

applies shall be considered to be transferred to the appropriate account in the manner provided for in §3.8(d) in the new fund in a nontaxable transaction which is in accordance with the provisions of the agreement under which such old fund was maintained. For purposes of determining the amount of interest under section 607(h)(3)(C) of the Act and §3.7(e), the date of deposit of any item so transferred shall be deemed to be July 1, 1971, or the date of the deposit in the old fund, whichever is the later.

§ 3.11 Definitions.

(a) As used in the regulations in this part and as defined in section 607(k) of the Act—

(1) The term *eligible vessel* means any vessel—

(i) Constructed in the United States, and if reconstructed, reconstructed in the United States,

(ii) Documented under the laws of the United States, and

(iii) Operated in the foreign or domestic commerce of the United States or in the fisheries of the United States. Any vessel which was constructed outside of the United States but documented under the laws of the United States on April 15, 1970, or constructed outside the United States for use in the U.S. foreign trade pursuant to a contract entered into before April 15, 1970, shall be treated as satisfying the requirements of subdivision (i) of this subparagraph and the requirements of subparagraph (2)(i) of this section.

(2) The term *qualified vessel* means any vessel—

(i) Constructed in the United States and, if reconstructed, reconstructed in the United States,

(ii) Documented under the laws of the United States, and

(iii) Which the person maintaining the fund agrees with the Secretary of Commerce will be operated in the U.S. foreign, Great Lakes, or noncontiguous domestic trade or in the fisheries of the United States.

(3) The term *agreement vessel* means any eligible vessel or qualified vessel which is subject to an agreement entered into under section 607 of the Act.

(4) The term *vessel* includes cargo handling equipment which the Sec-

retary of Commerce determines is intended for use primarily on the vessel. The term “vessel” also includes an ocean-going towing vessel or an ocean-going barge or comparable towing vessel or barge operated in the Great Lakes.

(b) Insofar as the computation and collection of taxes are concerned, other terms used in the regulations in this part, except as otherwise provided in the Act or this part, have the same meaning as in the Code and the regulations thereunder.

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

Sec.

4.954-0 Introduction.

4.954-1 Foreign base company income; taxable years beginning after December 31, 1986.

4.954-2 Foreign personal holding company income; taxable years beginning after December 31, 1986.

AUTHORITY: 26 U.S.C. 7805.

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

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

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

§ 4.954-0 Introduction.

(a) *Effective date.* (1) The provisions of §§4.954-1 and 4.954-2 apply to taxable years of a controlled foreign corporation beginning after December 31, 1986. Consequently, any gain or loss (including foreign currency gain or loss as defined in section 988(b)) recognized during such taxable years of a controlled foreign corporation is subject to these provisions. For further guidance, see §1.954-0(a) of this chapter.

(2) The provisions of §§1.954A-1 and 1.954A-2 apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

(b) *Outline of regulation provisions for sections 954(b)(3), 954(b)(4), 954(b)(5) and 954(c) for taxable years of a controlled*

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[T.D. 8216, 53 FR 27491, July 21, 1988. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

§ 4.954-1 Foreign base company income; taxable years beginning after December 31, 1986.

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

(2) *Gross foreign base company income.* For taxable years of a controlled foreign corporation beginning after December 31, 1986, the gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income:

(i) Its foreign personal holding company income, as defined in section 954(c) and § 1.954-2T,

(ii) Its foreign base company sales income, as defined in section 954(d) and the regulations thereunder,

(iii) Its foreign base company services income, as defined in section 954(e) and the regulations thereunder,

(iv) Its foreign base company shipping income, as defined in section 954(f) and the regulations thereunder, and

(v) Its foreign base company oil related income, as defined in section 954(g) and the regulations thereunder.

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

(4) *Net foreign base company income.* The term “net foreign base company income” means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions properly allocable to such income under the rules of section 954(b)(5) and paragraph (c) of this section. In computing net foreign base company income, foreign personal holding company income is reduced (but not below zero) by related person interest expense before allocating and apportioning other expenses in accordance with the rules of paragraph (c) of this section and § 1.904(d)-5(c)(2).

(5) *Adjusted net foreign base company income.* The term “adjusted net foreign base company income” means the net foreign base company income of a controlled foreign corporation reduced by any items of net foreign base company income for which the high tax exception of paragraph (d) of this section is elected. The term “foreign base company income” as used in the Code and elsewhere in the regulations generally

means adjusted net foreign base company income.

(6) *Insurance income definitions.* The term “gross insurance income” includes any item of gross income taken into account in determining insurance income under section 953 and the regulations thereunder. The term “adjusted gross insurance income” means gross insurance income as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section. The term “net insurance income” means adjusted gross insurance income reduced under section 953 and the regulations thereunder so as to take into account deductions properly allocable or apportionable to such income. The term “adjusted net insurance income” means net insurance income reduced by any items of net insurance income for which the high tax exception of paragraph (d) of this section is elected.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income. Thus, they are not included in the gross foreign base company income or gross insurance income of the controlled foreign corporation in computing adjusted gross foreign base company income or adjusted gross insurance income (for purposes of applying the de minimis and full inclusion tests of paragraph (b) of this section).

(8) *Illustration.* The order of computation is illustrated by the following example. Computations in this paragraph (a)(8) and in paragraph (b)(5) of this section involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section.

Example. (i) *Gross income.* CFC, a controlled foreign corporation, has gross income of \$1000 for the current taxable year. Of that \$1000 of income, \$100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954-2T(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), and is not

excluded from foreign personal holding company income under any provision of section 954(c) and § 1.954-2T. Another \$50 is foreign base company sales income under section 954(d) and the regulations thereunder. The remaining \$850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g), or 953 and the regulations thereunder, and is foreign source general limitation income described in section 904(d)(1)(I) and the regulations thereunder.

(ii) *Expenses.* CFC has expenses for the current taxable year of \$500. Of that \$500, \$8 is from interest paid to a related person and is allocable to foreign personal holding company income along with \$2 of other expense. Another \$20 of expense is allocable to foreign base company sales. The remaining \$470 of expense is allocable to income other than foreign base company income or insurance income.

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

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

(v) *Conclusion.* Based on these facts, if CFC elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have \$500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows. The following steps do not illustrate the computation of the subpart F income of a controlled foreign corporation that has income from a trade or service receivable treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

Step 1—Determine gross income:
 (1) Gross income\$1000

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

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

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

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

Step 4—Compute net foreign base company income:

- (9) Related person interest expense and other expense allocable and apportionable to foreign personal holding company income10
- (10) Deductions allocable and apportionable to foreign base company sales income20
- (11) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (2) or line (7), reduced (but not below zero) by line (9)).....90
- (12) Foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (3) or line (7), reduced (but not below zero) by line (10))30
- (13) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (11) plus line (12)) 120

Step 5—Compute net insurance income:

- (14) Net insurance income under section 953 and the regulations thereunder0

<p><i>Step 6—Compute adjusted net foreign base company income:</i></p> <p>(15) Foreign tax imposed on foreign personal holding company income (as determined under paragraph (d)).....30</p> <p>(16) Foreign tax imposed on foreign base company sales income (as determined under paragraph (d)).....14</p> <p>(17) Ninety percent of the maximum U.S. corporate tax rate30.6</p> <p>(18) Effective rate of foreign tax imposed on foreign personal holding company income (interest) under section 954(b)(4) and paragraph (d) (line (15) divided by line (11))33</p> <p>(19) Effective rate of foreign tax imposed on \$40 of foreign base company sales income under section 954(b)(4) and paragraph (d) (line (16) divided by line (12))47</p> <p>(20) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (11) if line (18) is greater than line (17))90</p> <p>(21) Foreign base company sales income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (12) if line (19) is greater than line (17))30</p> <p>(22) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (13), reduced by the sum of line (20) and line (21))0</p> <p><i>Step 7—Compute adjusted net insurance income:</i></p> <p>(23) Adjusted net insurance income.....0</p> <p><i>Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):</i></p> <p>(24) Earnings and profits for the current year500</p> <p>(25) The excess in earnings and profits over subpart F income subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (24) over the sum of lines (22) and (23); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year) 500</p> <p>(26) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder600</p> <p>(27) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (22), line (23), and the lesser of line (25) or line (26))</p>	<p>500</p> <p>(b) <i>Computation of adjusted gross foreign base company income and adjusted gross insurance income—(1) De minimis rule, etc.—(i) In general.</i> If the de minimis rule of paragraph (b)(1)(ii) of this section applies, then adjusted gross foreign base company income and adjusted gross insurance income are each equal to zero. If the full inclusion rule of paragraph (b)(1)(iii) of this section applies, then adjusted gross foreign base company income consists of all items of gross income of the controlled foreign corporation other than gross insurance income, and adjusted gross insurance income consists of all items of gross insurance income. Otherwise, the adjusted gross foreign base company income of a controlled foreign corporation consists of the gross foreign base company income of the controlled foreign corporation, and the adjusted gross insurance income of a controlled foreign corporation consists of the gross insurance income of the controlled foreign corporation.</p> <p>(ii) <i>Five percent de minimis test—(A) In general.</i> The de minimis rule of this paragraph (b)(1)(ii) applies if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—</p> <p>(1) 5 percent of gross income, or</p> <p>(2) \$1,000,000.</p> <p>Controlled foreign corporations having a functional currency other than the U.S. dollar shall translate the \$1,000,000 threshold using the exchange rate provided under section 989(b)(3) and the regulations thereunder for amounts included in income under section 951(a).</p> <p>(B) <i>Coordination with section 864(d).</i> Gross foreign base company income or gross insurance income of a controlled foreign corporation always includes items of income from trade or service receivables described in section 864(d)(1) or (6), even if the de minimis rule of this paragraph (b)(1)(ii) is otherwise applicable. In that case, adjusted gross foreign base company income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that</p>
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are included in gross foreign base company income, and adjusted gross insurance income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross insurance income.

(iii) *Seventy percent full inclusion test.* The full inclusion rule of this paragraph (b)(1)(iii) applies if the sum of the foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income.

(2) *Character of items of gross income included in adjusted gross foreign base company income.* The items of gross income included in the adjusted gross foreign base company income of a controlled foreign corporation retain their character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. Items of gross income included in adjusted gross income because the full inclusion test of paragraph (b)(1)(iii) of this section is met are termed “full inclusion foreign base company income,” and constitute a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Items of gross foreign base company income or gross insurance income that are excluded from adjusted foreign base company income or adjusted gross insurance income because the de minimis test of paragraph (b)(1)(ii) of this section is met are potentially subject to recharacterization as adjusted net foreign base company income or adjusted net insurance income (or other categories of income included in the computation of subpart F income under section 952 and the regulations thereunder) for the taxable year under the rules of section 952(c). Items of full inclusion foreign base company income that are included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(iii) of this section is met, and are included in subpart F income under section 952 and the regulations there-

under, do not reduce amounts that, under section 952(c), are subject to recharacterization in later years on account of deficits in prior years.

(4) *Anti-abuse rule—(i) In general.* For purposes of applying the de minimis and full inclusion tests of paragraph (b)(1) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if one principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to avoid the application of the de minimis or full inclusion requirements of paragraph (b)(1) of this section. For purposes of this paragraph (b), a principal purpose need not be the purpose of first importance.

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to avoid the effect of the de minimis and full inclusion requirements of paragraph (b)(1) of this section if the corporations are related persons as defined in subdivision (iii) of this paragraph (b)(4) and the corporations are described in subdivision (A), (B), or (C). This presumption may be rebutted by proof to the contrary.

(A) The activities now carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were carried on, or assets that were previously held by a single controlled foreign corporation, and the United States shareholders of the controlled foreign corporations or related persons (as determined under subdivision (iii) of this paragraph (b)(4)) are substantially the same as the United States shareholders of the one controlled foreign corporation in that prior taxable year. A presumption made in connection with the requirements of this subdivision (A) of paragraph (b)(4)(ii) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of § 1.367(a)-6T(g) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly

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or indirectly in a partnership (as defined in section 7701(a)(2) and § 301.7701-3) that is a related person (as defined in subdivision (iii) of this paragraph (b)(4)) with respect to each such controlled foreign corporation.

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

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). In determining for purposes of this paragraph (b) whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

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

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

	CFC1	CFC2	CFC3
Gross income	\$4,000,000	\$8,000,000	\$12,000,000

	CFC1	CFC2	CFC3
Five percent of gross income	200,000	400,000	600,000
Foreign base company income	199,000	398,000	597,000

Thus, without the application of the anti-abuse rule of this subparagraph (5), each controlled foreign corporation would be treated as having no foreign base company income after the application of the de minimis rule of section 954(b)(3)(A) and § 1.954-1T(b)(1).

However, under these facts the requirements of subdivision (i) of this paragraph (b)(4) are presumed to be met. The sum of the foreign base company income of the controlled foreign corporations is \$1,194,000. Thus, the amount of adjusted gross foreign base company income will not be less than the amount of gross foreign base company income by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(5) *Illustration.* The following example illustrates computations required by sections 952 and 954 and this § 1.954-1T if the full inclusion test of paragraph (b)(1)(iii) is met (see paragraph (a)(8) for an example illustrating computations required if the de minimis test of paragraph (b)(1)(ii) is met):

Example. (i) *Gross Income.* *CFC*, a controlled foreign corporation, has gross income of \$1,000 for the current taxable year. Of that \$1,000 of income, \$720 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954-2T(b)(ii), is not income from trade or service receivables described in section 864(d) (1) or (6), and is not excluded from foreign personal holding company income under any provisions of section 954(c) and § 1.954-2T. The remaining \$280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g) or 953 and the regulations thereunder, and is foreign source general limitation income for purposes of section 904(d)(1)(I).

(ii) *Expenses.* *CFC* has expenses for the current taxable year of \$650. Of that \$650, \$350 is from interest paid to related persons that is allocable to foreign personal holding company income along with \$50 of other expense. The remaining \$250 of expense is allocable to services income other than foreign base company income or insurance income.

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

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F income of *CFC* (consisting entirely of foreign source general limitation income) by \$600 for the prior taxable year.

(iv) *Taxes.* A foreign tax of \$120 is considered imposed on the \$720 of interest income under the rules of section 954(b)(4) and paragraph (d) of this section, and a foreign tax of \$2 is considered imposed on the services income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

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

Step 1—Determine gross income:

(1) Gross income\$1000

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

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

Step 3—Compute adjusted gross foreign base company income:

(3) Seventy percent of gross income (.70 × line (1))700
 (4) Adjusted gross foreign base company income or insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3)).....1000
 (5) Full inclusion foreign base company income under paragraph (a)(2)(vi) (line (4) minus line (2))280

Step 4—Compute net foreign base company income:

(6) Related person interest expense and other deductions allocable and apportionable to foreign personal holding company income under section 954(b)(5) and paragraph (c)400
 (7) Deductions allocable and apportionable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c)250
 (8) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced (but not below zero) by line (6))320
 (9) Full inclusion foreign base com-

pany income after allocating deductions under section 954(b)(5) paragraph (c) of this section (line (5) reduced (but not below zero) by line (7))30

(10) Total gross foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (8) plus line (9))350

Step 5—Compute net insurance income:

(11) Net insurance income under section 953 and the regulations thereunder0

Step 6—Compute adjusted net foreign base company income:

(12) Foreign tax imposed on foreign personal holding company income (interest)120
 (13) Foreign tax imposed on full inclusion foreign base company income2
 (14) Ninety percent of the maximum U.S. corporate tax rate30.6
 (15) Effective rate of foreign tax imposed on \$320 of foreign personal holding company income under section 954(b)(4) and paragraph (d) (line (12) divided by line (8)).....38
 (16) Effective rate of foreign tax imposed of \$30 of full inclusion foreign base company income under section 954(b)(4) and paragraph (d) (line (13) divided by line (9))7
 (17) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (8) if line (15) is greater than line (14))320
 (18) Full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (9) if line (16) is greater than line (14))0
 (19) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (10), reduced by the sum of line (17) and line (18)).....30

Step 7—Compute adjusted net insurance income:

(20) Adjusted net insurance income.....0

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

(21) Earnings and profits for the current year350
 (22) The excess in earnings and profits over subpart F income, which is subject to being recharacterized as adjusted net foreign base company

income under section 952(c)(2) (excess of line (21) over the sum of line (19) and line (20)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year320

(23) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder600

(24) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (19) and line (20) plus the lesser of line (22) or line (23))350

(25) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years under section 952(c) (excess of line (23) over line (22))280

(c) *Computation of net foreign base company income.* The net foreign base company income of a controlled foreign corporation is computed by reducing (but not below zero) the amount of gross income in each of the categories of adjusted gross foreign base company income described in paragraph (b)(2) of this section, so as to take into account deductions allocable and apportionable to such income. For purposes of section 954 and this section, expenses must be allocated and apportioned consistent with the allocation and apportionment of expenses for purposes of section 904(d). For purposes of this § 1.954-1T, an item of net foreign base company income must be categorized according to the category of adjusted gross foreign base company income from which it is derived. Thus, an item of net foreign base company income must be categorized as a net item of—

- (1) Foreign personal holding company income,
- (2) Foreign base company sales income,
- (3) Foreign base company services income,
- (4) Foreign base company shipping income,
- (5) Foreign base company oil related income, or
- (6) Full inclusion foreign base company income.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income—(1) Application of high tax exception.* Adjusted net foreign base

company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any item of such income (other than foreign base company oil related income as defined in section 954(g)) subject to the high tax exception provided by section 954(b)(4) and this paragraph (d). An item of income is subject to the high tax exception only if—

(i) It is established that the income was subject to creditable income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 or 15 for the taxable year of the controlled foreign corporation; and

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

See paragraph (d)(4) of this section for the definition of the term “item of income.” For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see § 904-1.4(c)(1).

(2) *Effective rate at which taxes are imposed.* For purposes of this paragraph (d), the effective rate at which taxes are imposed on an item of income is—

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

(ii) The item of net foreign base company income or net insurance income, determined under paragraph (d)(4) of this section (including the appropriate amount of income taxes referred to in subdivision (i) of this paragraph (d)(2), immediately above).

(3) *Taxes paid or accrued with respect to an item of income—(i) Income other than passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of income (other than an item of foreign personal holding company income that is passive income) for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes that would be deemed paid under section 960 with respect to that

item if that item were included in the gross income of a U.S. shareholder under section 951(a)(1)(A). For this purpose, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a).

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

(4) *Item of income*—(i) *Income other than passive foreign personal holding company income.* The high tax exception applies (when elected) to all income that constitutes a single item under this paragraph (d)(4). A single item of net foreign base company income or net insurance income is an amount of net foreign base company income (other than foreign personal holding company income that is passive income) or net insurance income that:

(A) Falls within a single category of net foreign base company income, as defined in paragraph (c) of this section, or net insurance income, and

(B) Also falls within a single separate limitation category for purposes of sections 904(d) and 960 and the regulations thereunder.

(ii) *Passive foreign personal holding company income*—(A) *In general.* For purposes of this paragraph (d) a single item of net foreign personal holding company income that is passive income is an amount of such income that falls within a single group of passive income under the grouping rules of § 1.904-4(c) (3), (4), and (5).

(B) *Consistency rule.* An election to exclude income from subpart F must be consistently made with respect to all items of passive foreign personal holding company income eligible to be excluded. Thus, high-taxed passive foreign personal holding company income of a controlled foreign corporation

must be excluded in its entirety, or remain subject to subpart F.

(5) *Procedure.* The election provided by this paragraph (d) must be made—

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

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

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

(6) *Illustrations.* The rules of this paragraph (d) are illustrated by the following examples.

Example 1. (i) *Items of income.* During its 1987 taxable year, controlled foreign corporation CFC receives from outside its country of operation portfolio dividend income of \$100 and interest income of \$100 (consisting of a gross payment of \$150 reduced by a third-country withholding tax of \$50). For purposes of illustration, assume that the CFC incurs no expenses. None of the income is taxed in CFC's country of operation. The dividend income was not subject to their-country withholding taxes. The interest income was subject to withholding taxes equal to \$50, and is therefore high withholding tax interest for purposes of section 960 (pursuant to the operation of section 904). The dividend income is passive income for purposes of section 960. Accordingly, pursuant to paragraph (d)(4) of this section, CFC has two items of income: (1) \$100 of FPHC/passive income (the dividends) and (2) \$100 of FPHC/high withholding tax income (the interest). The election under paragraph (d)(5) of this section to exclude high-taxed income from the operation of subpart F is potentially applicable to each such item in its entirety.

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to item (1). Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F under the rules of this paragraph (d). Foreign tax of \$50 would be deemed paid under section 960 with respect to item (2). Therefore, the effective rate of foreign tax is 33 percent (\$50 of creditable taxes paid, divided by \$150, consisting of the item of net foreign base company income (\$100) plus creditable taxes paid thereon (\$50). The highest rate of tax specified in

section 11 for the 1987 taxable year is 34 percent. Accordingly, item (2) may be excluded from subpart F pursuant to an election under paragraph (d)(5) of this section, since it is subject to foreign tax at an effective rate that is greater than 30.6 percent (90 percent of 34 percent). However, it remains high withholding tax interest when included.

Example 2. The facts are the same as in Example 1, except that CFC's country of operation imposes a tax of \$50 with respect to CFC's dividend income. The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) \$100 of FPFC/high withholding tax interest income, and (2) \$50 of FPFC/passive income (net of the \$50 foreign tax). Both items are taxed at an effective rate greater than 31.6 percent. Item 1: Foreign tax (\$50) divided by sum (\$150) of income item (\$100) plus creditable tax thereon (\$50) equals 33 percent. Item 2: Foreign tax (\$50) divided by sum (\$100) of income item (\$50) plus creditable tax thereon (\$50) equals 50 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either, both, or neither of items 1 and 2 from subpart F.

Example 3. The facts are the same as in Example 1, except that the \$100 of portfolio dividend income is subject to a third-country withholding tax of \$50, and the \$150 of interest income is from sources within CFC's country of operation, is subject to a \$10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (d)(4)(ii)(A) of this section they constitute separate items of income pursuant to the application of the grouping rules of § 1.904-4(c). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) \$50 (net of tax) of FPFC/non-country of operation/greater than 15 percent withholding tax income; and (2) \$140 (net of \$10 tax) of FPFC/country of operation income. Item 1 is taxed at an effective rate greater than 30.6 percent, but Item 2 is not. Item 1: Foreign tax (\$50) divided by sum (\$100) of income item (\$50) plus creditable tax thereon (\$50) equals 50 percent. Item 2: Foreign tax (\$10) divided by sum (\$150) of income item (\$140) plus creditable tax thereon (\$10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude Item 1 but not Item 2 from subpart F.

Example 4. The facts are the same as in Example 3, except that the \$150 of interest income is subject to an income tax of \$50 in CFC's country of operation. Accordingly, CFC has two items of income, as in Example 4, but both items are taxed at an effective rate greater than 30.6 percent. Item 1: For-

eign tax (\$50) divided by sum (\$100) of income item (\$50) plus creditable tax thereon (\$50) equals 50 percent. Item 2: Foreign tax (\$50) divided by sum (\$150) if income item (\$100) plus creditable tax thereon (\$50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(ii)(B) of this section, CFC's shareholders must consistently elect or not elect to exclude from subpart F all items of FPFC income that are eligible to be excluded. Therefore, an election may be made to exclude both Item 1 and Item 2 from subpart F, or neither may be excluded.

(e) *Character of an item of income*—(1) *Substance of the transaction.* For purposes of section 954 and the regulations thereunder, items of income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount received as “rent” which actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as “rent” but shall be characterized as income from the sale of property, royalties or income from services, respectively. Local law shall not be controlling in characterizing an item of income.

(2) *Separable character.* To the extent one of the definitional provisions of section 953 or 954 describes a portion of the income or gain derived from a transaction, that portion of income or gain is so characterized. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing and selling personal property, receives interest (including imputed interest and market discount) on an account receivable arising from a sale, a portion of the income derived from the transaction by the controlled foreign corporation will be interest, and another portion will be gain (or loss) from the sale of personal property. If the sale is denominated in a currency other than a functional currency as defined in section 985 and the regulations thereunder, the controlled foreign corporation may have additional income in the form of foreign currency gain as defined in section 988.

(3) *Predominant character.* The portion of income derived from a transaction

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

(4) *Coordination of categories of gross foreign base company income or gross insurance income.* The definitions of gross foreign base company income and gross insurance income are limited by the following rules (to be applied in numerical order):

(i) If an item of income is included in subpart F income under section 952(a)(1) and the regulations thereunder as insurance income, it is by definition excluded from any other category of subpart F income.

(ii) If an item of income is included in the foreign base company oil related income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivision (i) of this paragraph (e)(4).

(iii) If an item of income is included in the foreign base company shipping income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivisions (i) and (ii) of this paragraph (e)(4).

(iv) If an item of income is included in foreign personal holding company income of a controlled foreign corporation, it is by definition not included in any other category of foreign base company income, other than as provided in subdivisions (i), (ii), and (iii) of this paragraph (e)(4).

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

[T.D. 8216, 53 FR 27492, July 21, 1988. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

§ 4.954-2 Foreign personal holding company income; taxable years beginning after December 31, 1986.

(a) *Computation of foreign personal holding company income—(1) In general.* Foreign personal holding company income consists of the following categories of income:

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

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

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

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

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

Paragraph (a)(3) of this section provides rules for determining the use or purpose for which property is held, if a change in use or purpose would affect the computation of foreign personal holding company income under paragraphs (e), (f), and (g) of this section. Paragraphs (c) and (d) of this section provide rules for determining certain rents and royalties that are excluded from foreign personal holding company income under paragraph (b) of this section.

(2) *Coordination of overlapping definitions.* If a particular portion of income from a transaction in substance falls within more than one of the definitional rules of section 954(c) and this section, its character is determined under the rules of subdivision (i) through (iii) of this paragraph (a)(2). The character of loss from a transaction must be similarly determined under the rules of this paragraph (a)(2).

(i) If a portion of the income from a transaction falls within the definition of income equivalent to interest under paragraph (h) of this section and the definition of gain from certain property transactions under paragraph (e) of this section, gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales), or foreign currency gain under paragraph (g) of this section (whether or not derived from a qualified business transaction or a qualified hedging transaction), that portion of income is treated as income equivalent to interest for purposes of section 954(c) and this section.

(ii) If a portion of the income from a transaction falls within the definition of foreign currency gain under paragraph (g) of this section (whether or not derived from a qualified business transaction or a qualified hedging transaction) and the definition of gain from certain property transactions under paragraph (e) of this section, or gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales), that portion of income is treated as foreign currency gain for purposes of section 954(c) and this section.

(iii) If a portion of the income from a transaction falls within the definition of gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales) and the definition of gain from certain property transactions under paragraph (e) of this section, that portion of income is treated as gain from a commodities transaction for purposes of section 954(c) and this section.

(3) *Changes in the use or purpose with which property is held—(i) In general.* Under paragraphs (e), (f), and (g) 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. For purposes of this section, in determining the purpose or use for which property is held, the period shortly before disposition is the most significant period. However, if a controlled foreign corporation held property with a purpose that would have caused its disposition to give rise to gain or loss included in the computation of foreign personal holding company income under this section, and prior to disposition the controlled foreign corporation changed the purpose or use for which it held the property to one that would cause its disposition to give rise to gain or loss excluded from the computation of foreign personal holding company income, then the later purpose or use shall be ignored unless it was continuously present for a predominant portion of the period during which the controlled foreign corporation held the property. Under paragraph (g)(4)(iii) of this section, a currency hedging transaction may be treated as two or more separate hedging transactions, such that each portion is separately considered in applying this paragraph (a)(3).

(ii) *Illustrations.* The following examples illustrate the application of this paragraph (a)(3).

Example 1. 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

this 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. For purposes of paragraph (e) of this section (gains from the sale or exchange of certain property) the building is considered to be property that gives rise to rents, as described in paragraph (e)(2). Because there was a change of use at the beginning of year 3 that would cause the disposition of the building to give rise to gain or loss excluded from the computation of foreign personal holding company income, the characterization of the gain derived at the beginning of year 4 is determined according to the property's use during the predominant portion of the period from purchase to date of sale. Therefore, gain from the sale of that building is included in the computation of foreign personal holding company income under paragraph (e) of this section.

Example 2. For taxable years 1, 2, and 3, *CFC*, a controlled foreign corporation, is engaged in the active conduct of a commodity business as a handler of gold, as defined in paragraph (f)(3)(iii), and substantially all of its business is as an active handler of gold, as defined in paragraph (f)(3)(iv). At the beginning of taxable year 1, *CFC* purchases 1000 ounces of gold for investment. At the beginning of taxable year 3, *CFC* begins holding that gold in physical form for sale to customers. During taxable year 3, *CFC* sells the entire 1000 ounces of gold in transactions described in paragraph (f)(3)(ii) at a gain. For purposes of paragraph (f), *CFC* is considered to hold the gold for investment, and not in its capacity as an active handler of gold. Thus, under paragraph (f)(3)(i), the gold is not considered to be sold in the active trade or business of the *CFC* as a handler of gold, and gain from the sale is included in the computation of foreign personal holding company income under paragraph (f) of this section.

Example 3. *CFC*, a controlled foreign corporation, is a regular dealer in unimproved land. The functional currency (as defined in section 985 and the regulations thereunder) of *CFC* is country X currency. On day 1 of its current taxable year, *CFC* enters into an agreement with A to pay \$100 for certain real property to be held by *CFC* for investment. On day 10, under its method of accounting, *CFC* accrues the value of \$100 in country X currency, but payment will not be made until the first day of the next taxable year (day 366). On day 190, *CFC* determines to hold the property for sale to customers in a transaction that would be a qualified business transaction under paragraph (g)(3) of this section. For purposes of this section, the

land is considered to be held for investment, and the foreign currency gain attributable to that transaction is included in the computation of foreign personal holding company income under paragraph (g) of this section.

Example 4. *CFC*, a controlled foreign corporation, is a regular dealer in widgets. The functional currency (as defined in section 985 and the regulations thereunder) of *CFC* is country X currency. On day 1 of its current taxable year, *CFC* sells widgets held in inventory to A for delivery on day 60. The sales price is denominated in U.S. dollars, and payment is to be made by A on the same day the widgets are to be delivered to A. The remaining facts and circumstances are such that this sale would meet the definition of a qualified business transaction under paragraph (g)(4), the foreign currency gain from which would be excluded from the computation of foreign personal holding company income under paragraph (g). On day 1, *CFC* sells U.S. dollars forward for delivery in 60 days in a transaction that would be a qualified hedging transaction under paragraph (g)(5). On day 25 the sale of widgets to A is cancelled in a transaction that does not result in *CFC* realizing any foreign currency gain or loss with respect to the sale of widgets. However, *CFC* holds the dollar forward contract to maturity. Because the forward contract does not hedge a qualified business transaction during the period shortly before its maturity, it is not to be considered a qualified hedging transaction under paragraph (g), and any foreign currency gain or loss recognized therefrom is included in the computation of foreign personal holding company income under paragraph (g). However, if *CFC* identifies the portion of the foreign currency gain or loss derived from the forward contract that is attributable to days 1 through 25, and the portion that is attributable to days 25 through 60, the forward contract may be considered two separate transactions in accordance with the rules provided by paragraph (g)(4)(ii) of this section. Thus, the forward sale may be separately considered a qualified hedging transaction for day 1 through day 25, and the foreign currency gain or loss attributable to day 1 through day 25 may be excluded from the computation of foreign personal holding company income under paragraph (g) of this section.

Example 5. *CFC*, a controlled foreign corporation, has country X currency as its functional currency under section 985 and the regulations thereunder. On day 1 of the current taxable year, *CFC*, speculating on exchange rates, sells dollars forward for delivery in 120 days. On day 65, *CFC* sells widgets held in inventory at a price denominated in dollars to be paid on day 120 in a transaction that is a qualified business transaction. *CFC* had not made any other dollar sales between day 1 and day 65 and does not anticipate

making any other dollar sales during the taxable year. On day 65, *CFC* accrues the value of \$100 in country X currency. On day 120, *CFC* receives \$100 payment for the widgets and recognizes foreign currency loss pursuant to that transaction. On day 120 *CFC* also delivers dollars in connection with the forward sale, and recognizes foreign currency gain pursuant to the delivery. Under this paragraph (a)(3) the currency transaction is considered to have been entered into for speculation, and any currency gain recognized by *CFC* on the forward sale of dollars must be included in the computation of foreign personal holding company income under paragraph (g). However, if *CFC* identifies the portion of the forward sale, and the foreign currency gain or therefrom, that is attributable to day 1 through day 64, and the portion that is attributable to day 65 through day 120, the forward sale may be considered two separate transactions in accordance with the rules provided by paragraph (g)(4)(ii) of this section. Thus, the transaction for day 65 through day 120 may be considered a separate transaction that is a qualified hedging transaction, and the foreign currency gain attributable to day 65 through day 120 may be excluded from the computation of foreign personal holding company income under this paragraph (g) if all the other requirements for treatment as a qualified hedging transaction under paragraph (g) are met.

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

(i) *Interest.* The term “interest” includes amounts that are treated as ordinary income, original issue discount or interest income (including original issue discount and interest on a tax-exempt obligation) by reason of sections 482, 483, 864(d), 1273, 1274, 1276, 1281, 1286, 1288, 7872 and the regulations thereunder, or as interest or original issue discount income by reason of any other provision of law. For special rules concerning interest exempt from U.S. tax pursuant to section 103, see paragraph (b)(6) of this section.

(ii) *Inventory and similar property.* 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 which would properly be included in the inventory of the controlled corporation if on hand at the close of the taxable year (were the controlled foreign corporation 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. Rights to property held in bona fide hedging transactions that reduce the risk of price changes in the cost of “inventory and similar property” are included in the definition of that term if they are an integral part of the system by which a controlled foreign corporation purchases such property, and they are so identified by the close of the fifth day after the day on which the hedging transaction is entered into.

(iii) *Regular dealer.* The term “regular dealer” means a merchant with an established place of business that—

(A) Regularly and actively engages as a merchant in purchasing property and selling it to customers in the ordinary course of business with a view to the gains and profits that may be derived therefrom, or

(B) Makes a market in derivative financial products of property (such as forward contracts to buy or sell property, option contracts to buy or sell property, interest rate and currency swap contracts or other national principal contracts) by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business.

Purchasing and selling property through a regulated exchange or established off-exchange market (for example, engaging in futures transactions) is not actively engaging as a merchant for purposes of this section.

(iv) *Dealer property.* Property held by a controlled foreign corporation is “dealer property” if—

(A) The controlled foreign corporation is a regular dealer in property of such kind, and

(B) The property is held by the controlled foreign corporation in its capacity as a dealer.

Property which is held by the controlled foreign corporation for investment or speculation is not such property.

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

(b) *Dividends, etc.*—(1) *In general.* Foreign personal holding company includes:

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(3) of this section and distributions of previously taxed income under section 959(b) and the regulations thereunder;

(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)(3) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in (b)(4) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(5); and

(iv) Annuities.

(2) *Exclusion of certain export financing*—(i) *In general.* Pursuant to section 954(c)(2)(B), foreign personal holding company income computed under section 954(c)(1)(A) and this paragraph (b) does not include interest that is export financing interest. For purposes of section 954(c)(2)(B) and this section, 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) and the regulations thereunder. Pursuant to section 864(d)(5)(A)(iii), it does not include income from related party factoring that is treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

(ii) *Conduct of a banking business.* For purposes of this section, export financing interest as defined in section 904(d)(2)(G) and the regulations thereunder 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.

(iii) *Illustration.* The following example illustrates the application of this provision:

Example. 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) and the regulations thereunder, of each item of inventory or equipment sold by DS is attributable to products imported into the United States. CFC, a controlled foreign corporation related (as defined in section 954(d)) to DS, provides loans for the purchase of property from DS, if the property is purchased exclusively for use of consumption outside the United States.

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 paragraph (b)(2) of this section, which would not be included in foreign personal holding company income under section 954(c) and paragraph (b)(1)(i) of this section. However, interest from the loans made with respect to purchases from DS of property which 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 regulations thereunder, and thus is included in foreign personal holding company income under paragraph (b)(1)(ii) of this section. See § 1.864-8T(d) for rules concerning certain income from trade and service receivables qualifying under the same country exception of section 864(d)(7).

(3) *Exclusion of dividends and interest from related persons*—(i) *Excluded dividends and interest.* Foreign personal holding company income does not include dividends and interest if—

(A) The payor is a corporation that is a related person as defined in section 954(a)(3),

(B) The payor is created or organized (“incorporated”) under the laws of the same foreign country as the controlled foreign corporation, and

(C) A substantial part of the payor’s assets are used in a trade or business in the payor’s country of incorporation as determined under subdivision (iv) of this paragraph (b)(3).

Except as otherwise provided under this paragraph (b)(3), the principles of section 367(a) and regulations thereunder shall apply in 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.

(ii) *Interest paid out of adjusted foreign base company income or insurance income.* Interest may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(3) to the extent that the deduction for the interest is allocated under § 1.954-1T(c) to the payor's adjusted gross foreign base company income (as defined in § 1.954-1T(a)(3)), adjusted gross insurance income (as defined in § 1.954-1T(a)(6)), or other categories of income included in the computation of subpart F income under section 952(a), for purposes of computing the payor's net foreign base company income (as defined in § 1.954-1T(a)(4)), net insurance income (as defined in § 1.954-1T(a)(6)), or income described in sections 952(a) (3), (4), and (5).

(iii) *Dividends paid out of prior years' earnings.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(3) only to the extent they are paid out of earnings and profits which were earned or accumulated during a period in which the requirements of subdivision (i) of this paragraph (b)(3) were 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 be controlled foreign corporation and the other requirements of subdivision (i) of this paragraph (b)(3) are substantially satisfied.

(iv) *Fifty percent substantial assets test.* A substantial part of the assets of the payor will be considered used in a trade or business located in its country of incorporation only if, for each quarter during such taxable year, the average value (as of the beginning and end of the quarter) of its assets which are used in the trade or business and are located in such country constitutes over 50 percent of the average value (as of the beginning and end of the quarter) of all the assets of the payor (including assets not used in a trade or business). For such purposes the value of assets shall be determined under

subdivision (v) of this paragraph (b)(3), and the location of assets used in a trade or business of the payor shall be determined under subdivisions (vi) through (xi) of this paragraph (b)(3).

(v) *Value 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 actual 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 used in a trade or business—(A) In general.* Tangible property (other than inventory and similar property) used in a trade or business is considered located in the country in which it is physically located.

(B) *Exception.* If tangible personal property used in a trade or business is intended for use in the payor's country of incorporation, but is temporarily located elsewhere, it will be considered located within payor's country of incorporation if the reason for its location elsewhere is for inspection or repair, and it is not currently in service in a country other than the payor's country of incorporation and is not to be placed in service in a country other than the payor's country of incorporation following the inspection or repair.

(vii) *Location of intangible property used in a trade or business—(A) In general.* The location of intangible property (other than inventory or similar property and debt instruments) used in a trade or business is determined based on the site of the activities conducted by the payor during the current year in connection with using or exploiting that property. An item of intangible property is located in the payor's country of incorporation during each quarter of the current taxable year if the activities connected with its use or exploitation are conducted during the entire current taxable year by the payor in its country of incorporation. For this purpose, the determination of the country in which services are performed shall be made under the principles of section 954(e) and § 1.954-4(c).

(B) *Property located in part in the payor's country of incorporation and in*

part in other countries. If the activities connected with the use or exploitation of an item of intangible property are conducted during the current taxable year by the payor in the payor's country of incorporation and in other countries, then a percentage of the intangible (measured by the average value of the item as of the beginning and end of the quarter) is considered located in the payor's country of incorporation during each quarter. That percentage equals the ratio that the expenses of the payor incurred during the entire taxable year by reason of such activities that are conducted in the payor's country of incorporation bear to the expenses of the payor incurred during the entire taxable year by reason of all such activities worldwide. 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)(3) if they are deductible under section 162 or includible in inventory costs or the costs of goods sold (were the payor a domestic corporation).

(viii) *Location of property held for sale to customers—(A) In general.* Inventory or similar property is considered located in the payor's country of incorporation during each quarter of the taxable year if the activities of the payor in connection with the production and sale, or purchase and release, of such property and conducted in the payor's country of incorporation during the entire taxable year. If the payor conducts such activities through an independent contractor, then the location of such activities shall be the place in which they are conducted by the independent contractor.

(B) *Inventory located in part in the payor's country of incorporation and in part in other countries.* If the activities connected with the production and sales, or purchase and resale, of inventory or similar property are conducted by the payor in the payor's country of incorporation and other countries, then a percentage of the inventory or similar property (measured by the average value of the item as of the beginning and end of the quarter) is considered located in the payor's country of incorporation each quarter. That percentage equals the ratio that the costs

of the payor incurred during the entire taxable year by reason of such activities that are conducted in the payor's country of incorporation bear to all such costs incurred by reason of such activities worldwide. A cost incurred in connection with the production and sale or purchase and resale of inventory or similar property is included in this computation if it—

(1) Must be included in inventory costs or otherwise capitalized with respect to inventory or similar property under section 61, 263A, 471, or 472 and the regulations thereunder (whichever would be applicable were the payor a domestic corporation), or

(2) Would be deductible under section 162 (were the payor 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)(3), debt instruments are considered to be used in a trade or business only if they arise from the sale of inventory or similar 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, but only until such time as interest is required to be charged under section 482 and the regulations thereunder. Debt instruments that arise from the sale of inventory or similar property are treated as having the same location, proportionately, as inventory or similar property that is held during the same calendar 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.* For the purpose of determining the value of assets used in a trade or business in the country of incorporation, stock directly or indirectly owned by the payor within the meaning of section 958(a) in a controlled foreign corporation ("lower-tier corporation"), which is incorporated in the same

country as the payor, shall be considered located in the country of incorporation and 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)(3).

(xi) *Determination of period during which property is used in a trade or business.* Property purchased or produced for use in a trade or business shall not be considered used in a trade or business until it is placed in service, and shall cease to be considered used in a trade or business when it is retired from service. The dates during which depreciable property is determined to be in use must be consistent with the determination of depreciation under sections 167 and 168 and the regulations thereunder.

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

(4) *Exclusion of rents and royalties derived from related persons—(i) In general.* Foreign personal holding company income does not include rents or royalties if—

(A) The payor is a corporation that is a related person as defined in section 954(d)(3), and

(B) The rents or royalties are for the use of, or the privilege of using, property within the country under the laws of which the recipient of the payments is created or organized.

If the property is used both within and without the country under the laws of which the controlled foreign corporation is created or organized, the part of the rent or royalty attributable to the use of, or the privilege of using, the property outside such country of incorporation is, unless otherwise provided, foreign personal holding company income under this paragraph (b).

(ii) *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)(4) to the extent that deductions for the payments are allocated under section 954(b)(5) and § 1.954-1T(a)(4) to the

payor's adjusted gross foreign base company income (as defined in § 1.954-1T(a)(3)), adjusted gross insurance income (as defined in § 1.954-1T(a)(6)), or other categories of income included in the computation of subpart F income under section 952(a), for purposes of computing the payor's net foreign base company income (as defined in § 1.954-1T(a)(4)), net insurance income (as defined in § 1.954-1T(a)(6)), or income described in section 952(a) (3), (4), or (5).

(5) *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 which are derived in the active conduct of a trade or business and which are received from a person other than a related person within the meaning of section 954(d)(3). Whether or not rents or royalties are derived in the active conduct of a trade or business is to be determined from the facts and circumstances of each case; but see paragraph (c) or (d) of this section for specific cases in which rents or royalties will be considered for purposes of this paragraph to be derived in the active conduct of a trade or business. The frequency with which a foreign corporation enters into transactions from which rents or royalties are derived will not of itself establish the fact that such rents or royalties are derived in the active conduct of a trade or business.

(6) *Treatment of tax exempt interest.* Foreign personal holding company income includes all interest income, including interest that is exempt from U.S. tax pursuant to section 103 ("tax-exempt interest"). However, that net foreign base company income of a controlled foreign corporation that is attributable to such tax-exempt interest shall be treated as tax-exempt interest in the hands of the U.S. shareholders of the foreign corporation. Accordingly, any net foreign base company income that is included in the subpart F income of a U.S. shareholder and that is attributable to such tax-exempt interest shall remain exempt from the regular income tax, but potentially subject to the alternative minimum tax, in the hands of the U.S. shareholder.

(c) *Excluded rents—(1) Trade or business cases.* Rents will be considered for

purposes of paragraph (b)(5) 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 (“lessor”) from leasing—

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

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

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

(iv) Property which is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and which 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.* An organization in a foreign country will be considered substantial in relation to the amount of rents, for purposes of paragraph (c)(1)(iv) of this section, if active leasing expenses, as defined in paragraph (c)(2)(iii), equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.

(iii) *Active leasing expenses.* The term “active leasing expenses” means the deductions incurred by an organization of the lessor in a foreign country which are properly allocable to rental income and which would be allowable under

section 162 to the lessor (were the lessor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the lessor,

(B) Deductions for rents paid or accrued,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the lessor (were the lessor a domestic corporation) under sections other than section 162 (such as sections 167 and 168), and

(D) Deductions for payments made to independent contractors with respect to the leased property.

(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 controlled foreign corporation with respect to such gross rental income,

(B) The amounts which would be allowable to such lessor (were the lessor a domestic corporation) as deductions under section 167 or 168 with respect to such rental income, and

(C) The amounts paid to independent contractors with respect to such rental income.

(3) *Illustrations.* 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 A Corporation from the 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 which 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 which is regularly engaged in the business of marketing and servicing the motor vehicles which 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. [Reserved]

Example 4. Controlled foreign corporation *E* owns a complex of apartment buildings which 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 the owner. The rental income of *E* Corporation from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example 5. 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 6. Controlled foreign corporation *G* owns equipment which 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 *G* receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Trade or business cases.* Royalties will be considered for purposes of paragraph (b)(5) 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 (“licensor”) from licensing—

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

(ii) Property which is licensed as a result of the performance of marketing functions by such licensor and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and which 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), the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization.* An organization in a foreign country will be considered substantial in relation to the amount of royalties, for purposes of paragraph (d)(1)(ii) of this section, if the 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 which are properly allocable to royalty income and which would be allowable under section 162 to the licensor (were the licensor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the licensor,

(B) Deductions for royalties paid or incurred,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the licensor (were the controlled foreign corporation a domestic corporation)

under sections other than section 162 (such as section 167), and

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

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

(A) The royalties paid or incurred by the controlled foreign corporation with respect to such gross royalty income,

(B) The amounts which would be allowable to such licensor as deductions under section 167 (were the licensor a domestic corporation) with respect to such royalty income, and

(C) The amounts paid to independent contractors with respect to such royalty income.

(3) *Illustrations.* 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 full time scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, which 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 which 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).

Example 2. Assume that Corporation A in example 1, in addition to receiving royalties for the use of patents which it develops, receives royalties for the use of patents which 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 which 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 which it acquires by purchase. The primary business of Corporation B, operated on a regular basis, consists of licensing patents which 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 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 which is intended to promote the use of the patented property. Corporation D does not, however, maintain and operate an organization in a foreign country which 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) Inclusion in FPFC income.* Foreign personal holding company income includes the excess of gains over losses from the sale or exchange of—

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

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

If losses from the sale or exchange of such property exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (e), and may not be allocated to, or otherwise reduce, other foreign personal holding company income under section 954(b)(5) and § 1.954-1T(c). Gain or loss from a transaction that is treated as capital gain or

loss under section 988(a)(1)(B) is not foreign currency gain or loss as defined in paragraph (g), but is gain or loss from the sale or exchange of property which is included in the computation of foreign personal holding company income under this paragraph (e)(1). Paragraphs (e) (4) and (5) of this section provide specific rules for determining whether gain or loss from dispositions of debt instruments and dispositions of options or similar property must be included in the computation of foreign personal holding company income under this paragraph (e)(1). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (e).

(ii) *Dual character property.* Property may only in part constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or property that does not give rise to any income as described in paragraph (e)(3) of this section. In such cases, the property must be treated as two separate properties for purposes of this paragraph (e). 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 this paragraph (e), and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated for purposes of this paragraph (e)(1)(i) 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 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 which is included in the computation of foreign

personal holding company income under this paragraph (e)(1). This paragraph (e)(1)(ii) 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 and annuities described in paragraph (b) of this section, except for rents and royalties derived from unrelated persons in the active conduct of a trade or business under paragraph (b)(5) of this section. The property described by this paragraph (e)(2) includes property which gives rise to export financing interest described in paragraph (b)(2) of this section and property which gives rise to income from related persons described in paragraphs (b)(3) and (b)(4) of this section.

(ii) *Exception.* Property described in this paragraph (e)(2) does not include—

(A) Dealer property (as defined in paragraph (a)(4)(iv) of this section), and

(B) Inventory and similar property (as defined in paragraph (a)(4)(ii) of this section) other than securities.

(3) *Property that does not give rise to income.* The term “property that does not give rise to income” for purposes of this section includes all rights and interests in property (whether or not a capital asset) except—

(i) Property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (e)(2) of this section and property that gives rise to rents and royalties derived in the active conduct of a trade or business under paragraph (b)(5) of this section;

(ii) Dealer property (as defined in paragraph (a)(4)(iv) of this section);

(iii) Inventory and similar property (as defined in paragraph (a)(4)(ii)) other than securities;

(iv) Property (other than real property) used in the controlled foreign corporation’s trade or business that is of a character which would be subject to

the allowance for depreciation under section 167 or 168 and the regulations thereunder (including tangible property described in § 1.167(a)-2 and intangibles described in § 1.167(a)-3);

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

(vi) Intangible property as defined in section 936(h)(3)(B) and goodwill that is not subject to the allowance for depreciation under section 167 and the regulations thereunder to the extent used in the controlled foreign corporation's trade or business and disposed of in connection with the sale of a trade or business of the controlled foreign corporation.

(4) *Classification of gain or loss from the disposition of a debt instrument or on a deferred payment sale*—(i) *Gain*. Gain 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) It is treated as interest income (as defined in paragraph (a)(4)(i) of this section); or

(B) It is treated as income equivalent to interest under paragraph (h) of this section.

(ii) *Loss*. 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) It is directly allocated to interest income (as defined 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 Code or regulations thereunder;

(B) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Code or regulations thereunder; or

(C) The debt instrument was taken in consideration for the sale or exchange of property (or the provision of services) by the controlled foreign corporation and gain or loss from that sale or exchange (or income from the provision of services) is not includible in foreign base company income under this section.

(5) *Classification of options and other rights to acquire or transfer property*. Subject to the exceptions provided in paragraphs (e)(3) (ii) and (iii) of this section (relating to certain dealer property and inventory property), rights to acquire or transfer property, including property that gives rise to income, are classified as property that does not give rise to income under paragraph (e)(3) of this section. These rights include options, warrants, futures contracts, options on a futures contract, forward contracts, and options on an index relating to stocks, securities or interest rates.

(6) *Classification of certain interests in pass through entities*. [Reserved]

(f) *Commodities transactions*—(1) *In general*. Except as otherwise provided in this paragraph (f), foreign personal holding company income includes the excess of gains over losses from commodities transactions. If losses from commodities transactions exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (f), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954-1T(a)(4). The terms “commodity” and “commodities transactions” are defined in paragraph (f)(2) of this section. 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). The term “qualified active sales” is defined in paragraph (f)(3). The term “qualified hedging transaction” is defined in paragraph (f)(4) of this section. An election is provided under paragraph (g)(5) of this section to include all gains and losses from section 1256 foreign currency transactions, which would otherwise be commodities transactions, in the computation of foreign personal holding company income under paragraph (g) instead of this paragraph (f). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (f).

(2) *Definitions*—(i) *Commodity*. For purposes of this section, the term “commodity” means:

(A) Tangible personal property of a kind which is actively traded or with respect to which contractual interests are actively traded, and

(B) Nonfunctional currency (as defined under section 988 and the regulations thereunder).

(ii) *Commodities transaction*. A 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, 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 leverage transaction merchants,

(C) An exchange of futures for physical transaction,

(D) A transaction 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.

(3) *Definition of the term “qualified active sales”*—(i) *In general*. The term “qualified active sales” means the sale of commodities in the active conduct of a commodity 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 of like kind. The sale of com-

modities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of commodities of like kind is not a qualified active sale.

(ii) *Sale of commodities*. The term “sale of commodities” means any transaction in which the controlled foreign corporation intends to deliver to a purchaser a commodity held by the controlled foreign corporation in physical form.

(iii) *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 if—

(A) It holds commodities as inventory or similar property (as defined in paragraph (a)(4)(ii)); and

(B) It incurs substantial expenses in the ordinary course of a commodities business from engaging in one of the following activities directly, and not through an independent contractor:

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

(2) Substantial processing activities prior to the sale of commodities including concentrating, refining, mixing, crushing, aerating, or milling; or

(3) Significant activities relating to the physical movement, handling and storage of 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; owning and operating facilities for storage or warehousing or owning or chartering vessels or vehicles for the transportation of commodities.

For purposes of this paragraph (f), a corporation is not engaged in a commodities business as a producer, processor, merchant, or handler of commodities if its business is primarily financial. In general, the business of a controlled foreign corporation is financial if it primarily engages in commodities transactions for investment or speculation, or if it primarily provides

products or services to customers for investment or speculation.

(iv) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities if the activities described in paragraph (f)(3)(iii) give rise to 85 percent of the taxable income of the controlled foreign corporation (computed as though the corporation were a domestic corporation). For this purpose, gains or losses from qualified hedging transactions, as defined in paragraph (f)(4), are considered derived from the qualified active sales to which they relate or are expected to relate.

(4) *Definition of the term "qualified hedging transaction."* The term "qualified hedging transaction" means a bona fide hedging transaction that:

(i) Is reasonably necessary to the conduct of business as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others;

(ii) Is entered into primarily to reduce the risk of price change (but not the risk of currency fluctuations) with respect to commodities sold or to be sold in qualified active sales described in paragraph (f)(3) of this paragraph; and

(iii) Is clearly identified on the controlled foreign corporation's records before the close of the fifth day after the day during which the hedging transaction is entered into and at a time when there is a reasonable risk of loss; however, if the controlled foreign corporation does not at such time specifically and properly identify the qualified active sales (or category of such sales) to which a hedging transaction relates, the district director in his sole discretion may determine which hedging transactions (if any) are related to qualified active sales.

(g) *Foreign currency gain*—(1) *In general.* Except as provided in paragraph (g)(2), foreign personal holding company income includes the excess of foreign currency gains over losses (as defined in section 988(b)) attributable to any section 988 transactions. If foreign currency losses exceed gains, the net loss is not within the definition of foreign personal holding company income

under this paragraph (g), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954-1T(a)(4). To the extent the gain or loss from a transaction is treated as interest income or expense under sections 988(a)(2) or 988(d) and the regulations thereunder, it is not included in the computation of foreign personal holding company income under this paragraph (g). (For other rules concerning income described in more than one category of foreign personal holding company income, see § 1.954-2(a)(2).) A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (g).

(2) *Exceptions*—(i) *Qualified business units using the dollar approximate separate transactions method.* Any DASTM gain or loss computed under § 1.985-3(d) must be allocated under the rules of § 1.985-3 (e)(2)(iv) or (e)(3).

(ii) *Tracing to exclude foreign currency gain or loss from qualified business and hedging transactions.* A foreign currency gain or loss is excluded from the computation of foreign personal holding company income under this paragraph (g) if it is clearly identified on the records of the controlled foreign corporation as being derived from a qualified business transaction or a qualified hedging transaction. The term "qualified business transaction" is defined in paragraph (g)(3) of this section. The term "qualified hedging transaction" is defined paragraph (g)(4) of this section. However, currency gain or loss of a qualified business unit included in the computation of currency gain or loss under subdivision (i) of this paragraph (g)(2) may not be excluded from foreign personal holding company income under the tracing rule of this paragraph (g)(2)(ii). Furthermore, the tracing rule of this paragraph (g)(2)(ii) will not apply if a controlled foreign corporation makes the election provided by paragraph (g)(2)(iii) of this section.

(iii) *Election out of tracing.* A controlled foreign corporation may elect a method of accounting under which all

foreign currency gains or losses attributable to section 988 transactions are included in foreign personal holding company income. The scope and requirements for this election are provided in paragraph (g)(5) of this section. This election does not apply to foreign currency gains or losses of a qualified business unit included in the computation of gain or loss under paragraph (g)(2)(i) of this section.

(3) *Definition of the term “qualified business transaction”*—(i) *In general.* The term “qualified business transaction” means a transaction (other than a “qualified hedging transaction” as described in paragraph (g)(4) of this section) that:

(A) Does not have investment or speculation as a significant purpose;

(B) Is not attributable to property or an activity of the kind that gives rise to subpart F income (other than foreign currency gain under this paragraph (g)), or could reasonably be expected to give rise to subpart F income (including upon disposition); for example, the transaction may not be attributable to stock or debt of another corporation (including related corporations organized and operating in the same country), or property likely to give rise to foreign base company sales or services income; and

(C) Is attributable to business transactions described in subdivision (ii) of this paragraph (g)(3).

A qualified business transaction includes the disposition of a debt instrument that constitutes inventory property under paragraph (a)(4)(ii) or dealer property under paragraph (a)(4)(iv) of this section. The provisions of this paragraph (g)(3) do not apply to the foreign currency gain or loss of a qualified business unit (as determined under § 1.985-3T(d)(2)) included in the computation of gain or loss under paragraph (g)(2)(i) of this section. The provisions of this paragraph (g)(3) do, however, apply to other currency transactions of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency under section 985(b)(3) and § 1.985-2T. Qualified business transactions and the amount of foreign currency gain or loss derived therefrom must be clearly identified on its records by the con-

trolled foreign corporation. If the controlled foreign corporation is unable to specifically identify the qualified business transactions and the foreign currency gain or loss derived therefrom, the district director in his sole discretion may determine which transactions of the corporation giving rise to the foreign currency gains or losses are attributable to qualified business transactions.

(ii) *Specific business transactions.* A transaction of a controlled foreign corporation must meet the requirements of any of subdivisions (A) through (F) of this paragraph (g)(3)(ii) to be a qualified business transaction under this paragraph (g)(3).

(A) *Acquisition of debt instruments.* If the transaction is the acquisition of a debt instrument described in section 988(c)(1)(B)(i) and the regulations thereunder, the debt must be derived from—

(1) The sale of inventory and similar property to customers by the controlled foreign corporation in the ordinary course of regular business operations, or

(2) The rendition of services by the corporation in the ordinary course of regular business operations.

For purposes of this paragraph (g)(3)(ii)(A), a debt instrument will not be considered derived in the ordinary course of regular business operations unless the instrument matures, and is reasonably expected to be satisfied, within the period for which interest need not be charged under section 482 and the regulations thereunder.

(B) *Becoming the obligor under debt instruments.* If the transaction is becoming the obligor under a debt instrument described in section 988(c)(1)(B)(i) and the regulations thereunder, the debt must be incurred for:

(1) Payment of expenses that are includible by the controlled foreign corporation in the cost of goods sold under § 1.61-3 for property held primarily for sale to customers in the ordinary course of regular business operations, are inventoriable costs under section 471 and the regulations thereunder, or are allocable or apportionable under the rules of § 1.861-8 to gross income derived from inventory and similar property,

(2) Payment of expenses that are allocable or apportionable under the rules of § 1.861-8 to gross income derived from services provided by the controlled foreign corporation in the ordinary course of regular business operations,

(3) Acquisition of an asset that does not give rise to subpart F income during the current taxable year (other than by application of section 952(c)) and is not reasonably expected to give rise to subpart F income in subsequent taxable years, or

(4) Acquisition of dealer property as defined in paragraph (a)(4)(iv) of this section.

The identification requirements of subdivision (i) of this paragraph (g)(3) will not be met with respect to a borrowing if the controlled foreign corporation fails to clearly identify the debt and the expenses (or categories of expenses) to which it relates before the close of the fifth day after the day on which the expenses are incurred.

(C) *Accrual of any item of gross income.* If the transaction is the accrual (or otherwise taking into account) of any item of gross income or receipts as described in section 988(c)(1)(B)(ii) and the regulations thereunder, the item of gross income or receipts must be derived from:

(1) The sale of inventory and similar property in the ordinary course of regular business operations, or

(2) The provision of services by the controlled foreign corporation to customers in the ordinary course of regular business operations.

(D) *Accrual of any item of expense.* If the transaction is the accrual (or otherwise taking into account) of any item of expense as described in section 988(c)(1)(B)(ii) and the regulations thereunder, the item of expense must be:

(1) An expense that is includible by the controlled foreign corporation in the cost of goods sold under § 1.61-3 for property held primarily for sale to customers in the ordinary course of regular business operations, is an inventoriable cost under section 471 and the regulations thereunder, or is allocable or apportionable under the rules of § 1.861-8 to gross income de-

rived from inventory and similar property, or

(2) An expense that is allocable or apportionable under the rules of § 1.861-8 to gross income derived from services provided by the controlled foreign corporation in the ordinary course of regular business operations.

(E) *Entering into forward contracts, futures contracts, options and similar instruments.* If the transaction is entering into any forward contract, futures contract, option or similar financial instrument and if such contract or instrument is not marked to market at the close of the taxable year under section 1256, as described in section 988(c)(1)(B)(iii) and the regulations thereunder, then the contract or instrument must be property held as dealer property as defined in paragraph (a)(4)(ii) of this section.

(F) *Disposition of nonfunctional currency.* If the transaction is the disposition of nonfunctional currency, as described in section 988(c)(1)(C) and the regulations thereunder, then the transaction must be for a purpose described in paragraph (g)(3)(ii)(B), for the payment of taxes not attributable to subpart F income, or must be the disposition of property held as dealer property as defined in paragraph (a)(4)(iv) of this section.

(G) *Transactions in business assets.* The acquisition or disposition of an asset that is used or held for use in the active conduct of a trade or business.

(4) *Definition of the term "qualified hedging transaction"*—(i) *In general.* The term "qualified hedging transaction" means a bona fide hedging transaction meeting all the requirements of subdivisions (A) through (D) of this paragraph (g)(4)(i):

(A) The transaction must be reasonably necessary to the conduct of regular business operations in the manner in which such business operations are customarily and usually conducted by others.

(B) The transaction must be entered into primarily to reduce the risk of currency fluctuations with respect to property or services sold or to be sold or expenses incurred or to be incurred in transactions that are qualified business transactions under paragraph (g)(3) of this section.

(C) The hedging transaction and the property or expense (or category of property or expense) to which it relates must be clearly identified on the records of the controlled foreign corporation before the close of the fifth day after the day during which the hedging transaction is entered into and at a time during which there is a reasonable risk of currency loss.

(D) The amount of foreign currency gain or loss that is attributable to a specific hedging transaction must be clearly identifiable on the records of the controlled foreign corporation or its controlling shareholder (as defined in § 1.964-1(c)(5)).

The provisions of this paragraph (g)(4) do not apply to transactions of a qualified business unit included in the computation of gain or loss under paragraph (g)(2)(i). The provisions of this paragraph (g)(4) do apply, however, to other currency transactions of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency under section 985(b)(3) and § 1.985-3T. If the controlled foreign corporation does not specifically identify the qualified business transactions (or category of qualified business transactions) to which a hedging transaction relates or is unable to specifically identify the amount of foreign currency gain or loss derived from the hedging transactions, the district director in his sole discretion may make the identifications required of the controlled foreign corporation and determine which hedging transactions (if any) are related to qualified business transactions, and the amount of foreign currency gain or loss attributable to the qualified hedging transactions.

(ii) *Change in purpose of hedging transaction.* If a hedging transaction is entered into for one purpose, and the purpose for that transaction subsequently changes, the transaction may be treated as two separate hedging transactions for purposes of this paragraph (g)(4). In such a case, the portion of the transaction that relates to a qualified business transaction is considered a qualified hedging transaction if it separately meets all the other requirements of this paragraph (g)(4) for treatment as a qualified hedging trans-

action. For purposes of paragraph (g)(4)(i)(C), the foreign corporation must identify on its records the portion of the transaction that relates to a qualified business transaction by the close of the fifth day after the day on which the hedge becomes so related (*i.e.*, either the day on which the hedge is first entered into or on the day on which it first relates to a qualified business transaction due to a change in its purpose). The foreign corporation must identify on its records the portion of the transaction that does not relate to a qualified business transaction by the close of the fifth day after the day on which the purpose for the hedging transaction changes.

(5) *Election out of tracing—(i) In general.* A controlled foreign corporation may elect to account for currency gains and losses under section 988 and gains and losses from section 1256 currency contracts by including in the computation of foreign personal holding company income under this paragraph (g) all foreign currency gains or losses attributable to section 988 transactions, and all gains or losses from section 1256 foreign currency contracts. Separate elections for section 1256 foreign currency contracts and section 988 transactions are not permitted. If a controlled foreign corporation makes the election described in this paragraph (g)(5)(i), the election is effective for all related persons as defined in section 954(d)(3) and the regulations thereunder.

(ii) *Exception.* The election provided by this paragraph (g)(5) does not apply to foreign currency gain or loss of a qualified business unit determined under § 1.985-3T(d)(2). It does, however, apply to other foreign currency gains or losses of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency.

(iii) *Procedure—(A) In general.* The election provided by this paragraph (g)(5) shall be made in the manner prescribed in this paragraph and in subsequent administrative pronouncements.

(B) *Time and manner.* The controlled foreign corporation may make the election by filing a statement with its original or amended information return for the taxable year for which the election is made. The controlling

United States shareholders, as defined in § 1.964-1(c)(5), may make the election on behalf of the controlled foreign corporation and related corporations by filing a statement to such effect with their original or amended income tax returns for the taxable year during which the taxable year of the controlled foreign corporation for which the election is made ends. The election is effective for the taxable year of the controlled foreign corporation for which the election is made, for the taxable years of all related controlled foreign corporations ending within such taxable year, and for all subsequent years of such corporations. The statement shall include the following information:

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

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

(3) Any additional information to be required by the Secretary by administrative pronouncement.

Each United States shareholder or controlled foreign corporation filing the election must provide copies of the election to all controlled foreign corporations for which the election is effective, and all United States shareholders of such corporations. However, failure to provide such copies will not void (or cause to be voidable) an election under this paragraph (g)(5).

(C) *Termination.* The election provided by this paragraph (g)(5) may be terminated only with the consent of the Commissioner: Attn.: CC:INTL.

(h) *Income equivalent to interest—(1) In general.* Foreign personal holding company income includes income that is equivalent to interest. Income equivalent to interest includes, but is not limited to, income derived from the following categories of transactions:

(i) An investment, or series of integrated transactions which include an investment, in which the payments, net payments, cash flows, or return predominantly reflect the time value of money, and

(ii) Transactions in which the payments or a predominant portion thereof are in substance for the use or

forebearance of money, but are not generally treated as interest.

However, amounts treated as interest under section 954(c)(1)(A) and paragraph (b) of this section are not income equivalent to interest under this paragraph (h). Income from the sale of property will not be treated as income equivalent to interest for purposes of this paragraph (h), subject to the rule of paragraph (h)(4) of this section, unless the sale is part of an integrated transaction that gives rise to interest or income equivalent to interest. See sections 482, 483 and 1274 for the extent to which such income may be characterized as interest income subject to paragraph (b) of this section. Income equivalent to interest for purposes of this paragraph (h) includes all income attributable to a transfer of securities subject to section 1058. Income equivalent to interest also includes a portion of certain deferred payments received for the purpose of services, in accordance with the provisions of paragraph (h)(5) of this section. Income equivalent to interest does not include income attributable to notional principal contracts such as interest rate swaps, currency swaps, interest rate floor agreements, or similar contracts except to the extent that such contracts are part of an integrated transaction that gives rise to income equivalent to interest. Income derived from notional contracts by a person acting in its capacity as a regular dealer in such contracts will be presumed not to be integrated with an investment.

(2) *Illustrations.* The following examples illustrate the application of this paragraph (h):

Example 1. CFC, a controlled foreign corporation, promises that A, an unrelated person, 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, A pays CFC a commitment fee of \$2.00. Pursuant to this loan commitment, CFC lends \$80 to A. As a result, the entire \$2.00 fee is included in the computation of foreign personal holding company income under this paragraph (h)(1)(ii).

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 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 *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 *A* on the bond. That interest is foreign personal holding company income under section 954(c)(1) and § 1.954-2T(b), and thus is not income equivalent to interest. During its current taxable year, *CFC* incurs \$10 of interest expense with respect to the borrowing from *B*. That expense is allocated and apportioned to, and reduces, foreign base company income or insurance income to the extent provided in sections 954(b)(5), 863(e), and 864(e) and the regulations thereunder.

Example 3. (i) At the beginning of its 1988 taxable year, *CFC*, a controlled foreign corporation, purchases at face value a one-year debt instrument issued by *A* having a \$100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate (“LIBOR”) plus one percentage point payable on the last day of *CFC*’s current taxable year. *CFC* subsequently determines that it would prefer receiving interest at a fixed rate, and, on January 1, 1989, enters into an agreement with *B*, an unrelated person, whereby *B* promises to pay *CFC* on the last day of *CFC*’s 1989 taxable year an amount equal to 10 percent on a notional principal amount of \$100. In exchange, *CFC* promises to pay *B* on the last day of *CFC*’s 1989 taxable year an amount equal to LIBOR plus one percentage point on the notional principal amount.

(ii) *CFC* receives a total of \$10 from *B*, and pays \$9 to *B*. *CFC* also receives \$9 from *A*. The \$9 paid to *B* is directly allocated to, or is otherwise an adjustment to, the \$10 received from *B*. The transactions are considered an integrated transaction giving rise to \$9 of interest income (paid by *A*) and, under paragraph (h)(1)(i), \$1 of income equivalent to interest (paid by *B*).

Example 4. The facts are the same as in Example 3, except that *CFC* does not hold any debt obligations. Since the transaction with *B* is not integrated with an investment giving rise to interest or income equivalent to interest, the net \$1 of income realized by *CFC* does not constitute income equivalent to interest.

Example 5. (i) *CFC*, a controlled foreign corporation, enters into an agreement with *A* whereby *CFC* purchases commodity X from *A* at a price of \$100, and *A* contemporaneously repurchases commodity X from *CFC* for payment and delivery in 3 months at a price of \$104 set by the forward market.

(ii) The transaction is in substance a loan from *CFC* to *A* secured by commodity X. Thus, *CFC* accrues \$4 of gross income which is included in foreign personal holding com-

pany income as interest under section 954(c)(1)(A) and paragraph (b) of this section.

Example 6. (i) *CFC* purchases commodity Y on the spot market for \$100 and contemporaneously, sells commodity Y forward for delivery and payment in 3 months at a price of \$104 set by the forward market.

(ii) The \$100 paid on the spot purchase of commodity Y offsets any market risk on the forward sale so that the \$4 of income to be derived predominantly reflects time value of money. Thus, under paragraph (h)(1)(i), the spot purchase of commodity Y and the offsetting forward sale will be treated as an integrated transaction giving rise to \$4 of income equivalent to interest.

(3) *Income equivalent to interest from factoring*—(i) *General rule.* Income equivalent to interest includes factoring income. Except as provided in paragraph (h)(3)(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 rules of this paragraph (h)(3) 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. 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).

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

(A) Income treated as interest under section 864(d)(1) or (6) and the regulations thereunder (relating to income derived from trade or service receivables of related persons), even if such income is not treated as 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 equivalent 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)(3), 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)(3), 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) *Illustrations.* The following examples illustrate the application of this paragraph (h)(3).

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 short term Federal rate (determined as of the date the receivable is acquired). FS purchases the receivables from X for \$95 on Day 1 and collects \$100 from the obligor under the receivable on Day 40. Income (other than stated interest) derived by FS from the factored receivables is factoring income within the meaning of paragraph (h)(3)(i) of this section and, therefore, is income equivalent to interest.

Example 2. The facts are the same as in example 1, except that FS does not pay X for the receivables until Day 30. Income derived by FS from the factored receivables is not

factoring income by reason of paragraph (h)(3)(ii)(B) of this section.

Example 3. The facts are the same as in example 2, 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 not factoring income by reason of paragraph (h)(3)(ii)(C) of this section, and therefore does not give rise to income equivalent to interest.

Example 4. The facts are the same as in example 1, except that, rather than collecting \$100 from the obligor under the factored receivable on Day 40, FS sells the receivable to controlled foreign corporation Y on Day 15 for \$97. Both the income derived by FS on the factored receivable and the income derived by Y (other than stated interest) on the receivable are factoring income within the meaning of paragraph (h)(3)(i) of this section, and therefore, constitute income equivalent to interest.

Example 5. The facts are the same as in example 4, except that FS sells the factored receivable to Y for \$99 on Day 45, at which time interest is accruing on the unpaid balance of \$100. FS has \$4 of net factoring income that is income equivalent to interest. Because interest was accruing at the time Y acquired the receivable at a rate equal to at least 120 percent of the applicable short term Federal rate, income derived by Y from the factored receivable is not factoring income by reason of paragraph (h)(3)(ii)(B).

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. By prearrangement with DP, on Day 7, X transfers the receivable 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)(3)(i) of this section and, therefore, is income equivalent to interest.

(4) *Determination of sales income.* Income equivalent to interest for purposes of this paragraph (h) does not include income from the sale of property unless the sale is part of an integrated transaction that gives rise to interest or income equivalent to interest. 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 and 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.

(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 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 (section 1271 *et seq.*), if—

(A) Such provisions applied to contracts for the performance of services,

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

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

[T.D. 8216, 53 FR 27498, July 21, 1988; 53 FR 29801, Aug. 8, 1988, as amended by T.D. 8556, 59 FR 37672, July 25, 1994. Redesignated and amended by T.D. 8618, 60 FR 46530, Sept. 7, 1995]

PART 5—TEMPORARY INCOME TAX REGULATIONS UNDER THE REVENUE ACT OF 1978

AUTHORITY: 26 U.S.C. 7805.

§ 5.6411-1 Tentative refund under claim of right adjustment.

(a) *Effective date.* This section applies to applications for tentative refunds filed after November 5, 1978, under section 6411(d).

(b) *In general.* Section 6411(d) allows taxpayers to apply for a tentative refund of amounts treated under section 1341(b)(1) as an overpayment of tax

under a claim of right adjustment. This section contains rules for filing an application for this tentative refund. The computation of amounts treated as an overpayment must be made in accordance with section 1341 and the regulations under that section.

(c) *Method of applying for tentative refund—(1) In general.* For a corporation, the application is made by filing Form 1139. For taxpayers other than corporations, the application is made by filing Form 1045. The application must be made by filing those forms even if the taxpayer is not applying for a tentative carryback adjustment under section 6411(a). If the taxpayer files the form to apply for the section 6411(d) tentative refund only, it may disregard those lines on the form used to compute the section 6411(a) carryback adjustment. If the taxpayer has a carryback of a net operating loss, credit, or capital loss for the taxable year (determined without the deduction described in section 1341(a)(2)) and applies for both the section 6411(a) tentative carryback adjustment and the section 6411(d) tentative refund, an ordering rule applies. The taxpayer must take into account any adjustments made in applying for the tentative carryback adjustment under section 6411(a) before determining the amount of the overpayment for which an application under section 6411(d) is being made. The taxpayer must attach to the form a separate schedule containing the information required under paragraph (d) of this section.

(2) *Applications made before February 7, 1980.* Applications made before February 7, 1980 that are made under penalties of perjury will be considered meeting the requirements of this section if made by filing a separate statement whether or not it is attached to Form 1139 or 1045. This application, however, must contain the information required under paragraph (d) of this section (other than paragraph (d)(2)).

(d) *Information required—(1) In general.* The application must contain (i) the taxpayer's name, address, and identification number and (ii) the information set forth in paragraph (d) (2) and