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Defining the Passive Income of Controlled Foreign Corporations

Eric T. Laity, *Oklahoma City University School of Law*



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Defining the Passive Income of Controlled Foreign Corporations

Eric T. Laity[†]

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[†] B.A., J.D., Harvard University. Associate Professor of Law, Oklahoma City University School of Law. The research for this Article was supported in part by a grant from the Kerr Foundation. Copyright 1996 by Eric T. Laity.

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I. Introduction

The United States generally taxes its multinational corporations on the passive income of their controlled foreign corporations (CFCs).¹ Doing so removes the benefit of deferring United States tax on passive income until it is repatriated to the parent company in the form of a dividend or other payment. In contrast, the active income of a CFC generally enjoys the benefit of tax deferral and is not taxed to the parent company unless it is repatriated.² Removing the benefit of deferral from a CFC's passive income is justified on the basis of capital export neutrality. The Internal Revenue Code (Code), it is said, should be a neutral factor in a parent corporation's decision to export capital abroad or to invest the capital domestically.³ Bestowing the benefit of deferral, on the other hand, is justified on the conflicting basis of capital import neutrality. The Code, arguably, should permit a United States multinational group to receive the return on capital it imports into a foreign jurisdiction under the same overall tax burden as its local foreign competitors receive theirs.⁴ From this point of view, deferral permits United States multinationals to compete on an equal basis with their foreign competitors.⁵

The differing United States tax treatment of a CFC's passive income and its active income lends significance to the definition of passive income.⁶ In light of the dilemma posed by the conflicting goals of capital export neutrality and capital import neutrality, one would expect the boundary between a CFC's passive income and its

¹ I.R.C. §§ 951(a)(1)(A)(i), 952(a)(2), 954(a)(1) (West Supp. 1995).

² Exceptions include the foreign subsidiary's foreign base company sales income and services income, which are taxed to the United States parent as those types of income are earned. I.R.C. §§ 951(a)(1)(A)(i), 952(a)(2), 954(a)(2), (3).

³ or a brief account of capital export neutrality as a basis for international tax policy, see CHARLES H. GUSTAFSON & RICHARD C. PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* ¶ 1091 (1990).

⁴ For a brief account of capital import neutrality as a basis for international tax policy, see CHARLES H. GUSTAFSON & RICHARD C. PUGH, *TAXATION OF INTERNATIONAL TRANSACTIONS* ¶ 1091 (1991).

⁵ S. REP. No. 1881, 87th Cong., 2d Sess. 78 (1962), *reprinted in* 1962-3 C.B. 703, 789. For a brief account of the general background of Subpart F, see 2 JOSEPH ISENBERGH, *INTERNATIONAL TAXATION* ¶ 25.5 (1990).

⁶ The definition of a controlled foreign corporation's (CFC's) passive income is also important for the computation of its United States shareholders' foreign tax credits, the limitations on which distinguish between a CFC's passive income and its active income. I.R.C. § 904(1)(d)(A), (1)(d)(I), (2)(A)(i), (3). For one kind of United States multinational group, the characterization of a CFC's income as passive offers relief from United States income taxation. The Internal Revenue Service (IRS) currently is ruling that the foreign personal holding company income of captive offshore insurance subsidiaries is not taxed as unrelated business taxable income (UBTI) to United States shareholders who are tax-exempt organizations. Other types of Subpart F income, however, are taxed as UBTI to exempt organizations. Priv. Ltr. Rul. 90-43-039 (July 30, 1990).

active income to be fraught with uneasy compromises. This article analyzes in detail the United States definition of the passive income of CFCs and makes ten recommendations about the definition and its implementation.

The Code refers to the passive income of CFCs as "foreign personal holding company income."⁷ Foreign personal holding company income (FPHCI) consists of income in any of five categories: (1) the composite category of dividends, interest, rents, royalties and annuities; (2) income equivalent to interest; (3) foreign currency gain; (4) gain from commodities transactions; and (5) gain from the disposition of certain property.⁸ Each category comes with its own exclusions and special considerations, primarily as a result of the Code grappling with the distinction between passive and active income. If a single item of income falls within more than one category, the item is classified by giving priority to the categories in the order in which they have just been listed ((1)-(5)).⁹ In addition, an item of income falls outside the definition of FPHCI altogether if it also constitutes insurance income, oil-related income or shipping income as those terms are defined for purposes of Subpart F of the Code.¹⁰ For gain or loss falling within the last four categories of FPHCI, a change in the use or purpose of the property giving rise to the gain or loss can change the classification of the item. Such a change might move the item of gain or loss either among the categories of FPHCI or between a category and an exception to the category, possibly throwing the item out of FPHCI completely. Various rules apply to gauge the effect of a change in use or purpose.¹¹

⁷ I.R.C. § 954(a)(1), (c). The term "foreign personal holding company income" is a misnomer today. There is nothing necessarily personal about the CFC, for example. The use of the phrase came about through an economy of drafting. The Revenue Act of 1962 defined the passive income of controlled foreign corporations in section 954(c) by a cross-reference, with modifications, to the already-existing section 553 of the Internal Revenue Code (Code), one of several sections that deal with foreign personal holding companies. S. REP. No. 1881, *supra* note 5, at 78, *reprinted in* 1962-3 C.B. at 789. Today, the definition of foreign personal holding company income for purposes of controlled foreign corporations is self-contained in section 954(c), having been shorn of its connections to subchapter G; the label has remained. I.R.C. § 954(c).

⁸ I.R.C. § 954(c)(1).

⁹ Treas. Reg. § 1.954-2(a)(2) (1995).

¹⁰ *Id.* § 1.954-1(e)(4). The classification of FPHCI takes precedence over the classifications of foreign base company sales income and foreign base company services income. *Id.*

¹¹ The use or purpose that governs the classification of a gain or loss generally is determined solely by its duration; the use or purpose that continues for more than half of the CFC's holding period generally controls the classification of the gain or loss arising from the disposition of the asset. Treas. Reg. § 1.954-2(a)(3)(i). However, a change in purpose or use is ignored, even if the subsequent purpose or use is the predominant one, if a principal purpose of the change was to avoid including the gain or loss in the computation of FPHCI. Treas. Reg. § 1.954-2(a)(3)(ii)(A). Bona fide hedging transactions are not subject to the general rule. A hedging transaction will be considered a bona fide hedging

II. Dividends, Interest, Rents, Royalties and Annuities

FPHCI generally includes dividends, interest, rents, royalties and annuities.¹² These are certainly the classic examples of passive income. There are, however, several exclusions from this first category of FPHCI. The exclusions generally identify rents and royalties derived from active business activities, a narrow class of interest derived from financing export sales of American-made goods, and certain intragroup payments with little potential for tax avoidance.¹³ There is no exclusion per se for interest income derived from active business activities.¹⁴ All of the exclusions remove income entirely from the scope of FPHCI; income so excluded is not eligible for inclusion in another category of FPHCI.¹⁵

A. *Exclusion for Rents and Royalties Derived in an Active Business*

FPHCI does not include rents or royalties that are derived by the CFC in the active conduct of a trade or business.¹⁶ Rents or royalties received from a related person, however, are not eligible for the exclusion.¹⁷ Such rents and royalties are eligible for a separate exclusion only if additional requirements are met.¹⁸ Whether rents or royalties are derived in the active conduct of a trade or business is determined by reference to specific categories defined by the regulations under section 954(c).¹⁹ The general burden of those regulations is to separate active businesses from investing or financing activities.

There are four categories of rental income that are deemed to be derived in the active conduct of a trade or business. The first category is available to lessors who manufacture the products they lease.²⁰ The manufacturer of office equipment who sells or leases its products to its

transaction only for so long as it meets the definition of bona fide hedging transaction given in Treasury Regulation section 1.954-2(a)(4)(ii). Treas. Reg. § 1.954-2(a)(3)(ii)(B). Hence, if a change in purpose or use removes a hedging transaction from the definition of bona fide hedging transaction, gain or loss from the transaction is reclassified regardless of the duration of its status as bona fide.

¹² I.R.C. § 954(c)(1)(A).

¹³ I.R.C. § 954(c)(2)(A), (B).

¹⁴ Prior to the enactment of the Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (1986), there was an exclusion from FPHCI for certain interest and dividends derived by banks and insurance companies. I.R.C. § 954(c)(3)(B) (amended by Tax Reform Act of 1986, Pub. L. No. 99-514, § 1221(a)(1), 100 Stat. 2085, 2549 (1986)). For a discussion of the former exclusion, see Rev. Rul. 82-209, 1982-2 C.B. 157.

¹⁵ Treas. Reg. § 1.954-2(b)(2).

¹⁶ I.R.C. § 954(c)(2)(A).

¹⁷ *Id.*

¹⁸ *Id.* § 954(c)(3)(A)(ii). For a discussion of the exclusion for rents and royalties received from related persons, see part II.C.2 of this Article.

¹⁹ Treas. Reg. § 1.954-2(b)(6).

²⁰ *Id.* § 1.954-2(c)(1)(i).

customers qualifies for this exclusion.²¹ The lessor must be regularly engaged in the manufacturing of such products.²² Provision is made for those CFCs that do not manufacture from scratch, but that acquire property and add substantial value to the property.²³ For this purpose, the performance of marketing services is not considered to add substantial value.²⁴ The second category is available to owners of real property who, through their own employees, actively manage and operate their property.²⁵ The third category is available to a CFC that owns personal property it ordinarily uses in the active conduct of a trade or business, but that leases out the property temporarily when the property is idle.²⁶ The example given in the regulations is that of an oil well services company that leases out a drilling rig between drilling contracts.²⁷

The fourth category of rental income is available to those lessors who do not manufacture the property they lease, but who have a substantial marketing organization.²⁸ The marketing organization must be located in a foreign country and be staffed with employees of the lessor.²⁹ The marketing organization is permitted to service the leased property without causing the loss of the exclusion.³⁰ The substantiality of the marketing organization is usually a question of fact, but the regulations provide a safe harbor determined by comparing the expense incurred by the organization with the rental income generated by the leased property.³¹ A marketing organization is considered to be substantial if its specified leasing expenses³² equal or exceed twenty-five percent of the gross income of the lessor, adjusted as specified,³³ from the property leased through the efforts of the organization.³⁴ The typical car rental company is a candidate for this favored category, but not the usual car leasing company.³⁵

²¹ *Id.* § 1.954-2(c)(3), ex. 1.

²² *Id.* § 1.954-2(c)(1)(i).

²³ *Id.*

²⁴ *Id.* § 1.954-2(c)(2)(i).

²⁵ *Id.* § 1.954-2(c)(1)(ii).

²⁶ *Id.* § 1.954-2(c)(1)(iii).

²⁷ *Id.* § 1.954-2(c)(3), ex. 5.

²⁸ *Id.* § 1.954-2(c)(1)(iv).

²⁹ *Id.* The marketing organization need not be located in the same foreign country as the leased property, however. *Id.*

³⁰ *Id.*

³¹ *Id.* § 1.954-2(c)(1)(iv), (2)(ii).

³² *Id.* § 1.954-2(c)(2)(iii).

³³ *Id.* § 1.954-2(c)(2)(iv).

³⁴ *Id.* § 1.954-2(c)(2)(ii).

³⁵ *Id.* § 1.954-2(c)(3), ex. 2. The IRS has ruled privately that, as long as a CFC's marketing organization meets the requirements of the safe harbor, the conversion of the CFC's automobile leases into financial leases for purposes of generally accepted accounting principles through the purchase of residual value insurance does not affect the CFC's qualification for the active-rents exclusion. Priv. Ltr. Rul. 95-11-048 (Dec. 23, 1994).

There are two categories of royalty income that are deemed to be derived in the active conduct of a trade or business. The first category is available to licensors who create the property they license.³⁶ The licensor must be regularly engaged in the creation of such property.³⁷ Provision is made for those CFCs that do not develop property from scratch, but that acquire property and add substantial value to the property.³⁸ For this purpose, the performance of marketing services is not considered to add substantial value.³⁹ Designing specialized production equipment required for the commercial application of a purchased process patent would be adding substantial value to the patent if the equipment were designed through the efforts of a substantial staff of employees consisting of scientists, engineers and technicians.⁴⁰

The second category of royalty income is available to those licensors who do not create the property they license, but who have a substantial marketing organization.⁴¹ The marketing organization must be located in a foreign country and be staffed with employees of the licensor.⁴² The substantiality of the marketing organization is determined by comparing the expense incurred by the organization with the licensing income generated by the licensed property.⁴³ A marketing organization is considered to be substantial if its specified licensing expenses⁴⁴ equal or exceed twenty-five percent of the gross income of the licensor, adjusted as specified,⁴⁵ from the property licensed through the efforts of the organization.⁴⁶

Royalties derived from oil and gas properties or from mineral properties fall into neither category, and thus are ineligible for the exclusion for royalties derived in an active business.

B. Exclusion for Export-Related Interest

FPHCI does not include interest that is derived in the conduct of a banking business and that qualifies as export financing interest.⁴⁷ Export financing interest is any interest derived from financing the sale, for use outside the United States, of property produced within the

³⁶ Treas. Reg. § 1.954-2(d)(1)(i).

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.* § 1.954-2(d)(2)(i).

⁴⁰ *Id.* § 1.954-2(d)(3), ex. 3.

⁴¹ *Id.* § 1.954-2(d)(1)(ii).

⁴² *Id.*

⁴³ *Id.* § 1.954-2(d)(2)(ii).

⁴⁴ *Id.* § 1.954-2(d)(2)(iii).

⁴⁵ *Id.* § 1.954-2(d)(2)(iv).

⁴⁶ *Id.* § 1.954-2(d)(2)(ii).

⁴⁷ I.R.C. § 954(c)(2)(B) (West Supp. 1995).

United States.⁴⁸ Interest derived from financing the performance of services is not eligible for this exclusion. The property must have been produced by the CFC or a related person.⁴⁹ Hence, the interest must be earned by the financing arm of a producer, rather than by an independent bank. For purposes of this production requirement, a related person is one who controls the CFC, is controlled by the CFC or is under common control with the CFC.⁵⁰ Control is defined in turn as having more than fifty percent of the stock or beneficial interests in the persons involved.⁵¹ The exported property must be primarily of United States origin; not more than fifty percent of the fair market value of the property can be attributable to products imported into the United States.⁵² In order for interest income to be derived in the conduct of a banking business, the CFC in issuing and servicing the loan must have engaged, through its own employees, in all the activities in which banks customarily engage in issuing and servicing a loan.⁵³ Conventional factoring presumably is considered a part of the banking business for this purpose, and a CFC's interest income from factoring is eligible for the exclusion.

Because of the throw-back rule for income from related-person factoring, discussed below,⁵⁴ the exclusion for export-related interest is available primarily to CFCs that finance the sales by independent dealers of property produced by the CFC or a person related to the CFC. The exclusion is not available for financing the purchases of those dealers. If the exclusion for export-related interest applies to an item of income, the item is removed from FPHCI altogether.⁵⁵ It cannot fall within the category of income equivalent to interest, for example, since the exclusion is absolute for purposes of defining a CFC's FPHCI.

1. *Throw-Back Rule for Income from Related-Person Factoring*

Interest income that also constitutes income from related-person factoring, as defined, is excluded from the definition of export financing interest, and thus is thrown back into FPHCI.⁵⁶ Income

⁴⁸ *Id.* § 904(d)(2)(G).

⁴⁹ *Id.* § 904(d)(2)(G)(i).

⁵⁰ *Id.* §§ 904(d)(2)(H), 954(d)(3).

⁵¹ *Id.* § 954(d)(3). Ownership of stock is determined either by voting power or by value. Rules similar to the rules of section 958 for indirect and constructive ownership apply. *Id.*

⁵² *Id.* § 904(d)(2)(G)(ii). The fair market value of any imported property is its appraised value for purposes of section 402 of the Tariff Act of 1930, 19 U.S.C. § 1401a (1988). I.R.C. § 904(d)(2)(G).

⁵³ Treas. Reg. § 1.954-2(b)(2)(iii) (1995).

⁵⁴ See *infra* part II.B.1.

⁵⁵ Treas. Reg. § 1.954-2(b)(2).

⁵⁶ I.R.C. § 864(d)(5)(A)(iii).

from related-person factoring includes the income from a trade receivable acquired from a related person.⁵⁷ Such income also includes income from a loan made for the purpose of financing the purchase of inventory of a related person.⁵⁸ A loan made for the purpose of financing the purchase of property other than inventory will not give rise to income from related-party factoring, and hence its interest income may qualify for the exclusion from FPHCI for export-related interest.⁵⁹ A related person for the purposes of related-person factoring is defined as any United States shareholder of the CFC or any person deemed to be related to either the CFC or a United States shareholder under section 267(b) of the Code.⁶⁰ The use of a different definition of related person for the throw-back rule from the definition used for the producer requirement of the basic exclusion results in an anomaly. An estate related to the CFC can qualify as a related producer, and the CFC can purchase its receivables and finance its sales without engaging in related-person factoring.⁶¹

2. Same-Country Exception to the Throw-Back Rule

Income from related-party factoring does not include income arising from a trade receivable covered by the same-country exception.⁶² Hence, interest income arising from a receivable covered by the same-country exception is eligible for the export-related interest exclusion from FPHCI. The same-country exception applies to a trade receivable acquired by a CFC from a related person if three conditions are met. First, both the CFC and the related person must be orga-

⁵⁷ *Id.* § 864(d)(1). Income from a service receivable acquired from a related person is also income from related-person factoring. *Id.* However, the exclusion for export-related interest is available only in connection with receivables arising from the sale of goods. I.R.C. § 904(d)(2)(G).

⁵⁸ I.R.C. § 864(d)(6). Income from a loan made for the purpose of financing the payment for the performance of services by a related person is also included in income from related-party factoring. *Id.* However, the exclusion for export-related interest is available only in connection with the financing of the sale of goods and not of services. I.R.C. § 904(d)(2)(G).

⁵⁹ I.R.C. § 864(d)(3)(A); Treas. Reg. § 1.954-2(b)(2)(ii), (iv), ex. 1.

⁶⁰ I.R.C. § 864(d)(4).

⁶¹ The beneficiaries of the estate, however, may well be related persons of the CFC for the purposes of related-person factoring. *Id.* § 267(c)(1). Similar anomalies may exist for corporations in light of the absence of a voting power test in section 267(b) and the lack of an indirect ownership test in some parts of section 267(b). Compare I.R.C. § 954(d)(3) (use of a voting power test and an indirect ownership test to satisfy the ownership requirement) with I.R.C. § 267(b)(2), (8), (10), (11), (12) (no use of a voting power test) and I.R.C. § 267(b)(10), (11), (12) (no use of an indirect ownership test). Through these discrepancies it may be possible to identify producers who are related to a CFC for purposes of the basic exclusion, but who are not related persons for the purpose of the throw-back rule. A corporation that is not a related person under section 267(b) may still be a vehicle for attributing ownership to another person for purposes of determining whether that other person is related to the CFC. *Id.* § 267(c).

⁶² *Id.* § 864(d)(7).

nized under the laws of the same foreign country.⁶³ Second, the related person must have a substantial part of its assets that are used in its trade or business located in its country of incorporation.⁶⁴ Third, none of the income from such receivable, if it had been collected by the related person, may constitute foreign base company income or income effectively connected with the conduct of a trade or business within the United States.⁶⁵ The same-country exception also applies to a loan made for the purpose of financing the purchase of inventory of a related person, if the three conditions are met.⁶⁶ By virtue of this same-country exception, a CFC can finance the local sales by a related distributor, incorporated within the same country as the CFC itself, of goods produced by a related person. The definition of a related person in the context of the same-country exception is the same as that used for the throw-back rule for income from related-person factoring.⁶⁷

3. *Financing Distributors*

The combination of the requirements for the exclusion for export-related interest and the requirements for the throw-back rule for related-person factoring income produces the following results.

EXAMPLE ONE: Parent Corporation, a Delaware corporation, manufactures construction equipment in the United States from domestic components. Parent Corporation sells the equipment to Independent Distributor, S.A., a French corporation unrelated to Parent Corporation. Independent Distributor in turn sells the equipment to various construction companies in Europe all of whom are unrelated to Parent Corporation. Controlled Finance, B.V., a Netherlands corporation and wholly-owned subsidiary of Parent Corporation, finances Independent Distributor's purchases of construction equipment from Parent Corporation and also finances the construction companies' purchases of that equipment

⁶³ *Id.* § 864(d)(7)(A).

⁶⁴ *Id.* What constitutes a substantial part of the related person's assets used in a trade or business in such country is not defined in the regulations under section 864(d) of the Code. Use of the fifty percent substantial assets test of Treasury Regulations section 1.954-2(b)(4)(iv) seems appropriate, since the statutory substantiality test of Code section 954(c)(3)(A)(i)(II) is identical to the test of Code section 864(d)(7)(A). For purposes of determining the location of a substantial part of a related person's assets, Temporary Treasury Regulations section 1.864-8T(d)(1) directs the reader to what is now Treasury Regulations section 1.954A-2(e). In light of the fact that the Treasury Regulations section 1.954A-2 now applies only to taxable years of a CFC beginning before January 1, 1987, and has been superseded for current taxable years by Treasury Regulations section 1.954-2, a more apt source of guidance for determining the location of assets would be Treasury Regulations section 1.954-2(b)(4)(vi)-(x).

⁶⁵ I.R.C. § 864(d)(7)(B).

⁶⁶ Temp. Treas. Reg. § 1.864-8T(d)(2) (1988).

⁶⁷ I.R.C. § 864(d)(4).

from Independent Distributor. Result: The interest earned by Controlled Finance from financing the end users' purchases of equipment from Independent Distributor qualifies for the exclusion of export-related interest and is not FPHCI for Controlled Finance. The interest earned by Controlled Finance from financing Independent Distributor's purchases of equipment from Parent Corporation, however, is FPHCI. Such income is from a loan made for the purpose of financing the purchase of goods that are inventory in the hands of Parent Corporation, a person related to Controlled Finance. Such interest income constitutes income from related-person factoring and therefore is not eligible for the exclusion for export-related interest.

EXAMPLE TWO: Same facts as Example One, but the construction equipment is distributed in Europe by Related Distributor, S.A., a French corporation and wholly-owned subsidiary of Parent Corporation. Result: Both the interest earned by Controlled Finance from financing the purchase of equipment by Related Distributor and the interest it earns from financing the sale of equipment by Related Distributor is FPHCI. Neither type of interest income qualifies for the exclusion for export-related interest since both types are income from related-person factoring.

EXAMPLE THREE: Same facts as Example Two, but Related Distributor is incorporated in the Netherlands, conducts its operations there and has a substantial part of its assets located in the Netherlands. Result: The interest earned by Controlled Finance from financing Related Distributor's purchases of equipment from Parent Corporation is income from related-person factoring, does not qualify for the exclusion for export-related interest and is FPHCI. The interest earned by Controlled Finance from financing Related Distributor's sale of equipment to end users in the Netherlands does qualify for the exclusion for export-related interest, since the income qualifies for the same-country exception. The interest earned by Controlled Finance from financing Related Distributor's sale of equipment to end users in European countries other than the Netherlands, however, fails to qualify for the same-country exception and is FPHCI. Related Distributor derives foreign base company sales income from those sales, which disqualifies the interest income derived from financing those sales from the same-country exception.⁶⁸

EXAMPLE FOUR: Same facts as Example Three, but Controlled Finance is merged into Related Distributor and is managed as a separate division of the Dutch company. Result: None of the interest earned by the combined company from financing its own

⁶⁸ Temp. Treas. Reg. § 1.864-8T(d)(2)(iii)(A).

sales of equipment to European end users is FPHCI, since all of that interest qualifies for the export-related interest exclusion. The throw-back rule for income from related-person factoring does not apply, since the seller is financing its own sales.⁶⁹

EXAMPLE FIVE: Same facts as Example One, but Independent Distributor's purchases and sales are financed by Unrelated Controlled Finance, a Netherlands corporation wholly-owned by Domestic National Bank, a United States corporation. Domestic National Bank is not related to Parent Corporation. Result: All interest earned by Unrelated Controlled Finance from financing Independent Distributor's purchases and sales of equipment is FPHCI. The equipment was not produced by a person related to Unrelated Controlled Finance, the interest is not export financing interest, and therefore the interest income does not qualify for the export-related interest exclusion.

4. *Justifying the Exclusion*

From the baseline of including general interest income of a CFC within the income of the CFC's United States shareholders, the exclusion for export-related interest looks like a tax expenditure subsidizing United States exports. However, when viewed in the light of the related-producer requirement, the throw-back rule and the lack of a general exclusion for interest income derived from banking activities, the effectiveness of the exclusion as an export subsidy pales. The exclusion for export-related interest apparently has no justification. It is simply the residue of an export subsidy successively diminished by changes in Subpart F to reduce further the benefit of tax deferral. The exclusion can now be removed from the Code.

RECOMMENDATION ONE: Delete the exclusion for export-related interest, section 954(c)(2)(B), from the Code.

In the alternative, the export subsidy should be available for the interest derived from financing the performance of exported services as well as for the interest derived from financing the export of goods.

ALTERNATE RECOMMENDATION ONE: Expand the exclusion for export-related interest to include interest derived from financing the export of services. The expanded exclusion should be available for income equivalent to interest within the meaning of Treasury Regulations section 1.954-2(h)(5).

The income described by Treasury Regulations section 1.954-2(h)(5)

⁶⁹ The combined company's income derived from sales to end users outside the Netherlands constitutes foreign base company sales income, however. Treas. Reg. § 1.954-3(a)(1)(iii), ex. 5 (1983). In particular, the interest income derived by the combined company from financing those sales now qualifies as foreign base company sales income, since it no longer falls within FPHCI. Treas. Reg. § 1.954-1(e)(4)(ii) (1995).

generally consists of income from receivables arising from the performance of services that is recharacterized as income equivalent to interest under principles similar to those of sections 483 and 1274 of the Code.⁷⁰

C. Exclusions for Income Received from Related Persons

Two exclusions remove certain dividends, interest, rents or royalties from FPHCI if the payments are received by the CFC from related persons. The exclusions differ in three respects. First, the two exclusions differ in the nature of the payments they exclude from FPHCI. The first exclusion removes only dividends from FPHCI, while the second removes dividends, interest, rents and royalties. The two exclusions also differ in the kind of payor whose payments will qualify for favorable treatment. The first exclusion removes payments made only by a related CFC. The second removes payments made by a broader class of related payor. Lastly, the two exclusions differ in their range of ultimate beneficiaries. The first exclusion discriminates among shareholders, benefitting a subset of United States shareholders and leaving others unaffected. The second exclusion benefits all United States shareholders of the recipient CFC.

1. Exclusion for Certain Dividends Received from Another CFC

Earnings and profits of a CFC attributable to amounts that have previously been included in the income of a United States shareholder under section 951(a) are not included again in the income of the United States shareholder when those earnings and profits are distributed to another CFC.⁷¹ Hence, a dividend received by one CFC from another CFC is excluded from FPHCI with regard to a particular United States shareholder if the dividend is made out of earnings and profits attributable to Subpart F income of the payor that has been taxed previously to that United States shareholder. The exclusion prevents income being taxed twice to a single United States shareholder.⁷² For a qualifying United States shareholder, the exclusion removes the relevant portion of a dividend from a CFC's Subpart F income completely and not simply from its FPHCI.⁷³

For the exclusion to apply, the earnings and profits must be distributed through a qualifying chain of ownership.⁷⁴ The CFC

⁷⁰ See *infra* part III of this Article for a more complete description of this type of income.

⁷¹ I.R.C. § 959(b).

⁷² S. REP. No. 1881, *supra* note 5, at 256, *reprinted in* 1962-3 C.B. at 960. A different United States shareholder who is a successor-in-interest to the original United States shareholder may also qualify for the exclusion. I.R.C. § 959(b).

⁷³ I.R.C. § 959(b).

⁷⁴ *Id.*

receiving the distribution must own its stock in the payor CFC either directly, or indirectly through other foreign entities.⁷⁵ Indirect ownership through a domestic entity is not sufficient. Various rules apply to determine when a distribution out of a CFC's earnings and profits is made out of amounts that have previously been included in the income of a United States shareholder.⁷⁶ Even if the payor CFC's United States shareholders do not hold all of its stock, the amount of earnings and profits exempt from tax when distributed to another CFC is the full amount of Subpart F income that was used to calculate the United States shareholders' pro rata inclusions under section 951(a) of the Code, and not just the pro rata inclusions.⁷⁷

2. *Exclusion for Certain Payments from Related Persons*

FPHCI does not include dividends, interest, or certain rents or royalties, if the items are received by the CFC from certain related persons.⁷⁸ The exclusion does not extend to annuity income. The exclusion has been justified on the basis that such payments would not be taxed to the CFC's United States shareholders if the payments were made directly to those shareholders rather than channelled through the CFC.⁷⁹ On the basis of this argument, a United States shareholder should not be penalized for holding its investments in other corporations indirectly through a CFC rather than directly. This is a peculiar argument, in light of the fact that a United States shareholder would indeed be taxed on any payments it received directly from related persons. The justification for the exclusion, if one exists, must lie with the specific conditions for the exclusion established by the rules discussed below. The rules governing dividends and interest differ from the rules governing rents and royalties. The concept of a related person, however, is common to both sets of rules.

a. *Identifying Related Persons*

The related person must be a corporation.⁸⁰ A related person

⁷⁵ *Id.* § 958(a).

⁷⁶ A distribution out of a CFC's earnings and profits is deemed to be made, first, from that corporation's current earnings and profits that are attributable to amounts that are included in the United States shareholder's gross income; second, from the CFC's other current earnings and profits; third, from the CFC's accumulated earnings and profits that are attributable to amounts that have been included in the gross income of the United States shareholder; and, finally, from the CFC's other accumulated earnings and profits. *Id.* § 959(c).

⁷⁷ Rev. Rul. 82-16, 1982-1 C.B. 106.

⁷⁸ I.R.C. § 954(c)(3)(A).

⁷⁹ S. REP. No. 1881, *supra* note 5, at 78, *reprinted in* 1962-3 C.B. at 789.

⁸⁰ I.R.C. § 954(c)(3)(A)(i), (ii). A partnership may also be a related person, in a sense, but only if the partnership has a corporate partner. *Id.* § 954(c)(3)(A). A portion of any payment from such a partnership may be deemed to have been paid by the corporate partner and thus be eligible for the exclusion. *Id.* § 954(c)(3). A corporate partner is treated as the

for the purposes of this exclusion is a corporation that controls the CFC, is controlled by the CFC or is controlled by the same person or persons who control the CFC.⁸¹ Control, in turn, is defined as the ownership of stock possessing more than fifty percent of either the voting power or the value of the stock of the issuing corporation.⁸² Rules similar to the rules for indirect ownership and constructive ownership found in section 958 apply to the determination of control.⁸³ A related person can be either a domestic corporation or a foreign corporation. Moreover, a foreign corporation is not required to be another CFC in order to be a related person for the purposes of this exclusion.

b. Excluded Dividends and Interest

Dividends and interest paid to the CFC by a qualifying related person are generally excluded from FPHCI.⁸⁴ The exclusion permits a United States multinational to use multiple entities in a jurisdiction without adverse consequences under Subpart F if local regulatory requirements make their use advisable instead of the use of a single entity. For example, the exclusion permits the use of a local holding company to limit liability for a particular activity or the use of a local financing subsidiary. In addition to being a related person, the payor of the dividends or interest must meet three qualifications. First, the payor must be incorporated in the same country as the CFC (and thus will be a foreign corporation).⁸⁵ Second, the payor must have a trade or business located in its country of incorporation.⁸⁶ Third, a substantial part of the payor's assets must both be used in that trade or business⁸⁷ and be located in the payor's country of incorporation.⁸⁸

The last two requirements are derived from section 954(c)(3)(A)(i)(II) of the Code. That section specifies that the requisite type of related person is one that "has a substantial part of its assets used in its trade or business located in such same foreign country."⁸⁹ There are two possible readings of that section. On the one hand, the section can be read as a requirement about the location

payor of interest, rent or royalty paid by its partnership generally to the extent that the payment gives rise to a deduction allocable to the corporate partner under the partnership agreement. Treas. Reg. § 1.954-2(b)(4)(i)(B) (1995) (as to interest payments), 1.954-2(b)(5)(i)(B) (1995) (as to rents and royalties).

⁸¹ I.R.C. § 954(d)(3).

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* § 954(c)(3)(A)(i).

⁸⁵ *Id.* § 954(c)(3)(A)(i)(I).

⁸⁶ *Id.* § 954(c)(3)(A)(i)(II); Treas. Reg. § 1.954-2(b)(4)(i)(A)(3) (1995).

⁸⁷ I.R.C. § 954(c)(3)(A)(i)(II).

⁸⁸ Treas. Reg. § 1.954-2(b)(4)(iv).

⁸⁹ *Id.* The reference to "such same foreign country" is to the related person's country of incorporation. *Id.*

of assets. Under this first reading, the section requires that, of the assets the payor uses in its trade or business, a substantial part must be located in its country of incorporation, regardless of the location of its trade or business. Such a reading assumes that the section is equivalent in meaning to the phrase "has a substantial part of its assets [that are] used in its trade or business located in such same foreign country." On the other hand, the Code section can be read as a requirement about the location of a trade or business. Under this second reading, the section requires that the payor have a trade or business located in its country of incorporation, and that the payor use a substantial part of its assets in that trade or business, regardless of where any of those assets might be located. The second reading assumes that the section is equivalent in meaning to the phrase "has a substantial part of its assets used in its trade or business [that is] located in such same foreign country."

Neither reading embodies a satisfactory approach. The first reading leaves open the door for tax avoidance through the means of a related person simply warehousing assets in its country of incorporation without conducting a trade or business there. As long as the warehoused assets were used in the related person's trade or business outside the country and constituted a substantial part of the assets used in that trade or business, the requirements of the first reading would be met. This would permit the exclusion of dividends or interest that are attributable to economic activity taking place outside the recipient CFC's jurisdiction. The second reading permits a related person to qualify under the exclusion simply by maintaining within its country of incorporation a modest component of an international trade or business. Most of the assets used in that international trade or business could be located outside its country of incorporation without jeopardizing the related person's qualification under the exclusion. As with the first reading, this would permit the exclusion of dividends or interest that are attributable to economic activity taking place outside the recipient CFC's jurisdiction. Neither approach seems fully to recognize the existence of related persons with multiple trades or businesses or with international trades or businesses.

The proper approach would take into account two requirements. First, since the economic activity favored by the exclusion seems to be activity that could be carried on by the CFC itself without causing the resulting income to be Subpart F income, the proper approach would examine the location of the activities of the related person and its assets and the connection between the two. Second, since the exclusion in question excludes an entire dividend or interest payment, and not simply the part attributable to favored economic activity, the exclusion should exclude only those dividends and interest payments that are substantially attributable to favored economic activity. The

regulations interpreting the section are consistent with these requirements. The regulations have adopted the proper approach by choosing the second reading⁹⁰ and adding the requirement that the substantial part of the related person's assets used in such trade or business also be located in its country of incorporation.⁹¹ The regulations thereby avoid the flaw of the first reading and compensate for the shortcoming of the second reading.

Once the CFC has confirmed that a dividend or interest payment has been paid by a related person incorporated in the same foreign country as the CFC, the CFC must pursue the following line of analysis: (i) Does the related person have a trade or business in its country of incorporation? (ii) If so, what assets does the related person have in its country of incorporation? (iii) Then, which of those assets are used in its trade or business in that country? (iv) Then, are its assets so located and so used a substantial part of the assets of the related person? (v) Finally, is the dividend or interest payment subject to one of the applicable throw-back rules and thus still included within the CFC's FPHCI?

i. The Location of the Related Person's Trade or Business

The location of the related person's trade or business must be determined under all of the facts and circumstances.⁹² Generally, the location of the trade or business is determined by the location where the primary managerial and operational activities of the trade or business are conducted.⁹³ This rule should not be taken to mean that a trade or business can be located in only one country. A business with significant industrial plants in several countries presumably is located in all of those places.

ii. The Location of the Related Person's Assets

In order for the exclusion for dividends and interest to apply, the related person must have part of its assets located in its country of incorporation.⁹⁴ The general rules governing the location of assets differentiate between tangible and intangible property,⁹⁵ while specialized rules govern the location of inventory, debt instruments and stock in certain CFCs.⁹⁶ Tangible property, not surprisingly, is generally considered to be located in the country where it is physically

⁹⁰ *Id.* § 1.954-2(b)(4)(i)(C).

⁹¹ *Id.* § 1.954-2(b)(4)(iv).

⁹² Temp. Treas. Reg. § 1.367(a)-2T(b)(4) (1986); Treas. Reg. § 1.954-2(b)(4)(iii).

⁹³ Treas. Reg. § 1.954-2(b)(4)(iii).

⁹⁴ *Id.* § 1.954-2(b)(4)(iv).

⁹⁵ *Id.* § 1.954-2(b)(4)(vi), (vii).

⁹⁶ *Id.* § 1.954-2(b)(4)(viii), (ix), (x).

located.⁹⁷ An exception relocates tangible property that is physically located in another country for the purpose of inspection or repair back to its country of intended use.⁹⁸ The location of intangible property, on the other hand, is generally determined by the site of the related person's activities conducted in connection with the use or exploitation of the property.⁹⁹ If the related person conducts such activities in more than one country, the value of the asset is prorated among those countries.¹⁰⁰ The proration is computed on the basis of the expenses incurred by the related person in its activities conducted in connection with the use or exploitation of the intangible property.¹⁰¹

The specialized rule for inventory also employs an activities test. The location of inventory and dealer property is determined by the site of the related person's activities conducted in connection with the production and sale of such property.¹⁰² If the related person did not produce the property itself but purchased its inventory, the location of the inventory is determined by the site of the related person's activities conducted in connection with the purchase and resale of the property.¹⁰³ If the related person conducts its activities in connection with the inventory in more than one country, the value of the inventory is prorated among the countries.¹⁰⁴ Once again, the proration is accomplished by looking to the costs incurred by the related person in conducting its activities related to inventory.¹⁰⁵

The specialized rule for debt instruments is narrow in its scope. Debt instruments themselves are defined broadly. The term includes not only the usual candidates of bonds, notes and certificates, but includes accounts receivable and other evidences of indebtedness as well.¹⁰⁶ However, only the location of debt instruments that arise from the sale of inventory or from the rendition of services by the related person in the ordinary course of business is relevant for

⁹⁷ *Id.* § 1.954-2(b)(4)(vi)(A).

⁹⁸ *Id.* § 1.954-2(b)(4)(vi)(B).

⁹⁹ *Id.* § 1.954-2(b)(4)(vii)(A). The site of those activities is determined by where the expenses for the activities are incurred. *Id.* If the related person uses an agent or independent contractor for those activities, the related person's expense in using the agent or independent contractor is deemed to be located where the agent or independent contractor in turn incurred its expenses. *Id.*

¹⁰⁰ *Id.* § 1.954-2(b)(4)(vii)(B).

¹⁰¹ *Id.* Expenses used in the proration include not only expenses that are deductible under section 162 of the Code, but expenses that are includible in inventory costs or the costs of goods sold under United States tax accounting principles. *Id.* § 1.954-2(b)(4)(vii)(A).

¹⁰² *Id.* § 1.954-2(b)(4)(viii)(A).

¹⁰³ *Id.* If the related person conducts its activities in connection with the production and sale, or the purchase and resale, of inventory through an agent or independent contractor, the location of that third person's activities is used in applying the activities test. *Id.* Contract manufacturers and sales agents are examples of such third persons.

¹⁰⁴ *Id.* § 1.954-2(b)(4)(viii)(B).

¹⁰⁵ *Id.*

¹⁰⁶ *Id.* § 1.954-2(a)(4)(vii).

purposes of the exclusion. This is so because only those receivables are considered to be used in a trade or business of the related person, and then only for the period that elapses before the related person is required to charge interest on those receivables under the transfer pricing rules of section 482 of the Code.¹⁰⁷ The specialized rule provides that the location of an inventory receivable is determined by the location of the related person's total inventory during the quarter in which the receivable's period of eligibility falls.¹⁰⁸ If the related person's total inventory was located in more than one country, the inventory receivable is prorated among the locations.¹⁰⁹ The location of a service receivable, however, is determined by the location of the services that gave rise to the receivable.¹¹⁰

A specialized rule deems part of a related person's stock in certain CFCs to be located in the related person's country of incorporation (related person CFC look-through rule). The CFC must be incorporated in the same country as the related person, and the CFC must conduct a trade or business in that country.¹¹¹ The CFC should also have assets located in its country of incorporation, although the requirement is not explicit.¹¹² If those requirements are met, a pro-rata portion of the related person's stock in the CFC is deemed located in the related person's country of incorporation.¹¹³ The proration is based upon the value of the CFC's assets so located and used in a trade or business conducted by the CFC in its country of incorporation compared to the value of all of the CFC's assets.¹¹⁴

The implicit requirement about the location of the CFC's assets used in its trade or business conducted within its country of incorporation should be made explicit. The requirement is justified since it prevents the inclusion, in the determinations using the related-person CFC look-through rule, of economic activity conducted outside the

¹⁰⁷ *Id.* § 1.954-2(b)(4)(ix). The location of debt instruments that constitute inventory or dealer property is governed instead by the specialized rule for inventory. *Id.* § 1.954-2(b)(4)(viii)(A).

¹⁰⁸ *Id.*

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.* § 1.954-2(b)(4)(x). Treasury Decision 8618 omitted the words, "that are used in a trade or business in the country of incorporation," at the end of the first sentence of paragraph (x). T.D. 8618, 1995-40 I.R.B. 10. This surely is a clerical oversight, *see* Temp. Treas. Reg. § 1.954-2T(b)(3)(x) (1988), and the words no doubt will be restored in a subsequent announcement published in the Federal Register.

¹¹² Treas. Reg. § 1.954-2(b)(4)(x). The regulation implicitly requires that the assets be located in the CFC's country of incorporation. Note the regulation's instruction for the manner for determining the location of the CFC's assets. *Id.* This implicit requirement is in keeping with the requirement in Treas. Reg. § 1.954-2(b)(4)(iv) that only assets located in the related person's country of incorporation be used in determining whether a substantial part of the related person's assets are used in a trade or business in that country. *Id.*

¹¹³ Treas. Reg. § 1.954-2(b)(4)(x).

¹¹⁴ *Id.*

CFC's country of incorporation.

RECOMMENDATION TWO: Amend Treasury Regulation section 1.954-2(b)(4)(x) to provide expressly that the proration of the related person's stock in the lower-tier CFC is to be on the basis of the value of the lower-tier corporation's assets that are both located in the lower-tier corporation's country of incorporation and used in a trade or business conducted by the lower-tier corporation in that country compared to the value of all of the lower-tier corporation's assets.

There is no requirement in the look-through rule that the trade or business conducted by the CFC in its country of incorporation be the same as the trade or business the related person conducts there. The omission is justified, since the related person is permitted to conduct multiple trades or businesses in its country of incorporation and still qualify under the exclusion. Nor is there a requirement that a substantial part of the CFC's assets be used in its trade or business conducted within its country of incorporation. This too is justified, since the rule affects only a prorated portion of the related person's stock. A substantiality requirement would be appropriate if the look-through rule required all or none of the related person's shareholding to be located within the related person's country of incorporation.

iii. Use of Those Assets in the Related Person's Trade or Business

Once the CFC has identified the related person's trades or businesses and assets that are located in its country of incorporation, the CFC must then determine which of the assets of the related person are used in the favored trades or businesses. In order for an asset to be considered used in the related person's trade or business in its country of incorporation, the asset must have been placed in service and continue to be in service.¹¹⁵ Apart from that preliminary requirement, whether an asset is used in that trade or business is determined on the basis of all the facts and circumstances.¹¹⁶ Generally, however, and subject to the overriding requirement that the asset have been placed in service, an asset is used in such a trade or business if one of three requirements is met. First, the asset qualifies if it is held for the principal purpose of promoting the present conduct of the trade or business.¹¹⁷ Second, the asset qualifies if it is acquired and held in the ordinary course of the trade or business.¹¹⁸ Third, the asset qualifies if it is otherwise held in a direct relationship

¹¹⁵ *Id.* § 1.954-2(b)(4)(iii).

¹¹⁶ Temp. Treas. Reg. § 1.367(a)-2T(b)(5) (1986); Treas. Reg. § 1.954-2(b)(4)(iii).

¹¹⁷ Temp. Treas. Reg. § 1.367(a)-2T(b)(5)(i); Treas. Reg. § 1.954-2(b)(4)(iii).

¹¹⁸ Temp. Treas. Reg. § 1.367(a)-2T(b)(5)(ii); Treas. Reg. § 1.954-2(b)(4)(iii).

to the trade or business.¹¹⁹ An asset meets the third test if it is held to meet the present needs of the trade or business and not its anticipated future needs.¹²⁰ An asset fails the third test if it is held for the purpose of providing for future diversification into a new trade or business, future expansion of the present trade or business, future plant replacement or future business contingencies.¹²¹

Specialized rules apply to debt instruments and the stock in certain CFCs. For a debt instrument to be considered used in the trade or business that the related person conducts in its country of incorporation, the debt instrument must have arisen in the ordinary course of the trade or business from either the sale of inventory or the rendition of services by the related person.¹²² The receivable is used in the related person's trade or business only until interest must be charged on the debt under the transfer pricing rules of section 482 of the Code.¹²³ If the related-person CFC look-through rule causes part or all of the related person's stock in a CFC to be located in the related person's country of incorporation, that part of the stock is deemed to be used by the related person in a trade or business conducted in that country.¹²⁴

iv. A Substantial Part of the Related Person's Assets

A substantial part of the related person's assets are located in its country of incorporation and used in its trade or business conducted in that country only if more than fifty percent of its assets by value are so located and so used.¹²⁵ The value of the qualifying assets is compared to the value of all of the related person's assets, including those not used in any trade or business.¹²⁶ The fair market value of the related person's assets is used in the determination, without regard to liabilities.¹²⁷ In the absence of evidence to the contrary, the fair market value of an asset is deemed to be its adjusted basis.¹²⁸ If the related-person CFC look-through rule deems part or all of the related person's stock in a CFC to be used by the related person in a trade or

¹¹⁹ Temp. Treas. Reg. § 1.367(a)-2T(b)(5)(iii); Treas. Reg. § 1.954-2(b)(4)(iii).

¹²⁰ Temp. Treas. Reg. § 1.367(a)-2T(b)(5); Treas. Reg. § 1.954-2(b)(4)(iii).

¹²¹ Treas. Reg. § 1.954-2(b)(4)(iii).

¹²² *Id.* § 1.954-2(b)(4)(ix). Debt instruments that are inventory or dealer property are not subject to this specialized rule. *Id.*

¹²³ *Id.*

¹²⁴ *Id.* § 1.954-2(b)(4)(x).

¹²⁵ *Id.* § 1.954-2(b)(4)(iv). The related person must meet the threshold annually by averaging the values of its assets at the close of each quarter of the taxable year. *Id.* Prior regulations provided that the question of whether a substantial part of a related person's assets was located in its country of incorporation depended on the facts and circumstances of each case. A safe harbor test of 80% was available. Rev. Rul. 83-101, 1983-2 C.B. 147.

¹²⁶ Treas. Reg. § 1.954-2(b)(4)(iv).

¹²⁷ *Id.* § 1.954-2(b)(4)(v).

¹²⁸ *Id.*

business conducted in its country of incorporation, the value of that part of the stock is included in the calculation.¹²⁹

As presently worded, the more-than-fifty percent test is a necessary but insufficient condition for qualifying for the exclusion. Yet, there is no statement in the regulations providing that the question of substantiality is one of fact, which it would be if the more-than-fifty percent test was not conclusive on the issue. The failure by the drafters of the current regulations to carry over the eighty-percent safe harbor test of prior regulations suggests that they considered the more-than-fifty percent test to be conclusive.¹³⁰

RECOMMENDATION THREE: Amend Treasury Regulation section 1.954-2(b)(4)(iv) either (1) to provide that a substantial part of the assets of the related person will be considered as located within a related person's country of incorporation and as used in the trades or businesses conducted by the related person in that country if and only if, under the stated method of computation, the value of the assets so located and so used constitutes over fifty percent of all the assets of the related person; or (2) to state that the substantiality of the assets so located and so used depends on all of the facts and circumstances subject to satisfying the more-than-fifty percent test.

v. Throw-Back Rules for Dividends and Interest

Interest or a dividend received by a CFC from a related person will not qualify for the exclusion if the item falls under one of several throw-back rules. The throw-back rules for interest payments differ from the throw-back rules for dividends. The two throw-back rules for dividends are concerned with the possibility that the requirements for the exclusion were not met during the time when the related person accumulated the earnings and profits from which a subsequent dividend is made. The throw-back rules for dividends will deny the exclusion if at the earlier time either the necessary relationship between the payor and the payee did not exist or the related person did not meet the exclusion's definition of a qualified payor.

The first throw-back rule for dividends takes up the issue of the relationship between the CFC and the future payor of the dividend. The rule denies the exclusion to a dividend attributable to earnings and profits of the related person accumulated during a period when the CFC did not hold the stock on which the dividend is paid.¹³¹

¹²⁹ *Id.* § 1.954-2(b)(4)(x).

¹³⁰ Compare *id.* § 1.954A-2(e)(1)(i) with *id.* § 1.954-2(b)(4)(iv).

¹³¹ I.R.C. § 954(c)(3)(C) (West Supp. 1995). This throw-back rule can have a surprising effect. Consider the facts of Priv. Ltr. Rul. 82-26-113 (Mar. 31, 1982). In that ruling, the United States parent corporation proposed to reorganize its foreign subsidiaries so that all of its subsidiaries incorporated in country B would be owned in a single tier by a relatively

The exclusion is still available if, during the period of accumulation, the CFC held the stock indirectly through a chain of one or more subsidiaries, each of which is a related person that meets the necessary qualifications for its own dividends to fall within the exclusion.¹³² The indirect ownership exception makes no demands as to the status of the payor during the period of accumulation. The intervening subsidiaries must meet the necessary qualifications only during the period of accumulation, and not necessarily during later periods.¹³³ The CFC itself is required to hold the stock, either directly or indirectly, only during the period of accumulation and at the time the earnings and profits are distributed as a dividend.¹³⁴ A dividend might be attributable in part to earnings and profits that meet the

new holding company also incorporated in country B. The first step of the reorganization was for the parent corporation to contribute its stock in its own first-tier country-B subsidiaries to the desired holding company. One of those subsidiaries in turn held a number of country-B subsidiaries, so as a second step, that first-tier subsidiary distributed to the desired holding company all of its stock in its own country-B subsidiaries. In this reorganization, no entity was acquired from outside the original corporate family. The first throw-back rule for dividends now causes the second step of the reorganization to result in FPHCI to the new holding company. The holding company did not own the stock, directly or indirectly through a chain of subsidiaries of its own, of the distributing corporation at the time that the distributing corporation accumulated its earnings and profits. The distribution, to the extent of the distributing corporation's earnings and profits, is a dividend to the new holding company and thus is FPHCI.

¹³² I.R.C. § 954(c)(3)(C). The first throw-back rule modifies the holding of *Priv. Ltr. Rul.* 80-19-058 (Feb. 3, 1980). The debentures would now be included in the FPHCI of subsidiary F1 to the extent that they are attributable to the accumulated earnings and profits of any corporation other than the original corporation F2 or corporations F3, F4 or F7. Those are the only corporations that were subsidiaries of F1 prior to the amalgamation described in the private ruling. Note that the other corporations that were party to the amalgamation—F5, F6, F8 and F9—were all related to F1 prior to the amalgamation; no new entities were brought in from outside the corporate family.

¹³³ *Treas. Reg.* § 1.954-2(b)(4)(ii)(A) (1995). The Code uses the present tense, as if the subsidiaries were to meet the qualifications at the time the CFC receives the dividend. This cannot be the relevant period. The exclusion itself is only available for dividends paid directly to the recipient CFC and not indirectly through a chain of ownership. Thus, the intervening subsidiaries that compose the chain of indirect ownership permitted under the indirect-ownership exception must be liquidated (or otherwise removed from the chain of ownership) prior to the payment of the dividend. The intervening subsidiaries must therefore meet the qualifications during the period of accumulation, the period between accumulation and their liquidation, or both. Since the concern of the throw-back rule is with the conditions under which the earnings and profits were generated, the period of accumulation is germane and not the subsequent period. The regulation is justified in limiting the period of scrutiny to the period of accumulation.

¹³⁴ *Treas. Reg.* § 1.954-2(b)(4)(ii)(A). The CFC is not required to hold the stock in the interval between the period of accumulation and the time of payment. The exclusion refers only to the time of payment and the throw-back rule refers only to the period during which the earnings and profits are accumulated. Requiring the CFC to hold the stock in the intervening period is irrelevant to the purpose of the throw-back rule, which ensures that the dividend represents earnings from an activity that could have been conducted by the CFC. The CFC's ownership during a subsequent period cannot affect the source of the earnings. In addition, the statutory basis is lacking for requiring CFC ownership during the subsequent period. The regulation is justified in not requiring ownership of the stock by the CFC during the interval between the period of accumulation and the time of payment.

requirements for the related-person exclusion and in part to earnings and profits that fail to meet those requirements because of the throw-back rule. The throw-back rule applies only to the portion of the dividend attributable to the earnings and profits that fail to meet its requirements and not to the entire dividend.¹³⁵

The second throw-back rule for dividends addresses the status of the payor during the period of accumulation. The rule denies the exclusion to a dividend (even though the CFC held the stock of the payor during the relevant period and thus the dividend escapes the reach of the first throw-back rule for dividends) if, during the period when the payor was accumulating the earnings and profits to which the dividend is attributable, the payor itself was not a related person that met the qualifications for its dividends to be excluded from FPHCI.¹³⁶ There is no requirement that the payor satisfy those qualifications continuously in the interval between the accumulation period and the time of payment. Care must be taken in the reorganization of foreign subsidiaries; this second throw-back rule for dividends will cause distributions made by established foreign corporations to a new holding company to be FPHCI to the holding company.¹³⁷

There are three throw-back rules for interest. The first counteracts the shifting of Subpart F income to avoid United States taxation. The exclusion for interest income received from related persons is not available for payments of interest that reduce the Subpart F income of the payor.¹³⁸ Nor is the exclusion available for payments of interest that create or increase a deficit in the payor's earnings and profits that can be used to reduce Subpart F income under section 952(c).¹³⁹ Thus, the exclusion cannot be used by a United States shareholder to avoid the inclusion of Subpart F income realized by a CFC by shifting

¹³⁵ Treas. Reg. § 1.954-2(b)(4)(ii)(A). The regulation is consistent with Congressional committee reports that describe the throw-back rule as disqualifying a dividend *to the extent that* the distributed earnings and profits were accumulated by the payor during periods when the CFC did not hold the stock on which the dividend was paid. H.R. REP. No. 111, 103d Cong., 1st Sess. 701 (1993), *reprinted in* 1993 U.S.C.A.A.N. 378, 932; H. R. REP. No. 213, 103d Cong., 1st Sess. 636 (1993), *reprinted in* 1993 U.S.C.A.A.N. 1088, 1325.

¹³⁶ Treas. Reg. § 1.954-2(b)(4)(ii)(A)(2). This regulatory throw-back rule was intended by the House Committee on the Budget to survive the addition of Code section 954(c)(3)(C) by the Revenue Reconciliation Act of 1993, P.L. 103-66, § 13233(a)(1), 107 Stat. 312, 502. H.R. REP. No. 111, *supra* note 135, at 701, *reprinted in* 1993 U.S.C.A.A.N. at 932. The IRS has ruled privately that a foreign corporation created through an amalgamation succeeds to a predecessor's attribute of having engaged in a trade or business with respect to the use of its assets. Priv. Ltr. Rul. 80-19-058 (Feb. 13, 1980).

¹³⁷ For an illustration of this problem, see Priv. Ltr. Rul. 82-26-113 (Mar. 31, 1982) (holding that the distribution of stock in an affiliate was FPHCI to the receiving holding company to the extent that the distribution was not made out of earnings and profits of the distributing corporation accumulated during the brief period that the new holding company had been in existence).

¹³⁸ I.R.C. § 954(c)(3)(B) (West Supp. 1995); Treas. Reg. § 1.954-2(b)(4)(ii)(B).

¹³⁹ I.R.C. § 954(c)(3)(B).

that income to another CFC through a deductible payment.

EXAMPLE SIX: Foreign Manufacturing Subsidiary (Manufacturer) manufactures and sells farm equipment in Country X, its country of incorporation and the location of substantially all of its assets used in its trade or business in Country X. Manufacturer finances its sales to dealers in Country X by taking back wholesale installment sales paper issued by the dealers. Manufacturer carries the wholesale paper by borrowing the necessary funds at an arms-length interest rate from its sibling CFC, Foreign Finance Subsidiary (Finance). The interest income received by Finance from Manufacturer would qualify for the related-person exclusion from FPHCI but for the first throw-back rule for interest. To the extent that the manufacturer's interest payments to the finance affiliate reduce its own Subpart F income, the interest income is FPHCI to the finance subsidiary. The interest income that Manufacturer receives from its dealers is Subpart F income, specifically FPHCI, to Manufacturer. To the extent that Manufacturer's payments of interest to Finance are allocated to Manufacturer's Subpart F income, its interest payments to Finance are FPHCI in the hands of Finance.¹⁴⁰

The other throw-back rules for interest apply to portfolio interest and interest derived from related-person factoring. Interest derived from related-person factoring generally is included in FPHCI.¹⁴¹ This throw-back rule is identical to the throw-back rule for income from related-person factoring that applies to the exclusion for export-related interest.¹⁴² When applied to the exclusion for interest received from a related person, the throw-back rule applies to interest derived from trade receivables, services receivables and the financing of purchases of inventory or services from certain related persons.¹⁴³ The same-country exception to the throw-back rule is available.¹⁴⁴ Portfolio interest, as defined in section 881(c) of the Code, also is included in FPHCI.¹⁴⁵

¹⁴⁰ The facts of this example are taken with modifications from Priv. Ltr. Rul. 79-47-050 (Aug. 23, 1979). With the advent of the first throw-back rule for interest, that letter ruling would be decided differently today.

¹⁴¹ I.R.C. § 864(d)(5)(A)(iv).

¹⁴² For a discussion of the throw-back rule for income from related-person factoring, see *supra* part II.B.1 and 2 of this Article.

¹⁴³ I.R.C. § 864(d)(1), (6). Note that the definition of related person applicable to section 864(d) differs from the definition applicable to section 954(c). Compare § I.R.C. 864(d)(4) with I.R.C. § 954(d)(3). Income derived from related-person factoring other than interest is included in FPHCI as income equivalent to interest. I.R.C. § 954(c)(1)(E). Part III of this Article discusses income equivalent to interest as a component of FPHCI.

¹⁴⁴ For a discussion of the same-country exception to the throw-back rule for income from related-person factoring, see *supra* part II.B.2 of this Article.

¹⁴⁵ Treas. Reg. § 1.954-2(b)(4)(ii)(C) (1995).

c. Excluded Rents and Royalties – Throw-Back Rule

Qualifying rents or royalties paid to a CFC by a related person generally are excluded from FPHCI.¹⁴⁶ For rents or royalties to qualify for the exclusion, the income must be paid for the use of or for the privilege of using property within the country of the CFC's incorporation.¹⁴⁷ Unlike the case of dividends and interest received from a related person, there is no restriction on the related person's place of incorporation, the location of the related person's trade or business or on the use or location of the related person's assets.¹⁴⁸ For example, the related person can be a domestic corporation. The exclusion permits a United States multinational to split its operations in a foreign country between an operating subsidiary and a title-holding CFC, with only the title-holding CFC required to be incorporated in the country where the property is located.

The exclusion for rents and royalties received from related persons is not available for payments of rent or royalty that reduce the Subpart F income of the payor.¹⁴⁹ Nor is the exclusion available for payments of rent or royalty that create or increase a deficit in the payor's earnings and profits that can be used to reduce Subpart F income under section 952(c).¹⁵⁰ Thus, the exclusion cannot be used by a United States shareholder to avoid the inclusion of Subpart F income realized by a CFC by shifting that income to another CFC through a deductible payment.

d. Justifying the Exclusion

The exclusion as it pertains to dividends and interest permits the use of local holding companies and financing subsidiaries. The exclusion as it pertains to rents and royalties permits the use of a local property-holding subsidiary. Permitting the use of these specialized subsidiaries distinct from a United States operating subsidiary justifies the related-person exclusion.

D. Tax-Exempt Interest

Tax-exempt interest is included within a CFC's Subpart F income and retains its character when it is imputed to the corporation's United States shareholders.¹⁵¹ In this manner, the tax-exempt interest will

¹⁴⁶ I.R.C. § 954(c)(3)(A)(ii).

¹⁴⁷ *Id.*

¹⁴⁸ Compare I.R.C. § 954(c)(3)(A)(i) and Treas. Reg. § 1.954-2(b)(4)(iv) with I.R.C. § 954(c)(3)(A)(ii).

¹⁴⁹ *Id.*

¹⁵⁰ *Id.* § 954(c)(3)(B).

¹⁵¹ Treas. Reg. § 1.954-2(a)(4)(i) (1995); Temp. Treas. Reg. § 1.954-2T(b)(6) (1995). The Treasury Department has proposed that tax-exempt interest lose its character when it

not be included in a United States shareholder's gross income for purposes of the corporate or individual income taxes but may attract the alternative minimum tax for the United States shareholder.¹⁵² The Internal Revenue Service (IRS) has ruled privately that the earnings and profits of a CFC attributable to tax-exempt interest must be included in the gross income of the CFC's shareholders when those earnings and profits are actually distributed to shareholders.¹⁵³

III. Income Equivalent to Interest

A CFC's FPHCI includes any income that is equivalent to interest.¹⁵⁴ As a general matter, income equivalent to interest consists of those payments either that "predominantly reflect the time value of money"¹⁵⁵ or that in substance are for the use of money.¹⁵⁶ Income equivalent to interest does not include actual interest or income that is recharacterized as interest using the rules of sections 482, 483 or 1274 of the Code.¹⁵⁷ Those items are governed by the rules stated in part II of this Article.

A. Various Inclusions and Exclusions

Five kinds of income are specifically included in income equivalent to interest. First, income equivalent to interest includes the ordinary income realized from conversion transactions under section 1258 of the Code.¹⁵⁸ Also included are commitment fees for loans, whether or not the loans are actually funded.¹⁵⁹ Third, income equivalent to interest includes the income derived from a transfer of securities subject to section 1058 of the Code.¹⁶⁰ Fourth, income

is imputed to the corporation's United States shareholders. Prop. Treas. Reg. § 1.954-2(b)(3), 60 Fed. Reg. 46548, 46552 (1995). Until the Treasury Department adopts the proposal in final regulations, the rules of Temporary Treasury Regulation section 1.954-2T(b)(6) continue to apply. T.D. 8618, 1995-40 I.R.B. 10.

¹⁵² Temp. Treas. Reg. § 1.954-2T(b)(6).

¹⁵³ Priv. Ltr. Rul. 89-28-036 (Apr. 17, 1989).

¹⁵⁴ I.R.C. § 954(c)(1)(E).

¹⁵⁵ Treas. Reg. § 1.954-2(h)(2)(i)(A).

¹⁵⁶ *Id.* § 1.954-2(h)(2)(i)(B). Neither of these generalizations causes income from the sale of property to be treated as income equivalent to interest. *Id.* § 1.954-2(h)(2)(ii).

¹⁵⁷ *Id.* § 1.954-2(h)(1)(ii)(B).

¹⁵⁸ *Id.* § 1.954-2(h)(2)(i)(E). An example of such income is the income derived from buying a commodity on the spot market and simultaneously selling the same commodity forward at a greater price for delivery and payment three months hence. *Id.* § 1.954-2(h)(6), ex. 4. This arrangement is similar to a loan in that the CFC parts with cash at the beginning of the three-month period and receives a greater sum at the end of the period. The arrangement differs from a loan in that the recipient of the cash at the beginning of the term is not the same person as the payor of the cash at the end of the term.

¹⁵⁹ *Id.* § 1.954-2(h)(2)(i)(G). Such a transfer is typically a loan of securities extended by a tax-exempt organization or a mutual fund to a broker who is in need of securities to make timely delivery in another transaction.

¹⁶⁰ *Id.* § 1.954-2(h)(2)(i)(H).

equivalent to interest includes some of the income from receivables arising from the performance of services.¹⁶¹ A receivable from services gives rise to income equivalent to interest if payment is not to be made until more than 120 days after the date on which the services are performed.¹⁶² The specific amount of income that is equivalent to interest is computed by using the principles of section 483 or the original issue discount provisions of the Code, but with modified time periods.¹⁶³ Such income would be true interest if sections 483 and 1274 of the Code applied by their own terms to service receivables. For purposes of Subpart F, characterizing such income as being equivalent to interest remedies the omission of service receivables from the scope of those Code sections. Fifth, income equivalent to interest includes the income derived from notional principal contracts that are denominated in the CFC's functional currency if the value of the contract is determined solely by reference to interest rates or interest rate indices.¹⁶⁴ The regulations permit the Commissioner to add, through published guidance, income from other transactions to this category of FPHCI.¹⁶⁵

Two kinds of income are specifically excluded from the category of income equivalent to interest. The first exclusion removes income earned by a regular dealer from notional principal contracts that are dealer property.¹⁶⁶ Second, income from a notional principal contract that is identified with a liability under the source-of-income rules stated in Temporary Treasury Regulations section 1.861-9T(b)(6) will not constitute income equivalent to interest.¹⁶⁷ Income from such a contract will simply offset the CFC's interest expense.

B. The Inclusion of Factoring Income

Factoring income generally is categorized as income equivalent to interest.¹⁶⁸ Factoring income is defined to include any income derived from the acquisition of a factored receivable and its subsequent collection or disposition.¹⁶⁹ Thus, both the factor's compensation for assuming the credit risk of a receivable and its compensation for discounting the receivable are included in factoring income for purposes of calculating the factor's FPHCI. Interest paid to the factor

¹⁶¹ *Id.* § 1.954-2(h)(2)(i)(F).

¹⁶² *Id.* § 1.954-2(h)(5).

¹⁶³ *Id.*

¹⁶⁴ *Id.* § 1.954-2(h)(3)(i). Income from a notional principal contract denominated in a currency other than the CFC's functional currency generally is governed by the rules stated in part IV of this Article.

¹⁶⁵ *Id.* § 1.954-2(h)(2)(i)(I).

¹⁶⁶ *Id.* § 1.954-2(h)(3)(ii).

¹⁶⁷ *Id.* § 1.954-2(h)(1)(ii)(A).

¹⁶⁸ *Id.* § 1.954-2(h)(4)(i).

¹⁶⁹ *Id.*

by an account debtor pursuant to the terms of a receivable, however, is excluded from the definition of factoring income.¹⁷⁰ The inclusion of such interest income in FPHCI is governed by the rules stated in part II of this Article.

The factor's compensation for advancing a discounted amount arguably is actual interest income, since in commercial factoring such an advance is a nonrecourse loan secured and liquidated by the seller's right to payment from the factor on the maturity date. In the factoring of consumer receivables, however, it is generally not possible to isolate the interest component of the factor's compensation from the payment for assuming the credit risk on the receivables. Factors of consumer receivables generally do not quote to their clients a distinct price for payment at maturity, but only a price for immediate payment that combines the factor's compensation for assuming the credit risk and for immediate discounting of the receivable. For that reason, the regulations' general approach of characterizing both components of a factor's income as income equivalent to interest is appropriate for consumer receivables.

Whether the approach is appropriate for commercial receivables depends in part on three exceptions to the definition of factoring income. These exceptions generally identify receivables that produce income falling within another category of FPHCI or that present a low probability of generating factoring income other than compensation for assuming credit risk. First, factoring income does not include income derived from related-person factoring.¹⁷¹ The income from such factoring is usually included in the CFC's FPHCI under the rules stated in part II of this Article.¹⁷² This exception applies even if the receivable falls within the same-country exception to related-person factoring.¹⁷³ Thus, the income from same-country related-person factoring may escape inclusion within FPHCI altogether.

Second, factoring income does not include income derived from a qualifying receivable if payment for the receivable is made on or after the date on which interest under the receivable begins to accrue.¹⁷⁴ Thus, if a qualifying receivable already is accruing interest at the time

¹⁷⁰ *Id.*

¹⁷¹ *Id.* § 1.954-2(h)(4)(ii)(A). The excluded income includes both interest and income that is classified as interest under the rules of section 864(d)(1) or (6) of the Code.

¹⁷² In addition, the acquisition by a CFC of a receivable from a related person generally constitutes an investment in United States property if both the related person and the account debtor are United States persons. I.R.C. § 956(b)(3) (West Supp. 1995). The principal amount of such a receivable, subject to limitations, is taxable as income to the CFC's United States shareholders. *Id.* § 951(a)(1)(B). The taxation of a CFC's investments in United States property is analyzed in Eric T. Laity, *Anatomy of Sections 951(a)(1)(B) and 956 of the Internal Revenue Code*, 14 VA. TAX REV. 71 (1994).

¹⁷³ *Id.* § 1.954-2(h)(4)(ii)(A). The same-country exception is found in section 864(d)(7) of the Code.

¹⁷⁴ *Id.* § 1.954-2(h)(4)(ii)(B).

it is purchased by the factor, the income subsequently derived by the factor is not income equivalent to interest.¹⁷⁵ In order to qualify for this exception, the receivable must bear an interest rate that equals or exceeds, as of the date on which the receivable is purchased by the factor, 120% of the Federal short term rate.¹⁷⁶ By virtue of the exception, the CFC's compensation for assuming the credit risk on the receivable is removed from its FPHCI. The threshold rate of interest on the receivable minimizes the possibility of discount income to the CFC or having principal recharacterized as interest under the rules of sections 483 or 1274 of the Code. The interest income paid to the CFC by the account debtor is included in the CFC's FPHCI as actual interest.¹⁷⁷ The exclusion is available for both trade receivables and service receivables.¹⁷⁸

Third, factoring income does not include a factor's income derived from a factored receivable if payment for the purchase of the receivable is made only on or after the anticipated date of payment of all principal by the account debtor.¹⁷⁹ As a result of this exception, a factor's income from maturity factoring, in which the factor is compensated only for assuming the credit risk of the receivable and does not lend funds to its client, does not constitute income equivalent to interest. In the event that the factor pays for its purchase of the receivable in advance of the receivable's maturity date, however, both its compensation for assuming the credit risk and its compensation for advancing a discounted amount to the seller of the receivable will constitute income equivalent to interest, and thus will be included in the factor's FPHCI.¹⁸⁰

The residual class of factoring income that remains after taking into account these three exceptions contains a mixture of interest income arising from the discounting of receivables and service income arising from the assumption of credit risk. Is it appropriate to classify both of these types of income as income equivalent to interest and thus as FPHCI? In the case of commercial receivables, no. A factor of commercial receivables quotes two prices to its clients for each group of receivables presented for purchase; one price for payment at the maturity of the receivables and a lower price for immediate pay-

¹⁷⁵ *Id.* § 1.954-2(h)(4)(iv), ex. 5.

¹⁷⁶ *Id.* § 1.954-2(h)(4)(ii)(B). For receivables denominated in a foreign currency, the threshold rate is 120% of the "equivalent rate," which presumably includes any premium for foreign inflation charged by the money markets.

¹⁷⁷ *Id.* § 1.954-2(a)(2).

¹⁷⁸ *Id.* § 1.954-2(h)(4)(ii)(B).

¹⁷⁹ *Id.* § 1.954-2(h)(4)(ii)(C). For purposes of this exception, an anticipated weighted average date of payment may be used in the case of a pool of purchased receivables. *Id.*

¹⁸⁰ *Id.* § 1.954-2(h)(4)(iv), ex. 1.

ment.¹⁸¹ The two quotes together isolate the factor's potential interest income from discounting the receivables.¹⁸² The factor's interest income should be classified as actual interest income and treated under the rules stated in part II of this Article. The factor's service income should not be included in FPHCI at all. If the CFC cannot substantiate its division of factoring income into the two components of interest income and service income, treating them in the aggregate as income equivalent to interest and without the benefit of the exclusion for export-related interest is appropriate.

RECOMMENDATION FOUR: Amend Treasury Regulation section 1.954-2(h)(4)(ii) to exclude from FPHCI a CFC's service income for assuming the risk on purchased commercial accounts receivable and for collecting the receivables, but only if the CFC can establish the amount of such service income in contrast to its income for discounting the receivables.

IV. Foreign Currency Gain

FPHCI includes net foreign currency gain from section 988 transactions.¹⁸³ A net loss from section 988 transactions, as opposed to a net gain, cannot be included in the calculation of FPHCI.¹⁸⁴ A section 988 transaction, in very general terms, is one of a specified set of transactions if payment is to be made in a nonfunctional currency.¹⁸⁵ A nonfunctional currency, in turn, is usually a currency other than the one in which the CFC properly keeps its books and records.¹⁸⁶ Section 988 transactions include the acquisition or issuance of a debt instrument; the accrual of an item of gross income or expense; entering into or acquiring a forward contract, a futures contract, an option or a similar instrument;¹⁸⁷ and the disposition of a nonfunctional currency, regardless of whether payment is to be made in a nonfunctional currency.¹⁸⁸ The gain or loss attributable to a section 988 transaction generally is characterized as ordinary income or loss.¹⁸⁹

Several rules apply to the computation of a CFC's net foreign

¹⁸¹ Compare PETER H. WEIL ET AL., COMMERCIAL FINANCE, FACTORING, AND OTHER ASSET-BASED LENDING 52 (1980) (factor agreeing to pay for receivables at a future date) with *id.* 63-64 (factoring client having option to receive early payment of purchase price at a discount).

¹⁸² Sometimes the interest rate is explicit in the factoring agreement. *Id.* 64; JACOB RABKIN & MARK H. JOHNSON, 2B CURRENT LEGAL FORMS 6-1334 (Form 6.45 § 3).

¹⁸³ I.R.C. § 954(c)(1)(D) (West Supp. 1995).

¹⁸⁴ A net loss may indirectly affect the Subpart F inclusion of the CFC's United States shareholders through the loss's effect on the earnings and profits limitation. Treas. Reg. § 1.954-1(c)(1)(ii).

¹⁸⁵ I.R.C. § 988(c)(1).

¹⁸⁶ See *id.* § 985(b).

¹⁸⁷ *Id.* § 988(c)(1)(B).

¹⁸⁸ *Id.* § 988(c)(1)(C)(i)(I).

¹⁸⁹ *Id.* § 988(a)(1)(A).

currency gain. A foreign currency gain or loss from a section 988 transaction generally is limited to the gain or loss arising from exchange rate fluctuations between the booking date of the transaction and its payment date.¹⁹⁰ In the case of a financial instrument similar to a forward contract, futures contract or option, the foreign currency gain or loss is the entire gain or loss arising from entering into or acquiring such instrument.¹⁹¹ In the case of an interest-bearing liability, the foreign currency gain or loss is allocated between FPHCI and the other categories of Subpart F income, on the one hand, and non-Subpart F income, on the other, in the same manner as the interest expense of the liability is allocated between the two classifications.¹⁹² A separate method for computing foreign currency gain or loss is required of CFCs using the dollar approximate separate transactions (DAST) method for determining their income.¹⁹³

There are five exclusions from this category of FPHCI. First, capital gains or losses described in section 988(a)(1)(B) of the Code are not included in the CFC's foreign currency gains or losses for purposes of calculating its FPHCI; such gains and losses are treated under the rules stated in part VI of this Article.¹⁹⁴ Since capital gain or loss treatment under Code section 988(a)(1)(B) is elective, a CFC may choose whether foreign currency gain or loss eligible for the election will be included in the FPHCI category of foreign currency gain or the FPHCI category of gain from the disposition of certain property. Second, to the extent gain or loss from any section 988 transaction is recharacterized as interest income or expense, the gain or loss is not taken into account under this category of FPHCI; the gain or loss is treated under the rules stated in part II of this Article.¹⁹⁵ Third, gain or loss from a section 988(d) hedging transaction is excluded from this category of FPHCI.¹⁹⁶ Fourth, a foreign currency gain or loss is excluded from the computation of the corporation's FPHCI if it is attributable to a transaction that is directly related to the business needs of the CFC.¹⁹⁷ Fifth, a CFC may elect

¹⁹⁰ *Id.* §§ 954(c)(1)(D), 988(b).

¹⁹¹ *Id.* § 988(b)(3).

¹⁹² Treas. Reg. § 1.954-2(g)(2)(iii) (1995).

¹⁹³ *Id.* § 1.954-2(g)(5)(iii).

¹⁹⁴ *Id.* § 1.954-2(g)(5)(i).

¹⁹⁵ *Id.* § 1.954-2(g)(5)(ii). Gain or loss from a section 988 transaction can be recharacterized as interest income or expense only pursuant to Treasury Regulation section 1.988-3(c)(1).

¹⁹⁶ *Id.* § 1.954-2(g)(5)(ii). The CFC generally recognizes no gain or loss on a section 988(d) hedging transaction, and the hedging transaction is integrated with the underlying debt instrument. *Id.* § 1.988-5(a)(1). Hence, there generally is no gain or loss to include in another category of FPHCI. If the unrecognized gain or loss affects the amount of interest income earned by the CFC on an underlying debt instrument, the gain or loss will affect the CFC's interest income under part II of this Article.

¹⁹⁷ I.R.C. § 954(c)(1)(D) (West Supp. 1995).

to exclude foreign currency gains and losses from this category of FPHCI by transferring those gains and losses to the categories of FPHCI, or other classes of Subpart F income altogether, to which those gains and losses relate.¹⁹⁸ The last two exclusions are discussed below.¹⁹⁹ The CFC may elect to include most of its foreign currency gains and losses in its FPHCI, subject to the restrictions stated below.²⁰⁰

A. *The Exclusion for Business Needs*

A foreign currency gain or loss directly related to the business needs of a CFC is excluded from the CFC's FPHCI.²⁰¹ The exclusion is not available for the foreign currency gains and losses of a CFC to the extent the corporation calculates its income by the DAST method.²⁰² A CFC may elect not to take advantage of the exclusion and instead throw those foreign currency gains and losses into the calculation of its FPHCI.²⁰³

A foreign currency gain or loss is directly related to the business needs of the CFC if, generally speaking, the gain or loss arises in one of three ways: (1) from a transaction entered into in the normal course of business; (2) from property used in the normal course of business; or (3) from a bona fide hedging transaction with respect to such a transaction or property.²⁰⁴ If property or nonhedging transactions give rise to Subpart F income, foreign currency gain or loss arising from them cannot qualify for the exclusion.²⁰⁵ In addition, foreign currency gain or loss from forward contracts, futures contracts, options and similar financial instruments is not eligible for the exclusion unless the instruments qualify as bona fide hedging transactions and relate to a transaction or property that qualifies for the exclusion.²⁰⁶ A transaction that hedges the liabilities or assets of a related person is deemed not to be a bona fide hedging transaction for this purpose.²⁰⁷ Thus, the foreign currency gain or loss of a CFC serving as a currency coordination center for related persons is not eligible for this exclusion. There is a conclusive presumption in favor

¹⁹⁸ Treas. Reg. § 1.954-2(g)(3)(i). The election is made on behalf of the CFC by the controlling United States shareholders. *Id.* § 1.954-2(g)(3)(ii).

¹⁹⁹ See *infra* part IV.A-B of this Article.

²⁰⁰ Treas. Reg. § 1.954-2(g)(4)(i); see *infra* part IV.A.

²⁰¹ Treas. Reg. § 1.954-2(g)(2)(ii)(A).

²⁰² *Id.* § 1.954-2(g)(5)(iii).

²⁰³ *Id.* § 1.954-2(g)(4)(i). See *infra* part IV.D of this Article for a discussion of the election.

²⁰⁴ Treas. Reg. § 1.954-2(g)(2)(ii)(B). Bona fide hedging transactions are defined with reference to Treasury Regulations sections 1221-2(a) through (c). *Id.* § 1.954-2(a)(4)(ii)(A).

²⁰⁵ *Id.* Reg. § 1.954-2(g)(2)(ii)(B)(1)(ii).

²⁰⁶ *Id.* § 1.954-2(g)(2)(ii)(B)(1)(iii), (2).

²⁰⁷ *Id.* § 1.954-2(a)(4)(ii)(A).

of dealers in property. A section 988 transaction in dealer property entered into by a CFC that is a regular dealer in such property is deemed to be directly related to the CFC's business needs, provided that the specific transaction was entered into by the CFC in its capacity as a dealer.²⁰⁸ Hence, a CFC that is a dealer in forward contracts, futures contracts, options or similar financial instruments may exclude its foreign currency gains and losses arising from those transactions.²⁰⁹

Only section 988 transactions are of interest when considering the application of the business-needs exclusion. Recall that a transaction must be a section 988 transaction if any foreign currency gain or loss derived from the transaction is to fall within the scope of this Part IV. Hence, the class of foreign currency gains or losses arising from property used in the normal course of business seems superfluous. This classification of gain or loss, devoid as it is of foreign currency gain or loss from section 988 transactions, supports the classification for hedging transactions. If a section 988 transaction hedges foreign currency risks associated with such property, the foreign currency gain or loss from the hedging transaction is eligible for the business-needs exclusion.

B. Elective Exclusion Regarding Subpart F Income

The controlling shareholders of a CFC may elect on behalf of the corporation to remove foreign currency gain or loss from this category of FPHCI by transferring the gain or loss to the category of Subpart F income to which it relates.²¹⁰ The election prevents the separation, for purposes of the baskets of the foreign tax credit limitation, of a foreign currency gain or loss from the Subpart F income to which it relates.²¹¹ The categories to which the gain or loss may be transferred include not only the other categories of FPHCI, but include as well insurance income and the various classifications of foreign base company income apart from FPHCI.²¹² Once the decision is made to transfer foreign currency gain or loss to the category to which it relates, all foreign currency gain or loss relating to that category must

²⁰⁸ *Id.* § 1.954-2(g)(2)(ii)(C).

²⁰⁹ Note that if the instrument is a regulated futures contract or nonequity option that would be marked to market under section 1256 of the Code if held on the last day of the taxable year, entering into the instrument is not a section 988 transaction and therefore does not produce a foreign currency gain or loss includible in the CFC's FPHCI. I.R.C. § 988(c)(1)(D)(i) (West Supp. 1995).

²¹⁰ Treas. Reg. § 1.954-2(g)(3)(i). The controlling United States shareholders are those United States shareholders who, in the aggregate, own more than fifty percent of the voting power of the stock of the CFC and who undertake to act on its behalf. *Id.* § 1.964-1(c)(5).

²¹¹ T.D. 8618, 1995-40 I.R.B. 10.

²¹² Treas. Reg. § 1.954-2(g)(3)(i).

be transferred.²¹³ Foreign currency gain or loss relates to a category if it arises from a transaction or property that gives rise to income in that category or from a bona fide hedging transaction with respect to such a transaction or property.²¹⁴ The foreign currency gain or loss from a single hedging transaction that hedges risks in more than one category of Subpart F income cannot be transferred.²¹⁵ The election does not impair the exclusion from FPHCI of foreign currency gain or loss that is directly related to the business needs of the CFC; those gains and losses continue to be excluded.²¹⁶

It is unclear whether the election may be made on a category-by-category basis, so that a CFC's foreign currency gains and losses relating to some categories of Subpart F income remain in FPHCI while the gains and losses relating to other categories of Subpart F income are transferred.²¹⁷ If the purpose of the election is to permit the controlling United States shareholders of a CFC to keep foreign currency gain or loss related to a category of Subpart F income in the same basket, for purposes of the foreign tax credit limitation, as the underlying gain or loss to which the foreign currency gain or loss relates, the election should apply to all or none of the categories of Subpart F income.

RECOMMENDATION FIVE: Amend Treasury Regulations section 1.954-2(g)(3)(i) to provide that the election, if made, applies to all of a CFC's foreign currency gains and losses that relate to any category of Subpart F income.²¹⁸

If the foreign currency gains and losses transferred to a category of Subpart F income net into a loss, the net loss cannot reduce the CFC's Subpart F income in that category.²¹⁹ Such a net foreign currency loss reduces the CFC's Subpart F income only to the extent that it affects the total Subpart F inclusion through the earnings and profits limitation of section 952(c) of the Code.²²⁰ Two points remain unclear about the use of a net foreign currency loss under the election. First, does the above rule still hold true if the CFC's total foreign currency gains and losses produce a net gain overall, and only

²¹³ *Id.*

²¹⁴ *Id.*

²¹⁵ *Id.*

²¹⁶ T.D. 8618, 1995-40 I.R.B. 10.

²¹⁷ Compare the second sentence of Treasury Regulations section 1.954-2(g)(3)(i), which refers to an election with respect to a category or categories of Subpart F income, to paragraphs (g)(3)(ii) and (iii), which assume only a single election. The preamble to the regulations seems to assume a single election. T.D. 8618, 1995-40 I.R.B. 10.

²¹⁸ Foreign currency gain or loss that arises from a single hedging transaction that hedges risks in two or more categories of Subpart F income would continue not to be "related to" the underlying gain or loss and thus would continue to be ineligible for transfer. Treas. Reg. § 1.954-2(g)(3)(i).

²¹⁹ *Id.* § 1.954-2(g)(3)(iv).

²²⁰ *Id.* §§ 1.954-1(c)(1)(ii), 1.954-2(g)(3)(iv).

its foreign currency gains and losses related to the category of Subpart F income produce a net loss? There is no compelling reason to deny the transfer of a net loss within a category if the CFC's overall position is a net gain.

RECOMMENDATION SIX: Amend Treasury Regulations section 1.954-2(g)(3)(i) and (iv) to provide that, in the event that the election has been made and the CFC has a net foreign currency gain, foreign currency gains and losses may be transferred to the categories of Subpart F income to which they relate even though the gains and losses transferred to a single category produce a net foreign currency loss for that category.

Second, if the CFC has an overall net loss in its foreign currency gains and losses, does the election compel a transfer of a net gain within a category of Subpart F income? There seems to be no statutory basis in section 954(c) of the Code to permit the transfer in such an event. Such an overall foreign currency loss can affect the CFC's Subpart F income only through its effect on the earnings and profits limitation of section 952(c) of the Code.

RECOMMENDATION SEVEN: Amend Treasury Regulations section 1.954-2(g)(3)(i) and (iv) to provide that, in the event that the election has been made and the CFC has a net foreign currency loss, foreign currency gains and losses may not be transferred to the categories of Subpart F income to which they relate.

C. The Inclusion for Those Using the DAST Method

A CFC that operates in a hyperinflationary environment is required to use the DAST method for computing its income and its earnings and profits.²²¹ The DAST method computes a currency gain or loss for a business unit as a step in calculating the business unit's income.²²² The method computes the currency gain or loss on the basis of changes in the unit's net worth, rather than on the basis of individual transactions.²²³ The currency gain or loss as computed by the DAST method is then allocated to the CFC's FPHCI and other income.²²⁴ To the extent that a CFC uses the DAST method to compute its income, the CFC cannot take advantage of the business-needs exclusion or the elective exclusion for its foreign currency gains and losses.²²⁵

²²¹ *Id.* §§ 1.985-1(b)(2)(ii)(A), 1.985-3(a)(1).

²²² *Id.* § 1.985-3(b)(4), (d). The regulations refer to the currency gain or loss as the unit's DASTM gain or loss.

²²³ *Id.* § 1.985-3(d)(1).

²²⁴ *Id.* §§ 1.954-2(g)(5)(iii), 1.985-3(e)(2)(iv), (3).

²²⁵ *Id.* § 1.954-2(g)(5)(iii).

D. Elective Throw-Back of Foreign Currency Gains and Losses

The controlling United States shareholders of a CFC may elect on behalf of the CFC to include in its FPHCI all of its foreign currency gains and losses directly related to its business needs.²²⁶ The election relieves the CFC of the tracing required by the exclusion in connection with the CFC's bona fide hedging transactions. The election was intended for CFCs that hedge their foreign currency exposure and thus have a negligible net gain or loss.²²⁷ Under this election, a net foreign currency loss may be taken into account in calculating the CFC's FPHCI.²²⁸ If the election is made, the foreign currency gains and losses from both section 988 transactions and section 1256 foreign currency contracts, specifically, those section 1256 contracts that would be section 988 transactions but for section 988(c)(1)(D), must be included in the CFC's FPHCI.²²⁹ Furthermore, the election will cause the throw-back of all of the CFC's foreign currency gains and losses otherwise transferred to other categories of Subpart F income pursuant to the elective exclusion.²³⁰ The election does not bind related persons.²³¹ The election is not available for the foreign currency gains and losses of a CFC to the extent that it determines its income by the DAST method.²³²

The election does not permit the inclusion of foreign currency gains and losses covered by two other exclusions – those that are characterized as capital gain or loss under section 988(a)(1)(B) of the Code and those that are characterized as interest income or expense.²³³ Foreign currency gain or loss that is recharacterized as interest is included in the FPHCI category of dividends, interest, rents, royalties and annuities.²³⁴ The category does not have a net gain requirement and thus the inclusion of recharacterized foreign currency gain or loss in that category rather than in the throwback election is immaterial to the nation's aggregate tax revenue. Foreign currency gain or loss that is recharacterized as capital gain or loss, on the other hand, is included in a category of FPHCI that is limited to net gain from the disposition of certain property. Hence, subjecting foreign currency gain or loss recharacterized as capital under section 988(a)(1)(B) to the throwback election would favor the CFC's

²²⁶ *Id.* § 1.954-2(g)(4)(i).

²²⁷ T.D. 8216, 53 Fed. Reg. 27,489, 27,491 (1988).

²²⁸ Treas. Reg. § 1.954-2(g)(2)(i), (4)(i).

²²⁹ *Id.* § 1.954-2(g)(4)(i).

²³⁰ *Id.*

²³¹ *Cf.* Temp. Treas. Reg. § 1.954-2T(g)(5)(i) (1988) (election is effective for the CFC and all related persons as defined by I.R.C. § 954(d)(3) (West Supp. 1995)).

²³² Treas. Reg. § 1.954-2(g)(4)(i), (5)(iii).

²³³ I.R.C. § 988(a)(2) (West Supp. 1995).

²³⁴ Treas. Reg. § 1.954-2(a)(2)(i), (4)(i).

United States shareholders. As it is, the recharacterization itself of foreign currency gain or loss as capital under section 988(a)(1)(B) is at the election of the CFC, and thus the CFC can place such foreign currency gains and losses in the foreign currency category of FPHCI even without the throwback election.

V. Gain From Commodities Transactions

FPHCI generally includes a CFC's excess of gains over losses from commodities transactions.²³⁵ Such transactions include futures and forward transactions.²³⁶ A net loss from commodities transactions may not be used to offset other FPHCI; only a net gain will affect the amount of a CFC's FPHCI.²³⁷ Furthermore, gains or losses from commodities transactions that are also foreign currency gains or losses under section 988 of the Code are included in FPHCI under the rules given in part IV of this Article.²³⁸ A CFC may elect to remove the gains and losses arising from section 1256 foreign currency transactions from its commodities transactions, and include those gains and losses among its foreign currency gains and losses from section 988 transactions.²³⁹

The definitions of commodity and commodities transaction are fundamental to this category of FPHCI. In keeping with the conventional notion of a commodity, a commodity is defined in part as tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded.²⁴⁰ In addition, nonfunctional currency falls within the definition of a commodity.²⁴¹ Nonfunctional currency is defined with reference to the CFC and, generally speaking, is any currency other than the currency in which the CFC properly keeps its books and records.²⁴² Nonfunctional currency includes both currency and deposits.²⁴³ A commodities transaction is defined broadly to include the purchase or sale of a commodity for either immediate or deferred delivery or the purchase or sale of any right or obligation with respect to a commodity.²⁴⁴ Derivatives based on commodities and commodity options are

²³⁵ I.R.C. § 954(c)(1)(C).

²³⁶ *Id.*

²³⁷ Treas. Reg. § 1.954-1(c)(1)(ii). A net loss may indirectly affect the CFC's total Subpart F income through the loss's impact on the earnings and profits limitation of section 952(c) of the Code.

²³⁸ I.R.C. § 954(c)(1)(C)(iii). As a result, a currency futures contract generally is treated as a commodities transaction, and a currency forward contract is treated as a foreign currency transaction. *Id.* § 988(c)(1)(D)(i); T.D. 8618, 1995-40 I.R.B. 10.

²³⁹ Treas. Reg. § 1.954-2(g)(4). The election is discussed in part IV.D of this Article.

²⁴⁰ Treas. Reg. § 1.954-2(f)(2)(i).

²⁴¹ T.D. 8618, 1995-40 I.R.B. 10.

²⁴² See I.R.C. § 985(b)(1), (3).

²⁴³ *Id.* § 988(c)(1)(C)(ii).

²⁴⁴ Treas. Reg. § 1.954-2(f)(2)(ii).

included.²⁴⁵ Private transactions are included as well as those executed through an organized or over-the-counter market.²⁴⁶

The gains and losses from two types of transactions in commodities are excluded from the calculation of FPHCI for corporations active in the commodities business.²⁴⁷ These exclusions are available only to those CFCs that are producers, processors, merchants or handlers of a commodity.²⁴⁸ The exclusions are not available to CFCs insofar as they use commodities as raw materials in manufacturing.²⁴⁹

A. *Exclusion for Qualified Active Sales*

FPHCI does not include the gain or loss derived by a qualified CFC from the sale of a commodity if the sale meets two requirements. First, the gain or loss must be an active business gain or loss.²⁵⁰ A gain or loss is an active business gain or loss only if the CFC holds commodities as inventory or dealer property and incurs substantial expenses through specified activities.²⁵¹ The CFC must incur the expenses directly and not through an independent contractor.²⁵² The relevant activities are the production or processing of commodities and activities relating to the combination of physical movement, handling and storage of commodities.²⁵³ Expenses incurred in the distribution of commodities count toward the requirement of substantial expense, but the expenses of marketing commodities do not. A gain or loss is not an active business gain or loss if the CFC's business is primarily financial.²⁵⁴ Second, substantially all of the CFC's business must be that of an active producer, processor, merchant or handler of commodities.²⁵⁵ The CFC's commodity business is substantially all of the CFC's business if its gross receipts from qualified active sales and qualified hedging transactions equal or exceed eighty-

²⁴⁵ *Id.* § 1.954-2(f)(2)(ii)(D), (E).

²⁴⁶ *Id.* § 1.954-2(f)(2)(ii).

²⁴⁷ I.R.C. § 954(c)(1)(C)(i), (ii).

²⁴⁸ *Id.* Gains or losses from commodities transactions that are also foreign currency gains or losses under section 988 are included in FPHCI under a different provision, which requires exclusions for the business needs of a CFC. *Id.* § 954(c)(1)(C)(iii), (D). As a result, corporations whether or not they are producers, processors, merchants or handlers of commodities may be able to remove their business-related foreign currency gains or losses from the calculation of their FPHCI.

²⁴⁹ I.R.C. § 954(c)(1)(C)(i), (ii).

²⁵⁰ *Id.* § 954(c)(1)(C)(ii).

²⁵¹ Treas. Reg. § 1.954-2(f)(3)(iii)(B). The CFC must hold the commodities directly and not through an agent or independent contractor. *Id.* § 1.954-2(f)(2)(iii)(B)(1).

²⁵² *Id.* § 1.954-2(f)(2)(iii)(B)(2).

²⁵³ *Id.*

²⁵⁴ *Id.* § 1.954-2(f)(3)(iii)(E).

²⁵⁵ I.R.C. § 954(c)(1)(C)(ii) (West Supp. 1995). A third requirement has been dropped. T.D. 8618, 1995-40 I.R.B. 10. Previously, the gain or loss had to arise from the sale of a commodity that was similar in kind to the commodities that accounted for substantially all of the corporation's business. Temp. Treas. Reg. § 1.954-2T(f)(3)(i) (1988).

five percent of its total gross receipts for the taxable year as determined under United States tax accounting principles.²⁵⁶ The eighty-five percent test is not labeled as a safe harbor, but its formulation suggests that a CFC may instead meet the substantial activities requirement on the basis of all of the facts and circumstances.

B. Exclusion for Qualified Hedging Transactions

For purposes of a qualified CFC's FPHCI, commodities transactions do not include qualified hedging transactions.²⁵⁷ A qualified hedging transaction is one that meets requirements about the business to which the transaction relates, the purpose of the transaction, the type of transaction being hedged, and tracing.²⁵⁸ The hedging transaction must be reasonably necessary to the conduct of any business by a qualifying CFC "in the manner in which such business is customarily and usually conducted by others."²⁵⁹ The regulations limit the businesses to which the hedging transaction may relate to that of being a producer, processor, merchant or handler of a commodity.²⁶⁰ The hedging transaction must be bona fide.²⁶¹ The hedging transaction must also relate to commodities sold in qualified active sales, another addition to the Code by the regulations.²⁶² There are recordkeeping requirements for the CFC that must be fulfilled contemporaneously with each transaction.²⁶³

Whether the regulations' two additions to section 954(c)(1)(C)(i) of the Code will be upheld on judicial review remains to be seen. The additions place sensible limitations on the hedging transactions if the goal is to isolate those hedging transactions that can truly be seen as adjuncts to the active business of being a producer, processor, merchant or handler of commodities. The Code section, however, does not pursue that goal, and as a result the additions have no statutory foundation. The Code provides an exclusion for the "bona fide hedging transactions reasonably necessary to the conduct of *any business*" by a qualifying CFC.²⁶⁴

RECOMMENDATION EIGHT: Amend Code section 954(c)(1)(C)(i) to exclude only bona fide transactions reasonably necessary to hedge active business sales of commodities in the conduct of the business of producer, processor, merchant or

²⁵⁶ Treas. Reg. § 1.954-2(f)(3)(iii)(C) (1995).

²⁵⁷ *Id.* § 1.954-2(f)(1)(ii).

²⁵⁸ *Id.* § 1.954-2(f)(3)(iv).

²⁵⁹ I.R.C. § 954(c)(1)(C)(i).

²⁶⁰ Treas. Reg. § 1.954-2(f)(3)(iv)(B).

²⁶¹ *Id.* § 1.954-2(f)(3)(iv)(A).

²⁶² *Id.*

²⁶³ *Id.* §§ 1.954-2(a)(4)(ii)(A), (B), 1.954-2(f)(2)(iv)(A), 1.1221-2(e).

²⁶⁴ I.R.C. § 954(c)(1)(C)(i) (West Supp. 1995) (emphasis added).

handler of a commodity in the manner in which such business is customarily and usually conducted by others.

VI. Gain From the Disposition of Certain Property

FPHCI generally includes a CFC's excess of gains over losses from the sale or exchange of three classes of property.²⁶⁵ The first class consists of property that gives rise to dividends, interest, rents, royalties or annuities (DIRRA).²⁶⁶ The second class of property consists of interests in trusts, partnerships and real estate mortgage investment conduits (REMICs).²⁶⁷ The third class is property that produces no income.²⁶⁸ A net loss from the disposition of these three types of property may not be used to offset other FPHCI; only a net gain will affect the amount of a CFC's FPHCI.²⁶⁹ A net loss within a class of property is not required to be segregated, however.²⁷⁰ A loss from the disposition of property that gives rise to DIRRA, for example, may be used to offset gain from the disposition of property that produces no income.²⁷¹

Excluded from this category of FPHCI are the gains and losses from the sale or exchange of inventory as well as certain gains and losses realized by dealers in property.²⁷² Inventory, for this purpose, includes rights to property held in bona fide hedging transactions that reduce the risk of price changes in the cost of inventory.²⁷³ There is a similar exclusion for hedging transactions related to dealer property.²⁷⁴ If gain or loss from the disposition of specific property is characterized as income equivalent to interest, foreign currency gain or loss, or gain or loss from commodities transactions, the gain or loss is to be treated under the rules stated in parts III, IV or V of this Article, respectively, rather than under the rules of this part VI.²⁷⁵ Hence, the gains and losses from hedging inventory or dealer property may be included in FPHCI under the rules for commodities transactions, even though an exclusion for such gains and losses is otherwise available under the rules of this part VI.

²⁶⁵ *Id.* § 954(c)(1)(B).

²⁶⁶ *Id.* § 954(c)(1)(B)(i).

²⁶⁷ *Id.* § 954(c)(1)(B)(ii).

²⁶⁸ *Id.* § 954(c)(1)(B)(iii).

²⁶⁹ Treas. Reg. § 1.954-1(c)(1)(ii) (1995). A net loss may indirectly affect the CFC's total Subpart F income through the loss's impact on the earnings and profits limitation of section 952(c) of the Code.

²⁷⁰ *Id.*

²⁷¹ *Id.*

²⁷² I.R.C. § 954(c)(1)(B).

²⁷³ Treas. Reg. § 1.954-2(a)(4)(iii).

²⁷⁴ I.R.C. § 954(c)(1)(B).

²⁷⁵ Treas. Reg. § 1.954-2(a)(2).

A. *Property Giving Rise to DIRRA*

FPHCI includes gain or loss from the disposition of property that gives rise to DIRRA.²⁷⁶ The inclusion of such gain or loss in FPHCI reduces the incentive to convert DIRRA into capital gain to avoid a Subpart F inclusion for a CFC's United States shareholders. The scope of this classification of property exhibits two anomalies. The first anomaly lies with property that gives rise to income excluded from FPHCI. On the one hand, the class does not include property that gives rise to rents or royalties derived from unrelated persons in the active conduct of a business.²⁷⁷ Such rents and royalties are themselves excluded from FPHCI.²⁷⁸ On the other hand, the class does include property that gives rise to export financing interest or to income received from related persons.²⁷⁹ Hence, the disposition of stock in related persons may give rise to FPHCI. The anomaly can be eliminated by extending the exclusion to cover all property that gives rise to DIRRA that itself is excluded from FPHCI pursuant to sections 954(c)(2) and (3) of the Code.

RECOMMENDATION NINE: Amend section 954(c)(1)(B)(i) of the Code to read as follows: "which gives rise to income described in subparagraph (A) (after application of paragraphs (2) and (3))"

The second anomaly lies with property that gives rise to income that is either equivalent to interest or recharacterized as actual interest. On the one hand, the class includes property that gives rise to income that is recharacterized as interest using the rules of sections 482, 483 or 1274 of the Code.²⁸⁰ On the other hand, the class does not generally include property that gives rise solely to income equivalent to interest within the meaning of part III of this Article.²⁸¹ The same justification for including within FPHCI the gain from the disposition of property that gives rise to DIRRA argues for the inclusion of gain from the disposition of property that gives rise to income equivalent to interest.

RECOMMENDATION TEN: Amend section 954(c)(1)(B) of the Code to include within its scope the gain or loss from the sale or exchange of property that gives rise to income equivalent to interest to the extent that such gain or loss is not otherwise

²⁷⁶ I.R.C. § 954(c)(1)(B)(i).

²⁷⁷ *Id.*

²⁷⁸ *Id.* § 954(c)(2)(A). See *supra* part II.A of this Article for a discussion of the exclusion for rents and royalties derived from unrelated persons in the active conduct of a business.

²⁷⁹ Treas. Reg. § 1.954-2(e)(2)(i).

²⁸⁰ *Id.* § 1.954-2(a)(4)(i), (e)(2)(i).

²⁸¹ *Id.*

included in FPHCI.

Gain or loss from the disposition of a debt instrument is generally included within the calculation of a CFC's net gain from property transactions.²⁸² Debt instruments are defined broadly and include accounts receivable.²⁸³ Gain from the disposition of a debt instrument is excluded from this category of FPHCI if the gain is treated as interest income under any provision of law or as income equivalent to interest.²⁸⁴ If the gain is treated as interest income, it is governed by the rules stated in part II of this Article; if the gain is treated as income equivalent to interest, its inclusion is governed by the rules stated in part III of this Article. A loss from the disposition of a debt instrument is excluded if it is directly allocated to interest income or income equivalent to interest or if it is apportioned in the same manner as interest expense.²⁸⁵

B. Interests in Partnerships, Trusts, and REMICs

Gain or loss from the disposition of a CFC's interest in a partnership, trust or REMIC is included in the CFC's FPHCI.²⁸⁶ With the addition of this provision to the Code, Congress has expanded the scope of passive income to include gain from the disposition of assets that generate active business income. The rule also supports the inclusion of gain from the disposition of stock in a related person by treating interests in partnerships and trusts in a similar manner.²⁸⁷

C. Property Producing No Income

This classification of property generally includes all rights and interests in property regardless of whether the right or interest is a capital asset.²⁸⁸ Foreign currency is included in this class of property if transactions in the currency give rise to a capital gain or loss under section 988(a)(1)(B) for the CFC.²⁸⁹ Generally included within this classification are rights to acquire or transfer property, including property that gives rise to income.²⁹⁰ Such rights include options, futures contracts, forward contracts and the like.²⁹¹ Options and similar rights are not included, however, if they fall within the exclusion for certain dealer property or inventory other than securi-

²⁸² *Id.* § 1.954-2(e)(2)(ii).

²⁸³ Treas. Reg. § 1.954-2(a)(4)(vii) (1995).

²⁸⁴ Treas. Reg. § 1.954-2(e)(2)(ii)(A).

²⁸⁵ *Id.* § 1.954-2(e)(2)(ii)(B).

²⁸⁶ I.R.C. § 954(c)(1)(B)(ii) (West Supp. 1995).

²⁸⁷ *Id.*

²⁸⁸ Treas. Reg. § 1.954-2(e)(3).

²⁸⁹ *Id.* § 1.954-2(g)(5)(i).

²⁹⁰ *Id.* § 1.954-2(e)(3).

²⁹¹ *Id.*

ties.²⁹² In addition, if the gains or losses from options or other rights also constitute interest equivalent to interest or gains or losses from section 988 foreign currency transactions or commodity transactions, those gains and losses are included within the calculation of FPHCI pursuant to the rules stated in parts IV, V or VI of this Article, respectively, rather than under the rules of this part VI.C.²⁹³ Excluded from this classification is certain property used in the CFC's business: property subject to the allowance for depreciation;²⁹⁴ real property to the extent it is used in the CFC's business;²⁹⁵ and certain intangible property, goodwill and going concern value to the extent those are used in the CFC's trade or business.²⁹⁶ Notional principal contracts are excluded from the classification regardless of whether they are used in the CFC's trade or business.²⁹⁷

VII. Conclusion

This Article has recommended ten changes to section 954(c) of the Code and its supporting regulations. Four of the recommendations advocate changes to the Code itself. Recommendation One would delete the exclusion for export-related interest, found in section 954(c)(2)(B) of the Code, as a vestige of a former tax expenditure.²⁹⁸ Recommendation Eight would amend Code section 954(c)(1)(C)(i) to narrow the exclusion for hedging transactions and to furnish a statutory foundation for the regulations' limitations on the exclusion.²⁹⁹ Recommendation Nine would amend section 954(c)(1)(B)(i) of the Code to unify the treatment of assets that give rise to DIRRA excluded from FPHCI.³⁰⁰ Recommendation Ten would amend section 954(c)(1)(B) of the Code to include within FPHCI the gain or loss from the disposition of certain property that gives rise to income equivalent to interest.³⁰¹

The other recommendations urge modifications to the regulations under section 954(c) of the Code. Recommendation Two would refine the related-person CFC look-through rule by requiring the lower-tier corporation to have assets in its country of incorporation before the rule is applicable.³⁰² Recommendation Three would clarify the effect of the fifty-percent test used in the exclusion for certain dividend and

²⁹² *Id.* § 1.954-2(e)(1)(ii).

²⁹³ *Id.* § 1.954-2(a)(2).

²⁹⁴ *Id.* § 1.954-2(e)(3)(ii).

²⁹⁵ *Id.* § 1.954-2(e)(3)(iii).

²⁹⁶ *Id.* § 1.954-2(e)(3)(iv).

²⁹⁷ *Id.* § 1.954-2(e)(3)(v).

²⁹⁸ See *supra* part II.B.

²⁹⁹ See *supra* part V.B.

³⁰⁰ See *supra* part VI.A.

³⁰¹ See *supra* part VI.A.

³⁰² See *supra* part II.C.

interest income received from related persons.³⁰³ Recommendation Four would exclude a commercial factor's true service income from FPHCI, under certain conditions.³⁰⁴ Recommendations Five, Six, and Seven would modify the elective exclusion for foreign currency gains and losses relating to categories of Subpart F income.³⁰⁵ Recommendation Five would require that the election be made for all or none of the categories of Subpart F income to which foreign currency gains or losses relate.³⁰⁶ Recommendation Six would permit the transfer of a net foreign currency loss to a category of Subpart F income so long as the CFC did not have an overall net foreign currency loss.³⁰⁷ Lastly, Recommendation Seven would prevent the transfer of foreign currency gains or losses to categories of Subpart F income in the event that the CFC did have an overall net foreign currency loss.³⁰⁸

³⁰³ See *supra* part II.C.

³⁰⁴ See *supra* part III.B.

³⁰⁵ See *supra* part IV.B.

³⁰⁶ See *supra* part IV.B.

³⁰⁷ See *supra* part IV.B.

³⁰⁸ See *supra* part IV.B.

