3) of this section.

(ii) *Exceptions*. Gain or loss from certain property transactions described in section 954(c)(1)(B) and paragraph (e)(1)(i) of this section does not include gain or loss from the sale or exchange of—

(A) Inventory or similar property, as defined in paragraph (a)(4)(iii) of this section;

(B) Dealer property, as defined in paragraph (a)(4)(v) of this section; or

(C) Property that gives rise to rents or royalties described in paragraph (b)(6) of this section that are derived in the active conduct of a trade or business from persons that are not related persons (as defined in section 954(d)(3)) with respect to the controlled foreign corporation.

(iii) *Treatment of losses*. Section 1.954-1(c)(1)(ii) provides for the treatment of losses in excess of gains from the sale or exchange of property described in paragraph (e)(1)(i) of this section.

(iv) *Dual character property*. Property may, in part, constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or, in part, constitute property that does not give rise to any income as described in paragraph (e)(3) of this section.

However, property that is described in paragraph (e)(1)(i)(B) of this section cannot be dual character property. Dual character property must be treated as two separate properties for purposes of paragraph (e)(2) or (3) of this section. Accordingly, the sale or exchange of such dual character property will give rise to gain or loss that in part must be included in the computation of foreign personal holding company income under paragraph (e)(2) or (3) of this section, and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated under this paragraph (e)(1)(iv) pursuant to the method that most reasonably reflects the relative uses of the property. Reasonable methods may include comparisons in terms of gross income generated or the physical division of the property. In the case of real property, the physical division of the property will in most cases be the most reasonable method available. For example, if a controlled foreign corporation owns an office building, uses 60 percent of the building in its trade or business, and rents out the other 40 percent, then 40 percent of the gain recognized on the disposition of the property would reasonably be treated as gain that is included in the computation of foreign personal holding

company income under this paragraph (e)(1). This paragraph (e)(1)(iv) addresses the contemporaneous use of property for dual purposes. For rules concerning changes in the use of property affecting its classification for purposes of this paragraph (e), see paragraph (a)(3) of this section.

(2) *Property that gives rise to certain income*—(i) *In general*. Property the sale or exchange of which gives rise to foreign personal holding company income under this paragraph (e)(2) includes property that gives rise to dividends, interest, rents, royalties or annuities described in paragraph (b) of this section, including—

(A) Property that gives rise to export financing interest described in paragraph (b)(2) of this section; and

(B) Property that gives rise to income from related persons described in paragraph (b) (4) or (5) of this section.

(ii) *Gain or loss from the disposition of a debt instrument*. Gain or loss from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) In the case of gain—

(1) It is interest (as defined in paragraph (a)(4)(i) of this section); or

(2) It is income equivalent to interest (as described in paragraph (h) of this section); and

(B) In the case of loss—

(1) It is directly allocated to, or treated as an adjustment to, interest income (as described in paragraph (a)(4)(i) of this section) or income equivalent to interest (as defined in paragraph (h) of this section) under any provision of the Internal Revenue Code or Income Tax Regulations; or

(2) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Internal Revenue Code or Income Tax Regulations.

(3) *Property that does not give rise to income*. Except as otherwise provided in this paragraph (e)(3), for purposes of this section, the term *property that does not give rise to income* includes all rights and interests in property (whether or not a capital asset) including, for example, forwards, futures and options. Property that does not give rise to income shall not include—

(i) Property that gives rise to dividends, interest, rents, royalties or annuities described in paragraph (e)(2) of this section;

(ii) Tangible property (other than real property) used or held for use in the controlled foreign corporation's trade or business that is of a character that would be subject to the allowance for

depreciation under section 167 or 168 and the regulations under those sections (including tangible property described in § 1.167(a)-2);

(iii) Real property that does not give rise to rental or similar income, to the extent used or held for use in the controlled foreign corporation's trade or business;

(iv) Intangible property (as defined in section 936(h)(3)(B)), goodwill or going concern value, to the extent used or held for use in the controlled foreign corporation's trade or business;

(v) Notional principal contracts (but see paragraphs (f)(2), (g)(2) and (h)(3) of this section for rules that include income from certain notional principal contracts in gains from commodities transactions, foreign currency gains and income equivalent to interest, respectively); or

(vi) Other property that is excepted from the general rule of this paragraph (e)(3) by the Commissioner in published guidance. See § 601.601(d)(2) of this chapter.

(f) *Commodities transactions*—(1) *In general*—(i) *Inclusion in foreign personal holding company income.* Foreign personal holding company income includes the excess of gains over losses from commodities transactions.

(ii) *Exception.* Gains and losses from qualified active sales and qualified hedging transactions are excluded from the computation of foreign personal holding company income under this paragraph (f).

(iii) *Treatment of losses.* Section 1.954-1(c)(1)(ii) provides for the treatment of losses in excess of gains from commodities transactions.

(2) *Definitions*—(i) *Commodity.* For purposes of this section, the term *commodity* includes tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded.

(ii) *Commodities transaction.* The term *commodities transaction* means the purchase or sale of a commodity for immediate (spot) delivery or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, or an over-the-counter market, or in a transaction effected between private parties outside of any market. Commodities transactions include, but are not limited to—

(A) A futures or forward contract in a commodity;

(B) A leverage contract in a commodity purchased from a leverage transaction merchant;

(C) An exchange of futures for physical transaction;

(D) A transaction, including a notional principal contract, in which the income or loss to the parties is measured by reference to the price of a commodity, a pool of commodities, or an index of commodities;

(E) The purchase or sale of an option or other right to acquire or transfer a commodity, a futures contract in a commodity, or an index of commodities; and

(F) The delivery of one commodity in exchange for the delivery of another commodity, the same commodity at another time, cash, or nonfunctional currency.

(iii) *Qualified active sale*—(A) *In general.* The term *qualified active sale* means the sale of commodities in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities if substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant or handler of commodities. The sale of commodities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of commodities is not a qualified active sale. For example, the sale by a controlled foreign corporation of commodities that were held for investment or speculation would not be a qualified active sale.

(B) *Active conduct of a commodities business.* For purposes of this paragraph, a controlled foreign corporation is engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities only with respect to commodities for which each of the following conditions is satisfied—

(1) It holds the commodities directly, and not through an agent or independent contractor, as inventory or similar property (as defined in paragraph (a)(4)(iii) of this section) or as dealer property (as defined in paragraph (a)(4)(v) of this section); and

(2) With respect to such commodities, it incurs substantial expenses in the ordinary course of a commodities business from engaging in one or more of the following activities directly, and not through an independent contractor—

(i) Substantial activities in the production of the commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals;

(ii) Substantial processing activities prior to the sale of the commodities, including the blending and drying of agricultural commodities, or the concentrating, refining, mixing, crushing, aerating or milling of commodities; or

(iii) Significant activities as described in paragraph (f)(2)(iii)(B)(3) of this section.

(3) For purposes of paragraph (f)(2)(iii)(B)(2)(iii) of this section, the significant activities must relate to—

(i) The physical movement, handling and storage of the commodities, including preparation of contracts and invoices, arranging freight, insurance and credit, arranging for receipt, transfer or negotiation of shipping documents, arranging storage or warehousing, and dealing with quality claims;

(ii) Owning and operating facilities for storage or warehousing; or

(iii) Owning or chartering vessels or vehicles for the transportation of the commodities.

(C) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities if the sum of its gross receipts from all of its qualified active sales (as defined in this paragraph (f)(2)(iii) without regard to the substantially all requirement) of commodities and its gross receipts from all of its qualified hedging transactions (as defined in paragraph (f)(2)(iv) of this section, applied without regard to the substantially all requirement of this paragraph (f)(2)(iii)(C)) equals or exceeds 85 percent of its total gross receipts for the taxable year (computed as though the corporation were a domestic corporation). In computing gross receipts, the District Director may disregard any sale or hedging transaction that has as a principal purpose manipulation of the 85 percent gross receipts test. A purpose may be a principal purpose even though it is outweighed by other purposes (taken together or separately).

(D) *Activities of employees of a related entity.* For purposes of this paragraph (f), activities of employees of an entity related to the controlled foreign corporation, who are made available to and supervised on a day-to-day basis by, and whose salaries are paid by (or reimbursed to the related entity by), the controlled foreign corporation, are treated as activities engaged in directly by the controlled foreign corporation.

(E) *Financial activities.* For purposes of this paragraph (f), a corporation is not engaged in a commodities business as a producer, processor, merchant, or

handler of commodities if its business is primarily financial. For example, the business of a controlled foreign corporation is primarily financial if its principal business is making a market in notional principal contracts based on a commodities index.

(iv) *Qualified hedging transaction—(A) In general.* The term *qualified hedging transaction* means a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to qualified active sales (other than transactions described in section 988(c)(1) without regard to section 988(c)(1)(D)(i)).

(B) *Exception.* The term *qualified hedging transaction* does not include transactions that are not reasonably necessary to the conduct of business of the controlled foreign corporation as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others.

(g) *Foreign currency gain or loss—(1) Scope and purpose.* This paragraph (g) provides rules for the treatment of foreign currency gains and losses. Paragraph (g)(2) of this section provides the general rule. Paragraph (g)(3) of this section provides an election to include foreign currency gains or losses that would otherwise be treated as foreign personal holding company income under this paragraph (g) in the computation of another category of subpart F income. Paragraph (g)(4) of this section provides an alternative election to treat any net foreign currency gain or loss as foreign personal holding company income. Paragraph (g)(5) of this section provides rules for certain gains and losses not subject to this paragraph (g).

(2) *In general—(i) Inclusion.* Except as otherwise provided in this paragraph (g), foreign personal holding company income includes the excess of foreign currency gains over foreign currency losses attributable to any section 988 transactions (foreign currency gain or loss). Section 1.954-1(c)(1)(ii) provides rules for the treatment of foreign currency losses in excess of foreign currency gains. However, if an election is made under paragraph (g)(4) of this section, the excess of foreign currency losses over foreign currency gains to which the election would apply may be apportioned to, and offset, other categories of foreign personal holding company income.

(ii) *Exclusion for business needs—(A) General Rule.* Foreign currency gain or loss directly related to the business needs of the controlled foreign corporation is excluded from foreign personal holding company income.

(B) *Business needs.* Foreign currency gain or loss is directly related to the business needs of a controlled foreign corporation if—

(i) The foreign currency gain or loss—
(i) Arises from a transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the controlled foreign corporation's trade or business;

(ii) Arises from a transaction or property that does not itself (and could not reasonably be expected to) give rise to subpart F income other than foreign currency gain or loss;

(iii) Does not arise from a transaction described in section 988(c)(1)(B)(iii); and

(iv) Is clearly determinable from the records of the controlled foreign corporation as being derived from such transaction or property; or

(2) The foreign currency gain or loss arises from a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to a transaction or property that satisfies the requirements of paragraph (g)(2)(ii)(B)(1) of this section. For purposes of this paragraph (g)(2)(ii)(B)(2), a hedging transaction will satisfy the aggregate hedging rules of § 1.1221-2(c)(7) only if all (or all but a de minimis amount) of the aggregate risk being hedged arises in connection with transactions that satisfy the requirements of paragraph (g)(2)(ii)(B)(1) of this section.

(C) *Regular dealers.* Transactions in dealer property (as defined in paragraph (a)(4)(v) of this section) described in section 988(c)(1) (B) or (C) that are entered into by a controlled foreign corporation that is a regular dealer (as defined in paragraph (a)(4)(iv) of this section) in such property in its capacity as a dealer will be treated as directly related to the business needs of the controlled foreign corporation under paragraph (g)(2)(ii)(A) of this section.

(D) *Example.* The following example illustrates the provisions of this paragraph (g)(2).

Example. (i) *CFC1* and *CFC2* are controlled foreign corporations located in Country B, and are members of the same controlled group. *CFC1* is engaged in the active conduct of a trade or business that does not produce any subpart F income. *CFC2* serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks outside of the group. Pursuant to this arrangement, and to hedge the currency risk on a non-interest bearing receivable incurred by *CFC1* in the normal course of its business, on Day 1 *CFC1* enters into a forward contract to sell Japanese Yen to *CFC2* in 30 days. Also on Day 1, *CFC2* enters into a forward contract

to sell Yen to unrelated Bank X on Day 30. *CFC2* is not a regular dealer in Yen spot and forward contracts, and the Yen is not the functional currency for either *CFC1* or *CFC2*.

(ii) Because the forward contract entered into by *CFC1* to sell Yen hedges a transaction entered into in the normal course of *CFC1*'s business that does not give rise to subpart F income, it qualifies as a bona fide hedging transaction as defined in paragraph (a)(4)(ii) of this section. Therefore, *CFC1*'s foreign exchange gain or loss from that forward contract will not be treated as foreign personal holding company income or loss under this paragraph (g).

(iii) Because the forward contract to purchase Yen was entered into by *CFC2* in order to assume currency risks incurred by *CFC1* it does not qualify as a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section. Thus, foreign exchange gain or loss recognized by *CFC2* from that forward contract will be foreign personal holding company income. Because *CFC2* entered into the forward contract to sell Yen in order to hedge currency risks of *CFC1*, that forward contract also does not qualify as a bona fide hedging transaction. Thus, *CFC2*'s foreign currency gain or loss arising from that forward contract will be foreign personal holding company income.

(iii) *Special rule for foreign currency gain or loss from an interest-bearing liability.* Except as provided in paragraph (g)(5)(iv) of this section, foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and apportioned between subpart F income and non-subpart F income under §§ 1.861-9T and 1.861-12T.

(3) *Election to characterize foreign currency gain or loss that arises from a specific category of subpart F income as gain or loss in that category—(i) In general.* For taxable years of a controlled foreign corporation beginning on or after November 6, 1995, the controlling United States shareholders of the controlled foreign corporation may elect, under this paragraph (g)(3), to exclude foreign currency gain or loss otherwise includible in the computation of foreign personal holding company income under this paragraph (g) from the computation of foreign personal holding company income under this paragraph (g) and include such foreign currency gain or loss in the category (or categories) of subpart F income (described in section 952(a), or, in the case of foreign base company income, described in § 1.954-1(c)(1)(iii)(A) (1) or (2) to which such gain or loss relates. If an election is made under this paragraph (g)(3) with respect to a category (or categories) of subpart F income described in section 952(a), or,

in the case of foreign base company income, described in § 1.954-1(c)(1)(iii)(A) (1) or (2), the election shall apply to all foreign currency gain or loss that arises from—

(A) A transaction (other than a hedging transaction) entered into, or property used or held for use, in the normal course of the controlled foreign corporation's trade or business that gives rise to income in that category (or categories) and that is clearly determinable from the records of the controlled foreign corporation as being derived from such transaction or property; and

(B) A bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to a transaction or property described in paragraph (g)(3)(i)(A) of this section. For purposes of this paragraph (g)(3)(i)(B), a hedging transaction will satisfy the aggregate hedging rules of § 1.1221-2(c)(7) only if all (or all but a de minimus amount) of the aggregate risk being hedged arises in connection with transactions or property that generate the same category of subpart F income described in section 952(a), or, in the case of foreign base company income, described in § 1.954-1(c)(1)(iii)(A) (1) or (2).

(ii) *Time and manner of election.* The controlling United States shareholders, as defined in § 1.954-1(c)(5), make the election on behalf of the controlled foreign corporation by filing a statement with their original income tax returns for the taxable year of such United States shareholders ending with or within the taxable year of the controlled foreign corporation for which the election is made, clearly indicating that such election has been made. If the controlling United States shareholders elect to apply these regulations retroactively, under § 1.954-0(a)(1)(ii), the election under this paragraph (g)(3) may be made by the amended return filed pursuant to the election under § 1.954-0(a)(1)(ii). The controlling United States shareholders filing the election statement described in this paragraph (g)(3)(ii) must provide copies of the election statement to all other United States shareholders of the electing controlled foreign corporation. Failure to provide copies of such statement will not cause an election under this paragraph (g)(3) to be voidable by the controlled foreign corporation or the controlling United States shareholders. However, the District Director has discretion to void the election if it is determined that there was no reasonable cause for the failure to provide copies of such statement. The statement shall include the following information—

(A) The name, address, taxpayer identification number, and taxable year of such United States shareholder;

(B) The name, address, and taxable year of the controlled foreign corporation for which the election is effective; and

(C) Any additional information required by the Commission by administrative pronouncement.

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by or with the consent of the Commissioner.

(iv) *Example.* The following example illustrates the provisions of this paragraph (g)(3).

Example. (i) *CFC.* A controlled foreign corporation, is a sales company that earns foreign base company sales income under section 954(d). *CFC* makes an election under this paragraph (g)(3) to treat foreign currency gains or losses that arise from a specific category (or categories) of subpart F income (as described in section 952(a), or, in the case of foreign base company income, as described in § 1.954-1(c)(1)(iii)(A) (1) or (2)) as that type of income. *CFC* aggregates the currency risk on all of its transactions that generate foreign base company sales income and hedges this net currency exposure.

(ii) Assuming no more than a de minimus amount of risk in the pool of risks being hedged arises from transactions or property that generate income other than foreign base company sales income, pursuant to its election under (g)(3), *CFC's* net foreign currency gain from the pool and the hedging transactions will be treated as foreign base company sales income under section 954(d), rather than as foreign personal holding company income under section 954(c)(1)(D). If the pool of risks and the hedging transactions generate a net foreign currency loss, however, *CFC* must apply the rules of § 1.954-1(c)(1)(ii).

(4) *Election to treat all foreign currency gains or losses as foreign personal holding company income—(i) In general.* If the controlling United States shareholders make an election under this paragraph (g)(4), the controlled foreign corporation shall include in its computation of foreign personal holding company income the excess of foreign currency gains over losses or the excess of foreign currency losses over gains attributable to any section 988 transaction (except those described in paragraph (g)(5) of this section) and any section 1256 contract that would be a section 988 transaction but for section 988(c)(1)(D). Separate elections for section 1256 contracts and section 988 transactions are not permitted. An election under this paragraph (g)(4) supersedes an election under paragraph (g)(3) of this section.

(ii) *Time and manner of election.* The controlling United States shareholders, as defined in § 1.964-1(c)(5), make the election on behalf of the controlled foreign corporation in the same time and manner as provided in paragraph (g)(3)(ii) of this section.

(iii) *Revocation of election.* This election is effective for the taxable year of the controlled foreign corporation for which it is made and all subsequent taxable years of such corporation unless revoked by or with the consent of the Commissioner.

(5) *Gains and losses not subject to this paragraph—(i) Capital gains and losses.* Gain or loss that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss for purposes of this paragraph (g). Such gain or loss is treated as gain or loss from the sale or exchange of property that is included in the computation of foreign personal holding company income under paragraph (e)(1) of this section. Paragraph (a)(2) of this section provides other rules concerning income described in more than one category of foreign personal holding company income.

(ii) *Income not subject to section 988.* Gain or loss that is not treated as foreign currency gain or loss by reason of section 988 (a)(2) or (d) is not foreign currency gain or loss for purposes of this paragraph (g). However, such gain or loss may be included in the computation of other categories of foreign personal holding company income in accordance with its characterization under section 988 (a)(2) or (d) (for example, foreign currency gain that is treated as interest income under section 988(a)(2) will be included in the computation of foreign personal holding company income under paragraph (b)(ii) of this section).

(iii) *Qualified business units using the dollar approximate separate transactions method.* This paragraph (g) does not apply to any DASTM gain or loss computed under § 1.985-3(d). Such gain or loss is allocated under the rules of § 1.985-3 (e)(2)(iv) or (e)(3). However, the provisions of this paragraph (g) do apply to section 988 transactions denominated in a currency other than the United States dollar or the currency that would be the qualified business unit's functional currency were it not hyperinflationary.

(iv) *Gain or loss allocated under § 1.861-9.* [Reserved]

(h) *Income equivalent to interest—(1) In general—(i) Inclusion in foreign personal holding company income.* Except as provided in this paragraph (h), foreign personal holding company income includes income equivalent to

interest as defined in paragraph (h)(2) of this section.

(ii) *Exceptions—(A) Liability hedging transactions.* Income, gain, deduction or loss that is allocated and apportioned in the same manner as interest expense under the provisions of § 1.861-9T is not income equivalent to interest for purposes of this paragraph (h).

(B) *Interest.* Amounts treated as interest under section 954(c)(1)(A) and paragraph (b) of this section are not income equivalent to interest for purposes of this paragraph (h).

(2) *Definition of income equivalent to interest—(i) In general.* The term *income equivalent to interest* includes income that is derived from—

(A) A transaction or series of related transactions in which the payments, net payments, cash flows, or return predominantly reflect the time value of money;

(B) Transactions in which the payments (or a predominant portion thereof) are, in substance, for the use or forbearance of money;

(C) Notional principal contracts, to the extent provided in paragraph (h)(3) of this section;

(D) Factoring, to the extent provided in paragraph (h)(4) of this section;

(E) Conversion transactions, but only to the extent that gain realized with respect to such a transaction is treated as ordinary income under section 1258;

(F) The performance of services, to the extent provided in paragraph (h)(5) of this section;

(G) The commitment by a lender to provide financing, whether or not such financing actually is provided;

(H) Transfers of debt securities subject to section 1058; and

(I) Other transactions, as provided by the Commissioner in published guidance. See § 601.601(d)(2) of this chapter.

(ii) *Income from the sale of property.* Income from the sale of property will not be treated as income equivalent to interest by reason of paragraph (h)(2)(i) (A) or (B) of this section. Income derived by a controlled foreign corporation will be treated as arising from the sale of property only if the corporation in substance carries out sales activities. Accordingly, an arrangement that is designed to lend the form of a sales transaction to a transaction that in substance constitutes an advance of funds will be disregarded. For example, if a controlled foreign corporation acquires property on 30-day payment terms from one person and sells that property to another person on 90-day payment terms and at prearranged prices and terms such that the foreign corporation bears no

substantial economic risk with respect to the purchase and sale other than the risk of non-payment, the foreign corporation has not in substance derived income from the sale of property.

(3) *Notional principal contracts—(i) In general.* Income equivalent to interest includes income from notional principal contracts denominated in the functional currency of the taxpayer (or a qualified business unit of the taxpayer, as defined in section 989(a)), the value of which is determined solely by reference to interest rates or interest rate indices, to the extent that the income from such transactions accrues on or after August 14, 1989.

(ii) *Regular dealers.* Income equivalent to interest does not include income earned by a regular dealer (as defined in paragraph (a)(4)(iv) of this section) from notional principal contracts that are dealer property (as defined in paragraph (a)(4)(v) of this section).

(4) *Income equivalent to interest from factoring—(i) General rule.* Income equivalent to interest includes factoring income. Except as provided in paragraph (h)(4)(ii) of this section, the term *factoring income* includes any income (including any discount income or service fee, but excluding any stated interest) derived from the acquisition and collection or disposition of a factored receivable. The amount of income equivalent to interest realized with respect to a factored receivable is the difference (if a positive number) between the amount paid for the receivable by the foreign corporation and the amount that it collects on the receivable (or realizes upon its sale of the receivable). The rules of this paragraph (h)(4) apply only with respect to the tax treatment of factoring income derived from the acquisition and collection or disposition of a factored receivable and shall not affect the characterization of an expense or loss of either the person whose goods or services gave rise to a factored receivable or the obligor under a receivable.

(ii) *Exceptions.* Factoring income shall not include—

(A) Income treated as interest under section 864(d) (1) or (6) (relating to income derived from trade or service receivables of related persons), even if such income is treated as not described in section 864(d)(1) by reason of the same-country exception of section 864(d)(7);

(B) Income derived from a factored receivable if payment for the acquisition of the receivable is made on or after the date on which stated interest begins to

accrue, but only if the rate of stated interest equals or exceeds 120 percent of the Federal short-term rate (as defined under section 1274) (or the analogous rate for a currency other than the dollar) as of the date on which the receivable is acquired by the foreign corporation; or

(C) Income derived from a factored receivable if payment for the acquisition of the receivable by the foreign corporation is made only on or after the anticipated date of payment of all principal by the obligor (or the anticipated weighted average date of payment of a pool of purchased receivables).

(iii) *Factored receivable.* For purposes of this paragraph (h)(4), the term *factored receivable* includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness. For purposes of this paragraph (h)(4), it is immaterial whether the person providing the property or services agrees to transfer the receivable at the time of sale (as by accepting a third-party charge or credit card) or at a later time.

(iv) *Examples.* The following examples illustrate the application of this paragraph (h)(4).

Example 1. *DP*, a domestic corporation, owns all of the outstanding stock of *FS*, a controlled foreign corporation. *FS* acquires accounts receivable arising from the sale of property by unrelated corporation *X*. The receivables have a face amount of \$100, and after 30 days bear stated interest equal to at least 120 percent of the applicable Federal short-term rate (determined as of the date the receivable is acquired by *FS*). *FS* purchases the receivables from *X* for \$95 on Day 1 and collects \$100 plus stated interest from the obligor under the receivable on Day 40. Income (other than stated interest) derived by *FS* from the factored receivables is factoring income within the meaning of paragraph (h)(4)(i) of this section and, therefore, is income equivalent to interest.

Example 2. The facts are the same as in *Example 1*, except that, rather than collecting \$100 plus stated interest from the obligor under the factored receivable on Day 40, *FS* sells the receivable to controlled foreign corporation *Y* on Day 15 for \$97. Both the income derived by *FS* on the factored receivable and the income derived by *Y* (other than stated interest) on the receivable are factoring income within the meaning of paragraph (h)(4)(i) of this section, and

therefore, constitute income equivalent to interest.

Example 3. The facts are the same as in *Example 1*, except that *FS* purchases the receivables from *X* for \$98 on Day 30. Income derived by *FS* from the factored receivables is excluded from factoring income under paragraph (h)(4)(ii)(B) of this section and, therefore, does not give rise to income equivalent to interest.

Example 4. The facts are the same as in *Example 3*, except that it is anticipated that all principal will be paid by the obligor of the receivables by Day 30. Income derived by *FS* from this maturity factoring of the receivables is excluded from factoring income under paragraph (h)(4)(ii)(C) of this section and, therefore, does not give rise to income equivalent to interest.

Example 5. The facts are the same as in *Example 4*, except that *FS* sells the factored receivable to *Y* for \$99 on day 45, at which time stated interest is accruing on the unpaid balance of \$100. Because interest was accruing at the time *Y* acquired the receivable at a rate equal to at least 120 percent of the applicable Federal short-term rate, income derived by *Y* from the factored receivable is excluded from factoring income under paragraph (h)(4)(ii)(B) of this section and, therefore, does not give rise to income equivalent to interest.

Example 6. *DP*, a domestic corporation engaged in an integrated credit card business, owns all of the outstanding stock of *FS*, a controlled foreign corporation. On Day 1 individual *A* uses a credit card issued by *DP* to purchase shoes priced at \$100 from *X*, a foreign corporation unrelated to *DP*, *FS*, or *A*. On Day 7, *X* transfers the receivable (which does not bear stated interest) arising from *A*'s purchase to *FS* in exchange for \$95. *FS* collects \$100 from *A* on Day 45. Income derived by *FS* on the factored receivable is factoring income within the meaning of paragraph (h)(4)(i) of this section and, therefore, is income equivalent to interest.

(5) *Receivables arising from performance of services.* If payment for services performed by a controlled foreign corporation is not made until more than 120 days after the date on which such services are performed, then the income derived by the controlled foreign corporation constitutes income equivalent to interest to the extent that interest income would be imputed under the principles of section 483 or the original issue discount provisions (sections 1271 through 1275), if—

(i) Such provisions applied to contracts for the performance of services;

(ii) The time period referred to in sections 483(c)(1) and 1274(c)(1)(B) were 120 days rather than six months; and

(iii) The time period referred to in section 483(c)(1)(A) were 120 days rather than one year.

(6) *Examples.* The following examples illustrate the application of this paragraph (h).

Example 1. *CFC*, a controlled foreign corporation, promises that Corporation *A* may borrow up to \$500 in principal for one year beginning at any time during the next three months at an interest rate of 10 percent. In exchange, Corporation *A* pays *CFC* a commitment fee of \$2. The entire \$2 fee is included in the computation of *CFC*'s foreign personal holding company income under paragraph (h)(2)(i)(G) of this section, regardless of whether Corporation *A* actually borrows from *CFC*.

Example 2. (i) At the beginning of its current taxable year, *CFC*, a controlled foreign corporation, purchases at face value a one-year debt instrument issued by Corporation *A* having a \$100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (LIBOR) plus one percentage point. Contemporaneously, *CFC* borrows \$100 from Corporation *B* for one year at a fixed interest rate of 10 percent, using the debt instrument as security.

(ii) During its current taxable year, *CFC* accrues \$11 of interest from Corporation *A* on the bond. Because interest is excluded from the definition of income equivalent to interest under paragraph (h)(1)(ii)(B) of this section, the \$11 is not income equivalent to interest.

(iii) During its current taxable year, *CFC* incurs \$10 of interest expense with respect to the borrowing from Corporation *B*. That expense is allocated and apportioned to, and reduces, subpart F income to the extent provided in section 954(b)(5) and §§ 1.861-9T through 1.861-12T and 1.954-1(c).

Example 3. (i) On January 1, 1994, *CFC*, a controlled foreign corporation with the United States dollar as its functional currency, purchases at face value a 10-year debt instrument issued by Corporation *A* having a \$100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (LIBOR) plus one percentage point payable on December 31st of each year. *CFC* subsequently determines that it would prefer receiving a fixed rate of return. Accordingly, on January 1, 1995, *CFC* enters into a 9-year interest rate swap agreement with Corporation *B* whereby Corporation *B* promises to pay *CFC* on December 31st of each year an amount equal to 10 percent on a notional principal amount of \$100. In exchange, *CFC* promises to pay Corporation *B* an amount equal to LIBOR plus one percentage point on the notional principal amount.

(ii) On December 31, 1995, *CFC* receives \$9 of interest income from Corporation *A* with respect to the debt instrument. On the same day, *CFC* receives a total of \$10 from Corporation *B* and pays \$9 to Corporation *B* with respect to the interest rate swap.

(iii) The \$9 of interest income is foreign personal holding income under section 954(c)(1). Pursuant to § 1.446-3(d), *CFC* recognizes \$1 of swap income for its 1995 taxable year that is also foreign personal holding company income because it is income equivalent to interest under paragraph (h)(2)(i)(C) of this section.

Example 4. (i) *CFC*, a controlled foreign corporation, purchases commodity *X* on the spot market for \$100 and,

contemporaneously, enters into a 3 month forward contract to sell commodity *X* for \$104, a price set by the forward market.

(ii) Assuming that substantially all of *CFC*'s expected return is attributable to the time value of the net investment, as described in section 1258(c)(1), the transaction is a conversion transaction under section 1258(c). Accordingly, any gain treated as ordinary income under section 1258(a) will be foreign personal holding company income because it is income equivalent to interest under paragraph (h)(2)(i)(E) of this section.

Par. 4. Section 1.957-1 is amended by adding paragraphs (a), (c) *Examples 8* through *10*, and (d) to read as follows:

§ 1.957-1 Definition of controlled foreign corporation.

(a) *In general.* The term *controlled foreign corporation* means any foreign corporation of which more than 50 percent (or such lesser amount as is provided in section 957(b) or section 953(c)) of either—

(1) The total combined voting power of all classes of stock of the corporation entitled to vote; or

(2) The total value of the stock of the corporation, is owned within the meaning of section 958(a), or (except for purposes of section 953(c)) is considered as owned by applying the rules of section 958(b) and § 1.958-2, by United States shareholders on any day during the taxable year of such foreign corporation. For the definition of the term *United States shareholder*, see sections 951(b) and 953(c)(1)(A). For the definition of the term *foreign corporation*, see § 301.7701-5 of this chapter (Procedure and Administration Regulations). For the treatment of associations as corporations, see section 7701(a)(3) and §§ 301.7701-1 and 301.7701-2 of this chapter. For the definition of the term *stock*, see sections 958(a)(3) and 7701(a)(7). For the classification of a member in an association, joint stock company, or insurance company as a shareholder, see section 7701(a)(8).

* * * * *

(c) * * *

Example 8. For its prior taxable year, *JV*, a foreign corporation, had outstanding 1000 shares of class A stock, which is voting common, and 1000 shares of class B stock, which is nonvoting preferred. *DP*, a domestic corporation, and *FP*, a foreign corporation, each owned precisely 500 shares of both class A and class B stock, and each elected 5 of the 10 members of *JV*'s board of directors. The other facts and circumstances were such that *JV* was not a controlled foreign corporation on any day of the prior taxable year. On the first day of the current taxable year, *DP* purchased one share of class B stock from *FP*. *JV* was a controlled foreign corporation on that day because over 50 percent of the total value in the corporation

was held by a person that was a United States shareholder under section 951(b).

Example 9. The facts are the same as in Example 8 except that the stock of FP was publicly traded, FP had one class of stock, and on the first day of the current taxable year DP purchased one share of FP stock on the foreign stock exchange instead of purchasing one share of JV stock from FP. JV became a controlled foreign corporation on that day because over 50 percent of the total value in the corporation was held by a person that was a United States shareholder under section 951(b).

Example 10. X, a foreign corporation, is incorporated under the laws of country Y. Under the laws of country Y, X is considered a mutual insurance company. X issues insurance policies that provide the policyholder with the right to vote for directors of the corporation, the right to a share of the assets upon liquidation in proportion to premiums paid, and the right to receive policyholder dividends in proportion to premiums paid. Only policyholders are provided with the right to vote for directors, share in assets upon liquidation, and receive distributions. United States policyholders contribute 25 percent of the premiums and have 25 percent of the outstanding rights to vote for the board of directors. Based on these facts, the United States policyholders are United States shareholders owning the requisite combined voting power and value. Thus, X is a controlled foreign corporation for purposes of taking into account related person insurance income under section 953(c).

(d) *Effective date.* Paragraphs (a) and (c) Examples 8 through 10 of this section are effective for taxable years of a controlled foreign corporation beginning after November 6, 1995.

§ 1.954A-1 and 1.954A-2 [Removed]

Par. 5. Sections 1.954A-1 and 1.954A-2 are removed.

§ 1.957-1T [Removed]

Par. 6. Section 1.957-1T is removed.

PART 4—[ADDED]

Par. 7. 26 CFR part 4 is added to read as follows:

PART 4—TEMPORARY INCOME TAX REGULATIONS UNDER SECTION 954 OF THE INTERNAL REVENUE CODE

- Sec.
 4.954-0 Introduction.
 4.954-1 Foreign base company income; taxable years beginning after December 31, 1986.
 4.954-2 Foreign personal holding company income; taxable years beginning after December 31, 1986.

Authority: 26 U.S.C. 7805.

- Sec.
 4.954-0 also issued under 26 U.S.C. 954 (b) and (c).
 4.954-1 also issued under 26 U.S.C. 954 (b) and (c).
 4.954-2 also issued under 26 U.S.C. 954 (b) and (c).

§§ 1.954-0T, 1.954-1T and 1.954-2T [Redesignated as §§ 4.954-0, 4.954-1 and 4.954-2]

Par. 8. Sections 1.954-0T, 1.954-1T and 1.954-2T are redesignated as §§ 4.954-0, 4.954-1 and 4.954-2, respectively, and the language “temporary” is removed at the end of each section heading.

Par. 9. Newly designated § 4.954-0 is amended by:

1. Removing the language “§§ 1.954-1T and 1.954-2T” from the first sentence of paragraph (a)(1) and adding “§§ 4.954-1 and 4.954-2” in its place.

2. Adding a sentence at the end of paragraph (a)(1) to read as set forth below.

3. In paragraph (b) by removing the entries numbered (I), (II), and (III) and adding in their places entries for the headings of §§ 4.954-0 through 4.954-2 as follows:

§ 4.954-0 Introduction.

- (a) * * * (1) * * * For further guidance, see § 1.954-0(a) of this chapter.
 (b) * * *

- Sec.
 4.954-0 Introduction.
 * * * * *
 4.954-1 Foreign base company income.
 * * * * *
 4.954-2 Foreign personal holding company income.
 * * * * *

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 10. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 11. In § 602.101, paragraph c is amended by:

1. Removing the following entries from the table:

§ 602.101 OMB Control numbers.

CFR part or section where identified and described	Current OMB control No.
* * * * *	
(c) * * *	
* * * * *	
1.954-1T	1545-1068
1.954-2T	1545-1068

CFR part or section where identified and described	Current OMB control No.
* * * * *	
1.954A-2	1545-0755

2. Adding entries in numerical order to the table to read as follows:

§ 602.101 OMB Control numbers.

CFR part or section where identified and described	Current OMB control No.
* * * * *	
(c) * * *	
* * * * *	
1.954-1	1545-1068
1.954-2	1545-1068
* * * * *	
4.954-1	1545-1068
4.954-2	1545-1068
* * * * *	

Margaret Milner Richardson,
Commissioner of Internal Revenue.

Approved: August 22, 1995.

Cynthia Gibson Beerbower,
Deputy Assistant Secretary of the Treasury.

[FR Doc. 95-21838 Filed 9-6-95; 8:45 am]
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DEPARTMENT OF LABOR

Wage and Hour Division

29 CFR Part 801

Application of the Employee Polygraph Protection Act of 1988

AGENCY: Wage and Hour Division, Employment Standards Administration, Labor.

ACTION: Final rule.

SUMMARY: The purpose of this document is to change the address which is used to request an administrative hearing on a civil money penalty assessment. This revision is being made in order to streamline the process by which hearing requests are acknowledged by consolidating all aspects of processing hearing requests into the operations of the office which issued the administrative determination upon which the request for a hearing is based.

EFFECTIVE DATE: This rule is effective September 7, 1995.

FOR FURTHER INFORMATION CONTACT: Arthur M. Kerschner Branch of Child Labor and Polygraph Standards, Wage and Hour Division, Employment