AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

A, CFC's distributive share of income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to J Corp is also foreign base company sales income.

(4) *Effective date*. This paragraph (g) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

[T.D. 8618, 60 FR 46509, Sept. 7, 1995; 60 FR 62024, 62025, Dec. 4, 1995, as amended by T.D. 8704, 62 FR 20, Jan. 2, 1997; T.D. 8767, 63 FR 14615, Mar. 26, 1998; T.D. 8827, 64 FR 37677, July 13, 1999; T.D. 9008, 67 FR 48023, July 23, 2002]

§ 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 (d) 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(f). 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.

(5) *Special rules applicable to distributive share of partnership income*—(i) [Reserved]

(ii) *Certain other exceptions applicable to foreign personal holding company income.* To determine the extent to which a controlled foreign corporation's distributive share of an item of income of a partnership is foreign personal holding company income—

(A) The exceptions contained in section 954(c) that are based on whether the controlled foreign corporation is engaged in the active conduct of a trade or business, including section 954(c)(2) and paragraphs (b)(2) and (6), (e)(1)(ii) and (3)(ii), (iii) and (iv), (f)(1)(ii), (g)(2)(ii), and (h)(3)(ii) of this section, shall apply only if any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person;

(B) A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(h) unless the controlled foreign corporation is an eligible controlled foreign corporation within the meaning of section 954(h)(2) (taking into account the income of the controlled foreign corporation and any partnerships or other qualified business units, within the meaning of section 989(a), of the controlled foreign corporation, including the controlled foreign corporation's distributive share of partnership income) and the partnership, of which the controlled foreign corporation is a partner, generates qualified banking or financing income within the meaning of section 954(h)(3) (taking into account only the income of the partnership);

(C) A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(i) unless the controlled foreign corporation is a qualifying insurance company, as defined in section 953(e)(3), and the income of the partnership would have been qualified insurance income, as defined in section 954(i)(2), if received by the controlled foreign corporation directly. See §1.952–1(g)(1).

(iii) *Examples.* The application of paragraph (a)(5)(ii) is demonstrated by the following examples:

Example 1. B Corp, a Country C corporation, is a controlled foreign corporation within the meaning of section 957(a). B Corp is an 80 percent partner of RKS Partnership, a Country D partnership whose principal office is located in Country D. RKS Partnership is a qualified business unit of B Corp, within the meaning of section 989(a). B Corp, including income earned through RKS Partnership, derives more than 70 percent of its gross income directly from the active and regular conduct of a lending or finance business, within the meaning of section 954(h)(4), from transactions in various countries with customers which are not related persons. Thus, B Corp is predominantly engaged in the active conduct of a banking, financing, or similar business within the meaning of section 954(h)(2)(A)(i). B Corp conducts substantial activity with respect to such business within the meaning of section 954(h)(2)(A)(ii). RKS Partnership derives more than 30 percent of its income from the

active and regular conduct of a lending or finance business, within the meaning of section 954(h)(4), from transactions with customers which are not related persons and which are located solely within the home country of RKS Partnership, Country D. B Corp's distributive share of RKS Partnership's income from its lending or finance business will satisfy the special rule for income derived in the active conduct of banking, financing, or similar business of section 954(h). B Corp is an eligible controlled foreign corporation within the meaning of section 954(h)(2) and RKS Partnership generates qualified banking or financing income within the meaning of section 954(h)(3). B Corp does not have any foreign personal holding company income with respect to its distributive share of RKS Partnership income attributable to its lending or finance business income earned in Country D.

Example 2. D Corp, a Country F corporation, is a controlled foreign corporation within the meaning of section 957(a). D Corp is a qualifying insurance company, within the meaning of section 953(e)(3), that is engaged in the business of issuing life insurance contracts. D Corp has reserves of $100x, all of which are allocable to exempt contracts, and $10x of surplus, which is equal to 10 percent of the reserves allocable to exempt contracts. D Corp contributed the $100x of reserves and $10x of surplus to DJ Partnership in exchange for a 40-percent partnership interest. DJ Partnership is an entity organized under the laws of Country G and is treated as a partnership under the laws of Country G and Country F. DJ Partnership earns $30x of investment income during the taxable year that is received from persons who are not related persons with respect to D Corp, within the meaning of section 954(d)(3). D Corp's distributive share of this investment income is $12x. This income is treated as earned by D Corp in Country F under the tax laws of Country F and meets the definition of exempt insurance income in section 953(e)(1). This $12x of investment income would be qualified insurance income, under section 954(i)(2), if D Corp had received the income directly, because the $110x invested by D Corp in DJ Partnership is equal to D Corp's reserves allocable to exempt contracts under section 954(i)(2)(A) and allowable surplus under section 954(i)(2)(B)(ii). Thus, D Corp's distributive share of DJ Partnership's income will be excluded from foreign personal holding company income under section 954(i).

(iv) [Reserved]

(v) *Effective date.* This paragraph (a)(5) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(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, wholly owns two controlled foreign corporations organized in Country A, CFC1 and CFC2. CFC1 purchases from DS property that DS manufactures in the United States. CFC1 uses the purchased property as a component part of property that CFC1 manufactures in Country A within the meaning of §1.954–3(a)(4). CFC2 provides loans described in section 864(d)(6) to unrelated persons in Country A for the purchase of the property that CFC1 manufactures in Country A.

(ii) The interest accrued from the loans by CFC2 is not export financing interest as defined in section 904(d)(2)(G) because the property sold by CFC1 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.* For taxable years of a controlled foreign corporation beginning after March 3, 1997, foreign personal holding company income includes all interest income, including interest that is described in section 103 (see §1.952–2(c)(1)).

(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 that is more than 50-percent owned, directly or indirectly, by the payor within the meaning of section 958(a) shall be considered located in the payor's country of incorporation and, solely for purposes of section 954(c)(3), used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in a trade or business in the country of incorporation. 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, through its own officers or staff of employees, has manufactured or produced, or property that the lessor has acquired and, through its own officers or staff of employees, added substantial value to, but only if the lessor, through its officers or staff of employees, 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 through its own officers or staff of employees located in a foreign country or countries, if the lessor, through its officers or staff of employees, maintains and operates an organization either in such country or in such countries (collectively), as applicable, 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 either in a foreign country or in foreign countries (collectively) is substantial in relation to the amount of rents is determined based on all 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. In addition, for purposes of aircraft or vessels leased in foreign commerce, an organization will be considered substantial if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 10 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section. For purposes of paragraphs (c)(1)(iv) and (c)(2) of this section and §1.956–2(b)(1)(vi), the term *aircraft or vessels* includes component parts, such as engines that are leased separately from an aircraft or vessel.

(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;

(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; and

(E) Deductions for CST Payments or PCT Payments (as defined in §1.482–7(b)).

(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.

(v) *Leased in foreign commerce.* For purposes of paragraphs (c)(1)(iv) and (c)(2)(ii) of this section, an aircraft or vessel is considered to be leased in foreign commerce if the aircraft or vessel is used in foreign commerce and is used predominantly outside the United States. An aircraft or vessel is considered to be used in foreign commerce if it is used for the transportation of property or passengers between a port (or airport) in the United States and a port (or airport) in a foreign country or between foreign ports (or airports). An aircraft or vessel will be considered to be used predominantly outside the United States if more than 50 percent of the miles traversed during the taxable year in the use of the aircraft or vessel are traversed outside the United States or if the aircraft or vessel is located outside the United States more than 50 percent of the time during the taxable year.

(vi) *Leases acquired by the CFC lessor.* Except as provided in this paragraph (c)(2)(vi), the exception in paragraph (c)(1)(iv) of this section will also apply to rents from leases acquired from any person, if following the acquisition the lessor performs active and substantial management, operational, and remarketing (including remarketing for purposes of re-leasing or selling the property) functions with respect to the leased property. However, if any person is claiming a benefit with respect to an acquired lease pursuant to section 921

or 114 of the Internal Revenue Code or section 101(d) of the American Jobs Creation Act of 2004, (Pub. L. 108–357 (118 Stat. 1418) (2004)), the rents from such lease, notwithstanding paragraphs (b)(6) and (c) of this section, are ineligible for the exception in section 954(c)(2)(A).

(vii) *Marketing of leases.* Paragraph (c)(1)(iv) of this section can apply whether a lessor is engaged in the marketing of leases as a form of financing or is engaged in marketing the property as such, and regardless of whether the lease is classified as a finance lease or an operating lease for financial accounting purposes, so long as such lease is treated as a lease for Federal income tax purposes.

(viii) *Cost sharing arrangements (CSAs).* For purposes of paragraphs (c)(1)(i) and (iv) of this section, CST Payments or PCT Payments (as defined in §1.482–7(b)(1)) made by the lessor to another controlled participant (as defined in §1.482–7(j)(1)(i)) pursuant to a CSA (as defined in §1.482–7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the lessor's own officers or staff of employees.

(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).

Example 6. The facts are the same as in *Example 2,* except that controlled foreign corporation D purchases aircraft which it leases to others. If Corporation D incurs active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal to or in excess of 10 percent of its adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section, the organization maintained and operated by Corporation D in country X is substantial in relation to the amount of rents Corporation

D receives from leasing the aircraft. 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). If a particular aircraft subject to lease was not leased by the lessee corporation in foreign commerce, for example, because 50 percent or less of the miles during the taxable year were traversed outside the United States and the aircraft was located in the United States for 50 percent or more of the taxable year, Corporation D is not prevented from otherwise showing that it actively carries on a trade or business with regard to the rents derived from that aircraft under paragraph (c)(2)(ii) of this section, based on its facts and circumstances or a showing that active leasing expenses equal or exceed 25 percent of the adjusted leasing profit.

(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, through its own officers or staff of employees, has developed, created, or produced, or property that the licensor has acquired and, through its own officers or staff of employees, added substantial value to, but only so long as the licensor, through its officers or staff of employees, is regularly engaged in the development, creation, or production of, or in the acquisition 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 through its own officers or staff of employees located in a foreign country or countries, if the licensor, through its officers or staff of employees, maintains and operates an organization either in such foreign country or in such foreign countries (collectively), as applicable, 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 either in a foreign country or in foreign countries (collectively) 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;

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

(E) Deductions for CST Payments or PCT Payments (as defined in §1.482–7(b)).

(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.

(v) *Cost sharing arrangements (CSAs).* For purposes of paragraphs (d)(1)(i) and (ii) of this section, CST Payments or PCT Payments (as defined in §1.482–7(b)(1)) made by the licensor to another controlled participant (as defined in §1.482–7(j)(1)(i)) pursuant to a CSA (as defined in §1.482–7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the licensor's own officers or staff of employees.

(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.

(iv) *Qualified hedging transaction entered into prior to January 31, 2003*—(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.

(C) *Effective date.* This paragraph (f)(2)(iv) applies to gain or loss realized

by a controlled foreign corporation with respect to a qualified hedging transaction entered into prior to January 31, 2003.

(v) *Qualified hedging transaction entered into on or after January 31, 2003*—(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 one or more commodities transactions reasonably necessary to the conduct of any business by a producer, processor, merchant or handler of commodities in a manner in which such business is customarily and usually conducted by others. For purposes of this paragraph (f)(2)(v), a producer, processor, merchant or handler of commodities includes a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business.

(B) *Exception.* The term *qualified hedging transaction* does not include a transaction described in section 988(c)(1) (without regard to section 988(c)(1)(D)(i)).

(C) *Examples.* The following examples illustrate the provisions of this paragraph (f)(2)(v):

Example 1. CFC1 is a controlled foreign corporation located in country A. CFC1 manufactures and sells machinery in country B using aluminum and component parts purchased from third parties that contain significant amounts of aluminum. CFC1 conducts its manufacturing business in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aluminum used in the machinery it manufactures, CFC1 enters into futures purchase contracts for the delivery of aluminum. These futures purchase contracts are bona fide hedging transactions. As CFC1 purchases aluminum and component parts containing significant amounts of aluminum in the spot market for use in its business, it closes out an equivalent amount of aluminum futures purchase contracts by entering into offsetting aluminum futures sales contracts. The aluminum futures purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aluminum futures purchase contracts is excluded from the computation of foreign personal holding company income.

Example 2. CFC2 is a controlled foreign corporation located in country B. CFC2 operates an airline business within country B in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aviation fuel, CFC2 enters into forward contracts for the purchase of aviation fuel. These forward purchase contracts are bona fide hedging transactions. As CFC2 purchases aviation fuel in the spot market for use in its business, it closes out an equivalent amount of its forward purchase contracts for cash pursuant to a contractual provision that permits CFC2 to terminate the contract and make or receive a one-time payment representing the contract's fair market value. The aviation fuel forward purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aviation fuel forward purchase contracts is excluded from the computation of foreign personal holding company income.

(D) *Effective date.* This paragraph (f)(2)(v) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into on or after January 31, 2003.

(vi) *Financial institutions not a producer, etc.* For purposes of this paragraph (f), a corporation is not 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.

(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—

(*1*) 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, other than the trade or business of trading foreign currency;

(*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 paragraphs (g)(2)(ii)(B)(*1*)(*i*) through (*iii*) of this section, provided that any gain or loss arising from such transaction or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such transaction or property. For purposes of this paragraph (g)(2)(ii)(B)(*2*), a hedging transaction will satisfy the aggregate hedging rules of §1.1221–2(c)(3) only if all (or all but a de minimis amount) of the aggregate risk being hedged arises in connection with transactions or property that satisfy the requirements of paragraphs (g)(2)(ii)(B)(*1*)(*i*) through (*iii*) of this section, provided that any gain or loss arising from such transactions or property that is attributable to changes in exchange rates is clearly determinable from the records of the CFC as being derived from such transactions or property.

(C) *Regular dealers—(1) General rule.* 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.

(*2*) *Certain interest-bearing liabilities treated as dealer property—*(*i*) *In general.* For purposes of this paragraph (g)(2)(ii)(C), an interest-bearing liability incurred by a controlled foreign corporation that is denominated in (or determined by reference to) a non-functional currency shall be treated as dealer property of the type described in paragraph (g)(2)(ii)(C)(*1*) of this section if the liability, by being denominated in such currency, reduces the controlled foreign corporation's currency risk with respect to dealer property, and the liability is identified on the controlled foreign corporation's records as a liability treated as dealer property before the close of the day on which the liability is incurred.

(*ii*) *Failure to identify certain liabilities.* If a controlled foreign corporation identifies certain interest-bearing liabilities as liabilities treated as dealer property under paragraph (g)(2)(ii)(C)(*2*)(*i*) of this section but fails to so identify other interest-bearing liabilities that manage its currency risk with respect to assets held that constitute dealer property, the Commissioner may treat such other liabilities

as properly identified as dealer property under paragraph (g)(2)(ii)(C)(*2*)(*i*) of this section if the Commissioner determines that the failure to identify such other liabilities had as one of its principal purposes the avoidance of Federal income tax.

(*iii*) *Effective date.* This paragraph (g)(2)(ii)(C)(*2*) applies only to gain or loss from an interest-bearing liability entered into by a controlled foreign corporation on or after January 31, 2003.

(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)(2)(ii)(C)(*2*) or (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)(3) only if all (or all but a de minimis 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 §1.964–1(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 three 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 minimis 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 base company sales 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, if any portion of such financing is actually 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 receivables are 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 receivables 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 receivables on Day 40, *FS* sells the receivables to controlled foreign corporation *Y* on Day 15 for $97. Both the income derived by *FS* on the factored receivables and the income derived by *Y* (other than stated interest) on the receivables 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 receivables 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 receivables at a rate equal to at least 120 percent of the applicable Federal short-term rate, income derived by *Y* 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 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. Pursuant to this agreement, *CFC* lends $80 to Corporation *A.* As a result, 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.

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 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, enter 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.

(i) *Effective/applicability dates*—(1) *Paragraphs (c)(2)(v) through (vii).* Paragraphs (c)(2)(v) through (vii) of this section and *Example 6* of paragraph (c)(3) of this section apply to taxable years of controlled foreign corporations beginning on or after May 2, 2006, and for taxable years of United States shareholders with or within which such taxable years of the controlled foreign corporations end. Taxpayers may elect to apply paragraphs (c)(2)(v) through (vii) to taxable years of controlled foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within which such taxable years of the controlled foreign corporations end. If an election is made to apply §1.956–2(b)(1)(vi) to taxable years beginning after December 31, 2004, then the election must also be made for paragraphs (c)(2)(v) through (vii) of this section.

(2) *Other paragraphs.* Paragraphs (c)(1)(i) and (d)(1)(i) of this section apply to rents or royalties, as applicable, received or accrued during taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, but only with respect to property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015. Paragraphs (c)(1)(iv), (c)(2)(ii), (c)(2)(iii)(E), (c)(2)(viii), (d)(1)(ii), (d)(2)(ii), (d)(2)(iii)(E), and (d)(2)(v) of this section apply to rents or royalties, as applicable, received or accrued during taxable years of controlled foreign corporations ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end, to the extent that such rents or royalties are received or accrued on or after September 1, 2015. See §1.954–2(c)(1)(i), (c)(1)(iv), (c)(2)(ii), (c)(2)(iii), (d)(1)(i), (d)(1)(ii), (d)(2)(ii), and (d)(2)(iii), as contained in 26 CFR part 1 revised as of April 1, 2015, for rules applicable to

rents or royalties, as applicable, received or accrued before September 1, 2015.

[T.D. 8618, 60 FR 46517, Sept. 7, 1995]

EDITORIAL NOTE: For FEDERAL REGISTER citations affecting § 1.954–2, see the List of CFR Sections Affected, which appears in the Finding Aids section of the printed volume and at *www.fdsys.gov*.

§ 1.954–3 Foreign base company sales income.

(a) *Income included*—(1) *In general*—(i) *General rules.* Foreign base company sales income of a controlled foreign corporation shall, except as provided in paragraphs (a)(2), (a)(3) and (a)(4) of this section, consist of gross income (whether in the form of profits, commissions, fees or otherwise) derived in connection with the purchase of personal property from a related person and its sale to any person, the sale of personal property to any person on behalf of a related person, the purchase of personal property from any person and its sale to a related person, or the purchase of personal property from any person on behalf of a related person. See section 954(d)(1). For purposes of the preceding sentence, except as provided in paragraphs (a)(2) and (a)(4) of this section, personal property sold by a controlled foreign corporation will be considered to be the same property that was purchased by the controlled foreign corporation regardless of whether the personal property is sold in the same form in which it was purchased, in a different form than the form in which it was purchased, or as a component part of a manufactured product. This section shall apply to the purchase and/or sale of personal property, whether or not such property was purchased and/or sold in the ordinary course of trade or business, except that income derived in connection with the sale of tangible personal property will not be considered to be foreign base company sales income if such property is sold to a person that is not a related person, as defined in § 1.954–1(f), after substantial use has been made of the property by the controlled foreign corporation in its trade or business. This section shall not apply to the excess of gains over losses from sales or exchanges of securities or from futures transactions, to the extent such excess gains are includible in foreign personal holding company income of the controlled foreign corporation under § 1.954–2; nor shall it apply to the sale of the controlled foreign corporation's property (other than its stock in trade or other property of a kind which would properly be included in its inventory if on hand at the close of the taxable year, or property held primarily for sale to customers in the ordinary course of its business) if substantially all the property of such corporation is sold pursuant to the discontinuation of the trade or business previously carried on by such corporation. The term ''any person'' as used in this paragraph (a)(1)(i) includes a related person as defined in § 1.954–1(f).

(ii) *Special rule—(a) In general.* The term ''personal property'' as used in section 954(d) and this section shall not include agricultural commodities which are not grown in the United States (within the meaning of section 7701(a)(9)) in commercially marketable quantities. All of the agricultural commodities listed in table I shall be considered grown in the United States in commercially marketable quantities. Bananas, black pepper, cocoa, coconut, coffee, crude rubber, and tea shall not be considered grown in the United States in commercially marketable quantities. All other agricultural commodities shall not be considered grown in the United States in commercially marketable quantities when, in consideration of all of the facts and circumstances of the individual case, such commodities are shown to be produced in the United States in insufficient quantity and quality to be marketed commercially. The term ''agricultural commodities'' includes, but is not limited to, livestock, poultry, fish produced in fish farms, fruit, furbearing animals as well as the products of truck farms, ranches, nurseries, ranges, and orchards. A fish farm is an area where fish are grown or raised (artificially protected and cared for), as opposed to merely caught or harvested. However, the term ''agricultural commodities'' shall not include timber (either standing or felled), or any commodity at least 50 percent of the fair market value of which is attributable