REPORT #605

TAX SECTION

New York State Bar Association

Report on Regulations Relating to the Definitions of a Controlled Foreign Corporation, Foreign Base Company Income, and Foreign Personal Holding Company Income

by the Committee on Foreign Activities of U.S. Taxpayers

February 13, 1989

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Tax Report #+605

TAX SECTION

New York State Bar Association

February 15, 1989

The Honorable Lawrence B. Gibbs
Commissioner of Internal Revenue
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Temporary Section 954 and 957 Regulations on Definitions of a Controlled Foreign Corporation, Foreign Base Company Income, and Foreign Personal Holding Company Income

Dear Commissioner Gibbs:

I enclose a Report on Temporary Section 954 and 957 Regulations on Definitions of a Controlled Foreign Corporation, Foreign Base Company Income, and Foreign Personal Holding Company Income, prepared by our Committee on Foreign Activities of U.S. Taxpayers.

The Report was prepared by Alan O. Dixler, James A. Duncan, Randall K.C. Kau, Steven J. Miller, Robert G. Nassau, Lisa Norton, Willard B. Taylor and Victor Zonana. Messrs. Kau and Taylor were the principal draftsmen. Comments were received from William L. Burke, Herbert L. Camp, John A. Corry, Arthur A. Feder and Martin Rosenbaum.

The Report makes recommendations with respect to the de minimis and full inclusion rules, the high-taxed income exclusion, the definitions of “inventory and similar property” and dealer property,” tax-exempt interest, the “facts and circumstances” test, property that gives rise to no income, qualified active sales, the business needs exception, the full Subpart F method of tax accounting, income equivalent to interest, and other related matters.

As always, the Tax Section would be pleased to respond to questions concerning the Report and to assist in the development of final regulations.

Sincerely,

Wm. L. Burke

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Regulations Relating to the Definitions of a Controlled Foreign Corporation, Foreign Base Company Income, and Foreign Personal Holding Company Income

by the Committee on Foreign Activities of U.S. Taxpayers

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Report on Regulations Relating to the Definitions of a Controlled Foreign Corporation, Foreign Base Company Income, and Foreign Personal Holding Company Income

This report of the Committee on Foreign Activities of U.S. Taxpayers[*] comments on Regulations published on July 21, 1988 in proposed and temporary form (hereafter, the “Temporary Regulations”) with respect to the definitions of a controlled foreign corporation, foreign base company income and foreign personal holding company income.[**] These implement certain changes to Section 954 of the Internal Revenue Code that were made by the Tax Reform Act of 1986 (hereafter, the “1986 Act”) and also restate certain existing regulations (hereafter, the “prior Regulations”) under Section 954 and generally apply to taxable years of a controlled foreign corporation beginning after 1986.

[*] The Report was prepared by Alan O. Dixler, James A. Duncan, Randall K.C. Kau, Steven J. Miller, Robert G. Nassau, Lisa Norton, Willard B. Taylor and Victor Zonana. Messrs. Kau and Taylor were the principal draftsmen. Helpful comments were received from William L. Burke, Herbert L. Camp, John A. Corry, Arthur A. Feder and Martin Rosenbaum.

[**] 53 Fed. Reg. 27489 (July 21, 1988).

I. Summary of Comments

The Regulations do not cover changes made by the 1936 Act to the definition of a related party under Section 954(d)(3), the definition of foreign base company services income under Section 954(e) and the definition of foreign base company shipping income under Section 954(f), and generally do not reflect the amendments made by the Technical and Miscellaneous Revenue Act of 1988 (“TAMRA”). Our principal comments, set out in more length in the body of the report, are as follows:

> (1) Gross foreign base company income should exclude U.S. source income that is effectively connected with a U.S. business, as under the prior Regulations, and such income should not be taken into account for purposes of applying the full inclusion rule of Section 954(b)(3)(B).
>
> (2) The full inclusion rule of Section 954(b)(3)(B) should not apply to related party insurance income of a foreign corporation that would not be a controlled foreign corporation but for the special provisions of Section 953(c).
>
> (3) The anti-abuse rule set forth in connection with the *de minimis* and full inclusion rules of Sections 953(b)(3)(A) and (B) should be simplified by looking simply to whether the activities of multiple controlled foreign corporations comprise a single branch.
>
> (4) For purposes of the high-taxed income exclusion of Section 954(b)(4), the Temporary Regulations should consider whether items of income should be separate because they fall within different categories of Subpart F income, and should address directly the effect of consolidation (or its equivalent) under foreign tax law.
>
> (5) The separate definitions of “inventory and similar property” and “dealer property” in Temporary Regulations §§ 1.954-2T(a)(4)(ii) and (iv) create a potential for applying different rules to income that should be given identical treatment.

(6) The part of the definition of “dealer property” in Temporary Regulations § l.954-2T(a)(4)(iv)(B) that requires the property to be held in the controlled foreign corporation’s capacity as a dealer should be eliminated; if not eliminated, the Temporary Regulations should provide rules describing how taxpayers can meet the definition of “dealer property.”

(7) Principles developed under Section 3 67 to determine whether assets are used in a trade or business in a particular foreign country should not be used to determine exclusions for related-party interest and dividends under Section 954I(3)(A)(i).

(8) The rule in Temporary Regulations §§ 1.954-2T(a)(4)(i) and (b)(6) which treats tax-exempt interest of a controlled foreign corporation as a tax-exempt inclusion in a shareholder’s income, potentially subject to alternative minimum tax, should be eliminated.

(9) The “facts and circumstances” tests of prior Regulations § 1.954-2(d)(1)(i) for determining when unrelated party rents and royalties are derived from the active conduct of a trade or business should be reinstated.

(10) We question whether the list of exclusions from property that gives rise to no income is sufficiently inclusive and, specifically, whether all rights to acquire or transfer property should be regarded as property that gives rise to no income.

(11) The “qualified active sale” exclusion to the commodities transaction rules in Temporary Regulations § 1.954-2T(f)(3) should apply to active sales of any commodities (not just “like kind” commodities) by taxpayers meeting the “substantially all” test.

(12) The requirement in Temporary Regulations § l.954-2T(f)(4)(ii) that a qualified hedging transaction relate to a qualified active sale of commodities should be deleted.

(13) The business needs exception for foreign currency gains in Temporary Regulations § 1.9 54- 2T(g)(2)(ii) is overly restrictive and, because of their extreme complexity and detailed new record keeping requirements, the Temporary Regulations effectively require all foreign currency gains or losses to be treated as foreign personal holding company income.

(14) The full Subpart F method of tax accounting for foreign currency gains or losses under Regulations § 1.964-1(e) should be adopted under procedures similar to those in Temporary Regulations § 1.861-9T(f)(3).

(15) Taxpayers should be allowed to reduce foreign personal holding company income by the excess of foreign currency losses over foreign currency gains, as well as the excess of commodities transactions losses over commodities transactions gains and the excess of property transaction losses over property transaction gains.

(16) Further guidance should be provided in Temporary Regulations § 1.954-2T(h) for determining when a swap contact should be treated as part of an integrated transaction for purposes of the "income equivalent to interest" rules.

As a general comment, we also note that some changes have been made in long-standing rules in the regulations on points which have not been the subject of intervening legislative alterations. While a regulatory position does not necessarily become inviolate merely because of the passage of time, we believe that interests of reliance and predictability dictate that changes should not be made in such cases except to deal with a significant problem that has arisen or where there will be a, clear benefit from improved implementation of the underlying statutory provisions. We support some of the changes in the Temporary Regulations, but we believe others do not meet this standard.

II. Ordering Rules (Temporary Regulations § 1.954-1T(a))

Temporary Regulations § 1.954-1T(a) provides ordering rules for computing foreign base company income of a controlled foreign corporation. These rules largely revise and restate the ordering rules in prior Regulations § 1.952-3.

1. Overlap with Prior Regulations. The Temporary Regulations should expressly state the extent to which prior Regulations § 1.952-3 is superseded by Temporary Regulations § 1.954-lT(a). Provisions of prior Regulations § 1.952-3 addressing computation of gross income and application of the earnings and profits limitation in computing Subpart F income are not restated in the Temporary Regulations and therefore should be retained under

the Section 9 52 regulations, while the ordering rules of prior Regulations § 1.952-3 overlap with those of the Temporary Regulations.

2. Effectively Connected Income. The Temporary Regulations should follow prior Regulations § 1.9 52- 3(b)(3)(ii) in excluding from the definition of gross foreign base company income items of United States source income that are excluded under Section 952(b) from Subpart F because they are effectively connected with a United States trade or business. Although the provision of the prior Regulations was not mandated by the statute (which in Section 952(b) expressly excludes effectively connected income from Subpart F income, rather than from foreign base company income), it was a reasonable rule, since such income was by definition subject to U.S. tax, and nothing in the 1986 Act or its legislative history indicates that it should be changed.

3. Deficit Recapture. Under Temporary Regulations § 1.954-1T(a)(7), amounts includible in Subpart F income under the new deficit recapture rule of Section 952-(c)(2) are taken into account after application of the de minimis and full inclusion rules of Section 954(b)(3)(A) and (B). This is correct because, as noted in the Temporary Regulations, items includible under the recapture rule are items of net income that were subject to the de minimis and full inclusion rule in the prior year. It would be helpful for the examples to illustrate the need to make a Section 954(b)(4) election for items that are also excludible under the earnings and profits limitation to prevent subsequent inclusion

under the deficit recapture provision.

III. De Minimis and Full Inclusion Rules (Temporary Regulations § 1.954-1T(b))

Temporary Regulations § 1.954-1T(b) restates and revises prior Regulations § 1.954A-l(d) to reflect the 1986 Act amendments to Section 954(b)(3) and to provide a new "anti-abuse" rule.

1. Insurance Income. The Temporary Regulations follow the express statutory language of Section 954(b)(3) by requiring that all Section 953 insurance income be taken into account for purposes of the full inclusion rule. The Joint Committee's explanation,[*] however, states that related, party insurance income is not to be taken into account for this purpose where the income is attributable to a foreign corporation that would not be a controlled foreign corporation but for the special provisions of Section 953(c) applicable to related party insurance income, and we recommend that this statement be followed by the Temporary Regulations.

2. Anti-Abuse Rule. Temporary Regulations § 1.954-1T(b)(4) sets forth a new anti-abuse rule under which income of foreign corporations may be aggregated, for purposes of applying the de minimis and full inclusion rules, where one principal purpose" of separately organizing, acquiring or maintaining multiple corporations is to obtain the benefit of the de minimis

[*] Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (1987) (hereafter referred to as the "Blue Book") at 991.

rule or to avoid application of the full inclusion rule.*

The “one principal purpose” standard of the new anti-abuse rule is likely to produce uncertainty for U.S. taxpayers with multiple foreign subsidiaries.

The anti-abuse rule contains a rebuttable presumption that two or more corporations were organized, acquired or maintained for a principal purpose of obtaining the benefit of the de minimis rule or avoiding the full inclusion requirements if the corporations are related (as defined in the Temporary Regulations) and any of three conditions is satisfied. Under the first condition, the presumption applies if two or more corporations carry on substantially the same business or hold substantially the same assets as were previously carried on or held by a single controlled foreign corporation and the U.S. shareholders of the new and prior corporation are substantially the same.** Under the second condition, the presumption is satisfied with respect to any two related foreign corporations that carry on any operations as a partnership, without regard to whether the corporations carry on substantial operations

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* The Temporary Regulations do not include a provision comparable to the provision of prior Regulations § 1.954A-1(d)(4) which separately applied the de minimis and full inclusion rules to separate branches of a single foreign corporation that were treated as separate corporations under Section 954(d)(2) for purposes of the definition of foreign base company sales income. Neither of these changes in the Temporary Regulations reflects any change in the statute or statements in legislative history.

** This presumption may be rebutted by showing that the activities of each controlled foreign corporation would constitute a separate branch under the principles of Temporary Regulations § 1.367(a)-6T(g).

independently of each other. Under the third condition, the presumption is satisfied if the activities of two or more corporations constitute a single “branch” within the meaning of Temporary Regulations § 1.367(a)-6T(g)(2). The first condition seems unnecessary and overbroad in light of the third. If assets or operations were previously carried on or held by a single corporation but do not constitute a single “branch” after being divided among two or more corporations, the presumption should not apply. The second condition seems unfair in light of the many joint research and development projects which are characterized as partnerships.

It would seem that the purpose of all three’ conditions could be achieved by a single provision that looks to whether a substantial portion of the activities of two or more corporations comprise a single branch. Artificial shifting of items of income can be dealt with under Section 482, without the need for anti-abuse provisions as complex as those contained in the Temporary Regulations.

Similarly, the inclusion of a definition of related persons for purposes of the anti-abuse rule that is different from the definition in Section 954(d)(3) adds unnecessary complexity. The Temporary Regulations should provide an interpretation of Section 954(d)(3) (which was amended by the 1986 Act to provide that control includes 50% of voting control or value, and to provide that ownership through a partnership, estate or trust is taken into account) and provide that it applies for purposes of the anti-abuse rule as well as for all other purposes under Section 954.

IV. High Tax Exception (Temporary Regulations § 1. 9 54 – IT(d))

Among other changes, the 1986 Act changed the high tax kick out rule of Section 954 (b)(4) from a subjective test to a test, intended to be self-executing, which will exclude from foreign base company income and insurance income any "item of income" if it established that the rate of foreign income tax on the item was more than 90% of the U.S. corporate tax rate. The legislative history expresses the view (which is repeated in the preamble to the Temporary Regulations) that the high tax exception will be substantially more important under the 1986 Act because the 1986 Act broadens Subpart F.[*]

1. Effective Rate at which Taxes are Imposed. Temporary Regulations § 1.954-1T(d)(3) provides that the. Effective rate at which foreign income taxes are imposed on an item of income is determined by multiplying the amount of the item by the amount of foreign income tax that would be deemed paid or accrued with respect thereto under Section 960.[**] Temporary Regulations § 1.954-lT(d)(4) defines an "item" of income, in the case of income other than foreign personal holding company income that is passive income, as net income that falls within a single category of foreign base company income or insurance income and also falls within a single separate limitation category for purposes of Section 904(d); and, in the case of foreign personal holding company income that is passive income, an amount that falls within a single group of passive

[*] Blue Book at 983.

[**] The Temporary Regulations reflect the TAMRA provision that would make clear that the applicable U.S. testing rate for purposes of Section 954(b)(4) is that specified under Section 11 or Section 15.

income under the grouping rules of Regulations § 1.904-4I(3), (4) or (5) – for example, high withholding tax interest would be a separate "item" of income.

We question whether this definition of an "item of income" provides the flexibility that was intended. While treating items of income as separate if they are within a separate foreign tax credit limitation makes sense, since it generally conforms the Subpart F rules to the foreign tax credit rules, it is not clear why there should be the additional rule that separates items of income solely because they fall within different categories of foreign base company income or insurance income.

For example, as other parts of the Temporary Regulations acknowledge, it may be extremely difficult to separate out services and sales income when a controlled foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform in an integrated transaction[*] — why in such a case should the activity always produce two "items of income" for purposes of the high tax exception? A better rule, supported by the legislative history, would be to permit grouping if the items of income bear substantially equal effective rates of tax under the tax laws of the foreign country.[**].

2. Effect of Consolidation. While the determination of whether income is excluded by the high tax exclusion of Section

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[*] Temporary Regulations § 1.954-1T(e)(3).

[**] Blue Book at 983, stating that "Congress indicated that it expected that the Secretary would provide rules permitting reasonable groupings of items of income that bear substantially equal effective rates of tax in a given country."

954(b)(4) is made on a corporation- by-corporation basis, the calculation of the tax imposed on an item of income may in certain cases reflect the consequences of consolidation (or its equivalent) under a foreign country's tax laws. This issue is not addressed directly by the Temporary Regulations, however, and as a consequence it would appear that the effect of consolidation (or its equivalent) under foreign tax law will depend on whether there is joint and several liability for the consolidated taxes on the part of all of the controlled foreign corporations included in the consolidated return.[*] We question whether this is the best rule and whether additional guidance is not needed as to the allocation of foreign taxes when consolidated (or equivalent) returns are not filed. The effect of consolidation (or its equivalent) is an important issue that should be addressed directly by regulations issued under the high tax exclusion.

V. Determining the Character of Income (Temporary Regulations § 1.954-1T(e))

Temporary Regulations § 1.954-1T(e)(2) gives as an example of a situation which may be treated as giving rise to income in more than one category of foreign base company income, the "imputed interest and market discount" and "gain from the sale of personal property" derived in respect of receivables by a controlled foreign corporation that is in the business of purchasing and selling personal property. If, as will usually be the case, the controlled foreign corporation uses the accrual

[*] See Regulations § 1.901-2(f) (3).

method of accounting, it will take the full face amount of receivables into income at the time of sale* and thus there will neither be imputed interest nor market discount. We suggest that another example be used to illustrate the general point made by the Temporary Regulations.

VI. Computation of Foreign Personal Holding Company Income (Temporary Regulations § 1.954-2T(a))

1. Rules of Priority.

(A) General. The legislative history of the 1986 Act generally recognized the need for rules that would treat items of income described in more than one subsection of Section 954I(1) as governed by only one such subsection.** To this end, the coordination rules in Temporary Regulations § 1.954-2T(a)(2) assign priority to income equivalent to interest, then to foreign currency gain, then to gain from commodities transactions.

(B) Foreign Currency Gain. The priority accorded to foreign currency gains by Temporary Regulations § 1.954-2T(c)(2)(ii) represents a workable and fair rule, since “directly related” currency gains excludible under Section 954(c)(1)(D) generally should include all amounts that would have qualified for exclusion under Section 954(c)(1)(B) (for example, gains realized by a dealer in foreign currency, or on the sale of foreign currency- denominated inventory).In order to avoid the need to account separately for currency gains that would have

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* See Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934).

** The Blue Book indicates, for example, that gain from the sale of a commodity is to be characterized for Subpart F purposes only under the commodities rule of Section 954(c)(1)(C), and will not be subject to reexamination under the rules applicable to sales of property. Blue Book p. 974.

been excluded from foreign personal holding company income in any event, the Service should consider providing that no separate accounting for currency gain is required if the gain is realized in respect of a transaction qualifying for exclusion under Section 954I(1)(B).

(C) Commodities Transactions. Temporary Regulations § 1.954-2T(a)(2)(iii) implements the legislative intent that transactions subject to the commodities rules of Section 954(c)(1)(C) should not also be subject to the rules applicable to sales of property. While this coordination rule is unobjectionable, its existence highlights the need for a coherent and workable distinction between commodities and other property. As discussed in Section XI, supra, the definitions of commodities and commodities transaction found at Temporary Regulations §§ 1.954-2(f)(2)(i) and (ii) are broad and imprecise.

2. Changes in the Use of Property. Temporary Regulations § 1.954-2T(a)(3) prescribes rules for determining whether gain from the sale of property qualifies for exclusion from foreign personal holding company income when the use of the property, or the purpose for which it is held, changes between the time of acquisition and sale. The most notable provision is a one-way rule under which a change in purpose will be ignored if its effect would be to qualify gain for an exclusion from foreign personal holding company income and it occurs after the midpoint of the taxpayer’s holding period. In addition, the Temporary Regulations illustrate the operations of a provision permitting taxpayers to separately characterize currency gains accruing before and after a change in purpose.

The change of purpose rules would appear to have limited practical application, and it is questionable whether the goal of deterring abusive claims to exclusions from Subpart F income is fostered by prescribing irrebuttable presumptions concerning the effect of a change of purpose.* In addition, the examples illustrating the application of Temporary Regulations § 1.954-2T(g)(4)(ii) (which is incorrectly cross-referenced as paragraph (g)(4)(iii)) may foster an unnecessarily mechanical application of the currency hedging rules. Under those rules, a single currency transaction may be analyzed as a qualifying hedge (during the period the transaction met the requirements for such treatment) and a separate transaction generating Subpart F income (during the period when the taxpayer was considered to be speculating in foreign currency).

Example (4) of Temporary Regulations § 1.954-2T(a)(3)(ii) describes a situation in which a currency position being hedged is cancelled after 25 days, but the related forward contract is held for its full 60-day maturity. The example provides that "because the forward contract does not hedge a qualified business transaction during the period shortly before its maturity, it is not to be considered a qualified hedging transaction"; instead, the taxpayer may identify and characterize separately gain or loss attributable to the 25 days in which it had a purpose meeting the requirements of the hedging exception. While the example appears to apply correctly the rules to its facts, the Temporary Regulations should clearly indicate that a hedge need not be coterminous with the exposure being hedged: taxpayers using 90-day forwards to hedge receivables that turn

* The practical difficulties arising from the attempt to exclude speculative positions from "dealer property", as illustrated in Example (2) of Temporary Regulations § 1.954-2T(a)(3)(ii), are discussed below in connection with the definition of that term.

out to have an average life of 85 days, for example, should not be required to bifurcate the forwards into a 85-day qualified hedge and a 5-day speculation.

3. Definitions

(A) Interest. The definition of interest in Temporary Regulations § 1.954-2T(a)(4)(i) refers to amounts "treated as ordinary income, original issue discount or interest income" under ten cited Internal Revenue Code sections including Section 482. The reference to ordinary income appears to serve no purpose and should be deleted. Section 482, at least, deals with a variety of payments that should not be assimilated to interest. Finally, original issue discount falling within the exceptions set forth in Section 1272(a)(2) (other than interest on tax exempt obligations, which is subject to a pass-through rule) and the *de minimis* rule of Section 1273(a)(3) should be explicitly excluded from the definition of interest.

(B) Inventory and Similar Property. The Temporary Regulations provide separate definitions for the essentially similar (and largely contiguous) terms "inventory and similar property" and "dealer property". The use of two separately defined terms creates a potential for inadvertent differences in the characterization of income that should be accorded identical treatment. If separate definitions are retained, the Temporary Regulations should be carefully reviewed to eliminate unintended failures to refer to both terms wherever appropriate.

The first example of differential treatment occurs in the definitions themselves: inventory and similar property includes positions held in bona fide hedging transactions, while no similar rule is provided for hedges of dealer property. The enactment of TAMRA, which provides a broadly worded exemption for hedging transactions reasonably necessary to the conduct of business as a dealer,* furnishes an appropriate opportunity for the Service to prescribe hedging rules applicable to dealer property.

Other instances where the relationship between inventory and dealer property may not have been fully thought out include Temporary Regulations §§ 1.954-2T:

— (g)(3)(ii)(A)(1) (reference to inventory but not dealer property);
— (g)(3)(ii)(B)(4) (reference to dealer property but not inventory);
— (e)(2) (securities excluded from inventory and not explicitly included in dealer property); and
— (g)(3)(i) (notwithstanding exclusion referred to above, debt instruments included in inventory).

(C) <u>Regular Dealer</u>. It appears that the rules for regular dealers and dealer property were intended to apply to financial products and similar intangibles. The definition of regular dealer in Temporary Regulations § 1.954-2T(a)(4)(iii) generally represents a fair and workable attempt to provide uniform rules for dealers in financial products, without regard to whether the products are bought and sold in a manner indistinguishable from the manner of marketing tangible goods or whether the dealer instead "makes a market...by regularly and actively offering to enter into positions in such products to [with?] the public in the ordinary course of business."**

* TAMRA § 1012(i)(20).

** Temporary Regulations § 1.954-2T(a)(4)(iii)(B).

The Temporary Regulations provide that merely "purchasing and selling property through a regulated exchange or established off-exchange market (for example, engaging in futures transactions)" does not constitute a dealer activity. This limitation, which appears to be an attempt to distinguish dealers and traders, fails to recognize that dealers acting in their capacity as marketmakers can buy or sell through off-exchange markets.* The Temporary Regulations should confirm that dealers whose activity, individually or collectively, constitutes a market are not thereby transmuted into mere traders.

(D) Dealer Property. Temporary Regulations § 1.954-2T(a)(4)(iv) provides that property will constitute dealer property only if (i) it is held by a regular dealer in "property of such kind" and (ii) the controlled foreign corporation holds the property in its capacity as dealer, rather than for investment or speculation. The second of these requirements would appear to be unsupported by the statute and is likely to lead to substantial uncertainty. The statute referred, prior to the adoption of TAMRA, to gain derived from "any property by a regular dealer in such property"? the 1986 Act changes the order of the words without changing their meaning.

Limiting the definition of dealer property to positions held as a dealer could produce uncertainty, and create compliance burdens wholly disproportionate to any possible benefits, because securities businesses operating outside the United States historically have not been subject to any requirement under domestic (or, for the most part, foreign) law that is analogous to Section 1236. While it can be assumed that a bona fide dealer

* Interest rate swaps, for example, are not listed on any exchange.

in securities holds the great majority of its securities positions for sale to customers, no rules have required a foreign dealer to account for its purpose in acquiring and maintaining any particular securities position. Thus, limiting the definition of dealer property to property held as a dealer could require the adoption of procedures not required, until now, by any other provision of law, to identify the occasional transactions where investment or speculative motives can be said to predominate. If the definition of dealer property is to be so limited, the Temporary Regulations should provide rules, analogous to those in Section 123 6, describing how taxpayers are to make such identification.*

As indicated in the discussion of inventory and similar property, while it may make sense as a drafting matter to provide separate definitions for (predominantly tangible) inventory and (predominantly intangible) dealer property, there is no technical or policy reason for applying different rules to what is essentially a single statutory exemption. Accordingly, care should be taken to insure that the same treatment applies to inventory and to dealer property.

(E) Debt Instrument. The Temporary Regulations pervasively use the term "debt instrument" in a context where "trade receivable" would be more appropriate. See, for example, Temporary Regulations § 1.954-2T(b)(3)(ix). The Temporary Regulations should appropriately distinguish between debt instruments that constitute dealer property and trade receivables.

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* See, e.g., Notice 88-22, 1988-11 I.R.B. 19, in which the Service provided guidance as to how taxpayers are to identify non-passive stock and securities for purposes of Section 1296(a)(2) (relating to passive foreign investment companies).

VII. Foreign Personal Holding Company Income -- Dividends, etc. (Temporary Regulations § 1.954-2T(b))

1. Background.

The 1986 Act repealed the rules that previously excluded from foreign personal holding company income (1) dividends, interest and gains from the sale or exchange of stock or securities received from unrelated persons either in the active conduct of a banking, financing or similar business or from an insurance company's investment of unearned premiums, reserves and certain other funds, and (2) interest paid by a related person to a controlled foreign corporation if both were engaged in a banking, financing or similar business. The 1986 Act preserved tax deferral, however, for interest derived in a banking business in connection with certain export sales.*

Further, the 1986 Act (1) retained the prior law exclusion from Subpart F foreign personal holding company income for rents and royalties derived in the active conduct of a trade or business from unrelated persons** and (2) restricted the rule that excludes from foreign personal holding company income certain dividends, interest, rents and royalties received from related persons (by providing that payments do not qualify to the extent that such payments reduce Subpart F income of the payor).***

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* Section 954(c)(2)(B).

** Section 954(c)(2)(A).

*** Section 954(c)(3).

Temporary Regulations § 1.954-2T provides detailed rules for the calculation of foreign personal holding company income under Section 954(c). Temporary Regulations § 1.954-2T(b) provides for the inclusion in foreign personal holding company income of dividends, interest, rents, royalties and annuities and provides guidance on the export financing and same country related person exceptions applicable to certain types of income. Several of these rules are based on the prior Regulations (§§ 1.954-2(a)-(e), now §§ 1.954A-2 (a) - (e)) but they have been modified in several ways discussed below.

2. Export Financing Interest.

Section 954(c)(2)(B) provides that foreign personal holding company income does not include any interest which is derived in the conduct of a banking business and which is "export financing interest" as defined in Section 904(d)(2)(G). Pursuant to Temporary Regulations § 1.954-2T(b)(2)(i) and Section 864(d)(5)(A)(iii), export financing income does not include related person factoring income under Sections 864(d)(1) or (6). The Temporary Regulations do not define "export financing interest", but simply refer to Section 904(d)(2)(G) and the regulations thereunder.*

Under Temporary Regulations § 1.954-2T(b)(2)(ii), whether a controlled foreign corporation is deriving export financing interest in the "conduct of a banking business" turns on whether "in connection with the financing from which the interest is derived, the corporation, through its *

* These Regulations (§ 1.904-4(h)) were proposed in August 1987, made final in July 1988 and are not within the scope of this Report.

own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.” Prior Regulations § 1.954A-2(d)(2)(ii) set forth elaborate rules for the determination of whether a controlled foreign corporation could be considered to be engaged in a “banking, financing, or similar business.” Factors to be considered included carrying on one of more specified activities (all of which identified specifically dealings with the public). Whether the controlled foreign corporation was subject to the banking and credit laws of a foreign country was but a factor to consider; instead, the character of the business carried on actually determined whether the entity was conducting a banking business.[*]

The extensive specificity of the prior Regulations- was probably justified in light of the broad exclusion from the Subpart F income rules that prior law afforded controlled foreign corporations engaged in the banking business. With the scope of the exclusion narrowed considerably, the brevity and generalized approach of the Temporary Regulations on this topic is welcome. We are concerned, however, that the language regarding engaging in “all the activities in which banks customarily engage in issuing and servicing a loan” may be construed too narrowly in a case where the corporation may regularly transfer the loan servicing function to a related or unrelated third party. The Temporary Regulations should make it clear that the mere fact that the corporation does transfer the servicing of loans to third parties will not preclude the corporation from being considered engaged in the conduct of a banking business.

[*] Prior Regulations § 1.954A-2(d)(2)(ii)(G).

3. Dividends and Interest from Related Persons.

Section 954 (c)(3)(A)(i) provides that the term “foreign personal holding company income” does not include dividends and interest received from a related person which (1) is created or organized under the laws of the same foreign country under the laws of which the controlled foreign corporation is created or organized, and (2) has a substantial part of its assets used in its trade or business located in the same foreign country. This exception, however, does not apply to the extent that interest reduces the payor’s Subpart F income.* The language of Section 954(c)(3)(A)(i) is identical to the language that appeared under Section 954(c)(4)(A) of the Internal Revenue Code of 1954, as amended.

Some of the rules set forth in the Temporary Regulations (§ 1.954-2T(b)(3)) are based upon the prior Regulations (§ 1.954-2(e)(1)). There are, however, material differences. These differences, and the issues they raise, are noted below.

(A) General. Prior Regulations § 1.954A-2(e)(l) sought to determine whether the dividend-paying foreign corporation, in the year in question, “has a substantial part of the assets, which are used in its trade or business, located” in the same foreign country as the controlled foreign corporation. The prior Regulations did not define “trade or business.” As is apparent from a reading of the prior Regulations, the situs of the trade or business need not have been in the country of incorporation -- what appeared important, based on the statute, was whether a substantial part of the assets used in a trade or business was located in the country of incorporation. Thus, at least

* Section 954 (c)(3)(B).

technically, a trade or business of the foreign corporation could have a situs in a country other than the country of incorporation and, so long as a substantial part of the assets of that business were located in the country of incorporation, dividends paid by that corporation to a related party incorporated in the same country could qualify for the exclusion from foreign personal holding company income.

The Temporary Regulations, without any change in the statutory language or suggested by the legislative history, adopt a new approach. That approach is to determine (a) whether the paying corporation has a trade or business in the country of incorporation and (b) whether its assets are used in that trade or business. Temporary Regulations § 1.954-2T(b)(3)(i) imports the principles of Section 367(a) and the regulations thereunder to make those determinations. The relevant Regulations under Section 367(a) are Temporary Regulations §§ l.367(a)-2T(b)(2) (defining “trade or business”), 1.367(a)-2T(b)(4) (determination of whether a foreign corporation conducts a trade or business outside the United States) and 1.367(a)-2T(b)(5) (determination of whether property is used in the trade or business).

We generally favor the use of a single set of principles to be applied in the determination of whether statutory requirements that are (a) defined in identical terms and (b) serve essentially similar objectives have been satisfied. In this case, however, we do not believe it appropriate to turn to the principles and factors of Section 367(a) because there are sufficient differences between the relevant provisions to warrant regulations tailored specifically to Section 954(c)(3)(A)(i).

Moreover, as noted above, there has been neither a statutory change nor reported legislative history to warrant a new approach.

Section 367(a)(3)(A) is concerned with the “active” conduct of a trade or business “outside the United States” and the temporary regulations under Section 367(a), quite properly, set forth principles to determine whether these requirements have been satisfied. Thus, for example, Temporary Regulations § 1.367(a)-2T(b)(3) establishes the principle that substantial managerial and operational activities must be carried out by the corporation’s officers and employees in order to have the corporation considered engaged in the active conduct of a trade or business. For the business to be considered conducted outside the United States, Temporary Regulations § 1.367(a)-2T(b)(4) requires that both managerial and operational activities be conducted outside the United States. In determining whether assets are “used” in the trade or business, these temporary regulations reject the notion that assets held for anticipated future needs (whether for expansion, replacement or contingencies) qualify as being used in the business.

In contrast, Section 954(c)(3)(A)(i) requires the existence of a “trade or business” that has a substantial part of its assets used in its trade or business located in the same foreign country in which it is incorporated. The principles developed in the Section 3 67 temporary regulations that derive from the “active” trade or business requirement may not be imported wholesale, particularly in the face of a statutory requirement that focuses especially on the use of assets. Whether the dividend-paying corporation has officers who carry on substantial managerial activities in the country in which it is incorporated is not the relevant test to determine whether the corporation has a trade or business and whether a substantial part of the assets of that business are located in the country of incorporation.

(B) Substantial Assets Test. Prior Regulations § 1.954-2(e)(1) acknowledged initially that the determination of whether a substantial part of the assets used in a trade or business are located in the country of incorporation depends on the “facts and circumstances of each case.” Temporary Regulations § 1.954-2T(b)(3)(iv) makes no such acknowledgement.

Prior Regulations § 1.954A-2(e)(1) provided that the substantial assets test could be satisfied if for each quarter during the taxable year of the corporation the average value of the assets which are used in the trade or business and are located in the country of incorporation constitute 80 percent or more of the average value of all its assets used in such trade or business (the “80-percent test”). The Temporary Regulations introduce a new test: the average value (as of the beginning and end of the quarter) of the corporation’s assets which are used in the trade or business and are located in the country of incorporation must constitute over 50 percent of the average value (at the beginning and end of the quarter)’ of all the assets of the payor, including assets not used in the trade or business (the “50-percent test”).

The new 50-percent test, looking as it does to the location of all of the assets of the corporation, is simply not supported by the language of the statute, extant for more than 2 0 years, which, as the statute provides, looks to whether a substantial part of the corporation’s assets used in its trade or business are located in the same foreign country. In the absence of a statutory basis (and no apparent change even suggested by the legislative history) we urge a return to the standards developed under the prior Regulations.

(C) Location of Assets Prior Regulations § 1.954-2(e)(1)(ii) provided rules for the determination of the location of tangible property (other than inventory), (b) bills receivable, accounts receivable, notes receivable and open accounts, (c) interests in real estate and (d) in-tangibles. Temporary Regulations §§ 1.954-2T(b)(3)(vi)-(x) provide specific rules with respect to the location of (a) tangible property (other than inventory), (b) intangible property, (c) inventory, (d) debt instruments and (e) certain stock interests.

(1) Tangible Property -- The Temporary Regulations make it clear that physical location governs. Pursuant to Temporary Regulations § 1.954-2T(b)(3)(vi)(B), property physically located outside the country of incorporation will nonetheless qualify as located in the country of incorporation if its physical location abroad is temporary, for inspection or repair, and the property is not currently in service nor placed in service abroad. The prior Regulations focused merely on purchased property located abroad and intended for prompt shipment to the country of incorporation. The situations addressed by the Temporary Regulations are appropriately resolved. We see no reason, however, for omitting from the Temporary Regulations the purchased property situation and recommend that the final regulations incorporate that portion of the prior Regulations.

(2) Intangible Property -- Temporary Regulations § 1.954-2T(b)(3)(vii)(A) provides that the locus of intangible property (and query whether intangible property includes goodwill) will be determined on the basis of the site of the

activities conducted by the payor in connection with the use or exploitation of that property. Prior Regulations § 1.954A-2(e)(1)(ii) applied an arbitrary rule based on the ratio that the amount of the foreign corporation’s tangible property, debt instruments and real property used in its trade or business bears to the total amount of such assets used in its trade or business. The approach of the Temporary Regulations in this regard appears reasonable although it does invite a difficult factual inquiry as to the locus of the activities related to a particular intangible. The advantage of the approach of the prior Regulations was that it provided a “brightline” test. On balance, we favor the approach of the Temporary Regulations because it is likely to lead to more rational results.

We note, however, that the Temporary Regulations are particularly restrictive in one respect -- they require that the use or exploitation be carried out during the <u>entire</u> taxable year in the country of incorporation in order to have the particular intangible item treated as located in the country of incorporation for each quarter of the year. The percentage test of the Temporary Regulations as to the location of substantial assets is applied on a quarter-by- quarter basis and must be satisfied as to each quarter of the year. In light of the change in the Temporary Regulations as to the assets considered in the application of the percentage test, it seems unfair to take into account all of the assets of the payor (as opposed to the assets used in a particular trade or business) and at the same time, as to intangibles, permit those assets to be counted favorably only if they have been used or exploited for the entire year.

With respect to activities carried on in more than one country by the payor corporation, Temporary Regulations § 1.954-2T (b)(3)(vii)(B) provides that the value of the intangible deemed located in the country of incorporation will be determined by an allocation of the value based on expenses.

(3) Inventory -- The prior Regulations did not specifically address the status of inventory as a business asset or its location. The only reference is in prior Regulations § 1.954A-2(e)(1)(ii), which provides the rules applicable to determine the location of assets other than inventory or similar assets. Under Temporary Regulations § 1.954-2T(b)(3)(viii)(A), the location of inventory is based upon whether the activities of the payor in connection with the production and sale, or purchase and resale, are conducted in the country of incorporation. In the case of activities carried on in both the country of incorporation, and other countries, Temporary Regulations § 1.954- 2T(b)(3)(viii)(B) provides that the portion of the inventory deemed located in the country of incorporation will be determined by an allocation based on inventory costs.

(4) Debt Instruments -- Temporary Regulations § 1.954-2T(b)(3)(ix) provides initially that debt instruments are considered to be used in a trade or business only if they arise from the sale of inventory or from the rendition of services in the ordinary course of a trade or business of the payor, but only until such time as interest is required to be charged under Section 482. Under prior Regulations § 1.954A-2(c)(1)(iii)(A), the amount of receivables considered to be assets used in the trade or business was determined by reference to the amount which is “ordinary and necessary” to carry on the business of both parties to the transaction. The Internal Revenue Service’s

interpretation of “ordinary and necessary” was based on the standards of Section 482.[*] To that extent the Temporary Regulations are consistent with the prior Regulations. The location of debt instruments is determined by reference to the location of inventory for the relevant calendar quarter or the place where the services were per-formed, as the case may be.

(5) Stock Interests -- Temporary Regulations § 1.954-2T(b)(3)(x) provides that the stock of a lower-tier corporation incorporated in the same country as the payor is considered located in the country of incorporation and used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in the trade or business in the country of incorporation. The prior Regulations had no parallel provisions. To the extent that the final regulations retain the 50- percent test, this provision of the Temporary Regulations is appropriate. As noted above, however, we believe that a departure from the 80-percent test of the prior Regulations is not warranted.

VIII. Treatment of Tax-Exempt Interest (Temporary Regulations §§ 1.954-2T(a)(4) and 2T(b)(6))[**]

The effect of Temporary Regulations §§ 1.954-2T(a)(4)(i) and (b)(6) is to treat interest described in Section 103(a) which is earned by a controlled foreign corporation as foreign personal holding company income for Subpart F purposes. Under the Temporary Regulations, the resulting Section

[*] See PLR 8835003 (May 30, 1988) for an application of the rules of Section 482 to a determination of whether receivables were “ordinary and necessary.”

[**] TAMRA does not affect this discussion.

951(a)(1)(A) inclusion is tax-exempt to the U.S. shareholder but potentially subject to the alternative minimum tax.

We believe that this treatment by the Temporary Regulations of interest described in Section 103(a), which reverses the position set forth in Revenue Ruling 72-527,[*] is without statutory support and should be eliminated.

Section 954(c)(1), which sets out what is included in foreign personal holding company income for purpose of the foreign base company income definition, starts with the statement that foreign personal holding company income is a “portion” of “gross income”.[**] In order to be foreign personal holding company income, therefore, an item must first be gross income. Interest described in Section 103(a) is not included in gross income, and it follows that Section 103(a) interest is not foreign personal holding company income. This was the conclusion reached in Revenue Ruling 72-527.

The treatment by the Temporary Regulations of Section 103(a) interest creates collateral problems with respect to actual distributions of any tax-exempt Section 951(a)(1)(A) inclusion. Under Section 959(a), an actual distribution of a Section 951(a)(1)(A) inclusion does not result in a taxable dividend. There is, however, no separate mechanism in the Internal Revenue Code for dealing with a Section 951(a)(1)(A) inclusion that is tax-exempt, and the result under the Temporary

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[*] 1972-2 C.B. 456.

[**] It should be noted that the Temporary Regulations refer to the “subpart F income of a U.S. shareholder.” Subpart F income is income earned by a controlled foreign corporation, and not the amount included in income by a U.S. shareholder under Section 951(a)(1)(A).

Regulations is apparently that interest shall be treated as tax-exempt interest in the hands of the U.S. shareholders of the foreign corporation. A cash distribution of such a tax-exempt inclusion from the controlled foreign corporation apparently has no tax consequences to the shareholder. This may be a “better” result for most U.S. taxpayers than the statutory language would permit, i.e., a taxable U.S. source dividend.

It is possible that the concern which led to this treatment of tax-exempt interest was that a U.S. corporation with a potential alternative minimum tax exposure might invest through a controlled foreign corporation in “private activity bonds” that would produce tax preference income under Section 57(a)(5). While Section 103(a) excludes- certain interest from gross income, however, it is clear that such interest is included in earnings and profits; and, thus, when actually distributed to the U.S. shareholder, all Section 103(a) interest of a controlled foreign corporation will be taxed as dividend income and generally sourced to the United States under Section 904(g). Accordingly, the U.S. shareholder would avoid a current 20% tax, but would (in the absence of the Temporary Regulations) be subject to a 34% tax upon distribution. As a result it is quite unlikely that such attempts at avoidance of Section 55 will be undertaken.

IX. Exclusion For Certain Rents (Temporary Regulations §§ 1.954-2T(b)(4) and -2T(c))[*]

Prior law excluded rents from foreign personal holding company income if (a) the rents were derived in the active conduct of a trade or business and not received from a related person or (b) the rents were received from a related person for the use of, or the privilege of using, property within the country under the laws of which the controlled foreign corporation is created or organized. The 1986 Act did not change these exclusions except to provide that the exception for related person rents would not apply to the extent the rent reduced the payor’s Subpart F income.[**]

Consistent with the absence of any change in the statute, the Temporary Regulations with respect to the related person rent exclusion (set out in Temporary Regulations § 1.954-2T(b)(4)) simply restates prior Regulations §.1.954-2(e)(3) (which in turn simply restated the statute) and provided that where there was use in more than one country, only the part attributable to use within the country of incorporation or organization is excluded, with respect to the exclusion for active trade or business rents, however, the Temporary Regulations make significant changes, as follows:

(1) Prior Regulations § 1.954-2(d)(1)(i) said that the active trade or business issue was “to

[*] There is nothing in TAMRA that will affect these rules except for a change in the definition of a related person.

[**] It also changed the last two sentences of the definition of related person in Section 954(d)(3).

be determined from the facts and circumstances in each case" and that the "frequency" of transactions would not by itself establish that there was an active trade or business, and then set out safe harbor rules under which qualifying rents would always be considered to be derived from an active trade or business. Temporary Regulations § 1.954-2T(c)(1) eliminates the facts and circumstances rule, thus turning the safe harbor rule into a bright line test for determining whether the active trade or business exception applies.

(2) Prior Regulations § 1.954-2(d)(1)(ii)(b)(2) said that the issue of whether an organization operated in a foreign country was substantial in relation to the amount of its rental income, which is relevant to the safe harbor rule that excludes rentals from properties if the lessor maintains and operates an organization in a foreign country which is regularly engaged in marketing or marketing and servicing, "is to be determined from the facts and circumstances of each case", and then set out a safe harbor rule. Temporary Regulations § 1.954-2T(c)(2)(ii) eliminates this facts and circumstances rule, again turning the safe harbor rule into a bright line test for determining "substantially." Example (2) of Temporary Regulations § 1.954-2T(c)(3), which corresponds to Example (3) of the prior Regulations, confirms that this is the intent.

We question whether it is desirable to eliminate the facts and circumstances test for determining whether rents are derived from an active trade or business (or for determining whether an organization in a foreign country is "substantial"). That alternative has been available for many years. In addition, while the legislative history of the 1986 Act changes to Subpart F provides no particular guidance on the rules with respect to rent, the legislative history of the foreign tax credit changes seems to endorse the facts and circumstances tests that would be eliminated by the Temporary Regulations. Thus, the Blue Book states that

> In general, under Regulations § 1.954-2(d)(1), whether rents and royalties received from unrelated persons are derived in the active conduct of a trade or business is determined under a facts and circumstances test. In addition, these regulations provide safe harbor rules. In general Congress anticipated that the standards contained in these existing regulations.... would be followed [for foreign tax credit purposes in determining whether they were “passive income” or not, although] Congress noted that the standards would have to be modified somewhat [for foreign tax credit purposes].

In addition to the foregoing, the Temporary Regulations make the following changes in the prior Regulations:

(1) (Temporary Regulations § 1.954-2T(c)(1)(ii) adds to prior Regulations § 1.954-2(d)(1)(ii)(a)(2), relating to the safe harbor for leasing real estate with respect to which the lessor performs active and substantial management and operational functions, a requirement that those functions be performed by the lessor “through its own officers or staff of employees”.

(2) Temporary Regulations § 1.954-2T(c)(2)(ii), relating to the safe harbor, adds a rule that excludes from active leasing expenses (which must be 25% or more of adjusted leasing profit in order for the safe harbor to be available) “payments made to independent contractors with respect to the leased property” (and correspondingly eliminates such amount from adjusted leasing profit).

In determining whether a corporation is actively engaged in a trade or business in other contexts, the Service has generally disregarded activities not performed by the corporation's own employees, and the proposed changes are consistent with that position.[*]

X. Exclusion For Certain Royalties (Temporary Regulations § 1.954-2T(d))[**]

The rules in Temporary Regulations § 1.954-2T(d) for excluding active trade or business royalties from foreign personal holding company income follow the rules applied to rents by Temporary Regulations § 1.954-2T(c). They therefore eliminate the "facts and circumstances" test for determining when royalties will be considered to be derived from the active conduct of a trade or business, leaving the mechanical safe harbor of the prior regulations as the only test. For the reasons set out in our comments on Temporary Regulations § 1.954-2T(c), we do not believe that such a change should be made.

XI. Inclusion of Certain Net Gains (Temporary Regulations § 1.954-2T(e))

Prior law included gains in foreign personal holding company income only by cross-reference to the foreign personal holding company provisions, which included gains from the sale or exchange of stock or securities, except in the case of a regular dealer therein, and certain commodities gains. As amended by the

[*] In addition, the Temporary Regulations delete Examples (2) and (7) of the prior Regulations (relating to motion pictures).

[**] The enactment of TAMRA does not materially affect these issues.

1986 Act, Section 954(c)(1)(B) includes net gains from the sales or exchanges of (1) property that gives rise to dividends, interest, royalties, rents and annuities, after the application of the exclusion of rents and royalties that are derived in the active conduct of a trade or business and received from an unrelated person; and (2) property "which does not give rise to any income".[*]

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[*] TAMRA changed the statutory rules with respect to gains from sales and exchanges of property by amending Section 954(c)(1)(B)

(a) To add (in new clause (ii)) property "which is an interest in a trust, partnership, or REMIC". The Temporary Regulations reserve on the treatment of sales of interests in pass through entities. As a corollary, says the legislative history, these net gains will generally constitute passive income for purposes of the foreign tax credit limitation.

(b) To clarify that losses from sales of inventory and regular dealer property do not reduce foreign personal holding company income. The last sentence of Section 954(c), which previously referred only to gains from such property, was amended to refer to both gains and losses.

(c) To provide a new hedging exception for regular dealers in property that would exclude gains and losses arising out of bona fide hedging transactions. A new sentence was added to Section 954(c)(1)(B) which provides that:

> In the case of any regular dealer in property, gains and losses from the sale or exchange of any such property or arising out of bona fide hedging trans-actions reasonably necessary to the conduct of the business of being a dealer in such property shall not be taken into account under this subparagraph.

The legislative history says that:

> Thus, where a regular dealer in bonds, for example, uses forwards, futures, options, or similar instruments in which it is not a regular dealer to hedge its exposure to losses on its bonds, the bill permits netting of gains and losses from both bonds and hedging instruments in arriving at the dealer's non-subpart F income.

Temporary Regulations § 1.954-2T(e)(1)(i) puts Section 988(a)(1)(B) gains or losses in this category, rather than under foreign currency gains, although such gains and losses do not appear to fall within either clause of Section 954(c)(1)(B).

Temporary Regulations § 1.954-2T(e)(l)(ii) introduces, without apparent support in the legislative history, a concept of dual character property which may "in part" constitute income described in Section 954(c)(1)(B). The example of dual character property gain in the Temporary Regulations is a building, of which 60% is used for one purpose and 40% for another. While this makes sense, it would be useful to clarify, by further examples or otherwise, what is not dual character property -- for example, that it will not include property used to produce income on a seasonable basis or property which is withdrawn from use in a trade or business and offered for sale within a reasonable time thereafter.

Temporary Regulations § 1.954-2T(e)(3) defines property that does not give rise to any income in the negative, i e., as property other than specifically enumerated items. There is no specific support for this approach in the legislative history (which gives, as the only examples of property that does not give rise to any income, diamonds and a painting held for investment), but it would nonetheless seem to be a reasonable approach to the problem so long as the list of excepted properties is sufficiently inclusive.*

* The legislative history (Blue Book at page 974) supports this approach insofar as it says that "The provision also is not intended to apply to gain on the sale of land, buildings, or equipment used by the seller in an active trade or business of the seller at the time of the sale."

In this respect, it is unclear whether gain from the sale of items of property whose cost is expensed (e.g., certain supplies) will, as it should, be excluded by the definition in Temporary Regulations § 1.954-2T(e)(3); and whether “goodwill” will, as it should, include all intangibles used in a trade or business that are neither depreciable nor enumerated in Section 936(h)(3)(B) (such as, for example, contractual rights that cannot be amortized because of the uncertain life of the contract). We also question whether there should be a requirement, in the case of intangible property enumerated in Section 936(h)(3)(B), that the property be disposed of in connection with the sale of a trade or business. If, for example, rights to a customer list are sold but the business is retained (and assuming that the customer list cannot be amortized under Regulations § 1.167(a)-3), why is the gain from “property that does not give rise to income”?

We also question the rule in Temporary Regulations § 1.954-2T(e)(5) which deems any right to acquire or transfer property, such as an option, future or forward, to be property that does not give rise to any income unless it is dealer property or inventory. Such rights may very well be property which, in any normal reading of the statute, would “give...rise to income”; and there is nothing in the legislative history (which, as noted above, refers only to diamonds and a painting held for investment) which suggests the statute was not intended to be read in a straightforward way. Moreover, it is difficult to reconcile the blanket treatment of all such rights as “property that does not give rise to income” with (1) the general rule that trade or business assets will not be regarded as property that does not give rise to any income or (2) the rules in Sections 954(c)(1)(C) and (D) that would, under specified circum-stances, exclude rights that relate to commodities and foreign currencies from Subpart F income.

XII. Commodities Transactions (Temporary Regulations § 1.954-2T(f))

Temporary Regulations § 1.954-2T(f) sets forth rules implementing Section 954(c)(1)(C), relating to the treatment of commodities transactions. Under the rules of Temporary Regulations § 1.954-2T(f), foreign personal holding company income generally includes net gains from commodity transactions (other than Section 988 transactions, which are dealt with under Temporary Regulations § 1.954- 2T(g)) excluding gains and losses from “qualified hedging transactions” or “qualified active sales.” We have several comments on these rules.

1. Definitions. The definitions of “commodities” and “commodities transactions” in Temporary Regulations § 1.954-2T(f)(2) are overbroad and imprecise. There is no indication in the legislative history that the meaning of “commodities” for purposes of Section 954(c)(1)(C) was intended to be any broader than the meaning of commodities for other purposes. Accordingly, we recommend that the definition in Temporary Regulations § 1.954-2T(f)(2) conform more closely to existing rules governing commodities transactions, such as those relevant for purposes of Sections 553 and 864 and Regulations § 1.6045-1(a)(5).

2. Qualified Active Sales. “Qualified active sales” are defined in Temporary Regulations § 1.954-2T(f)(3)(i) as “sales of commodities in the active conduct of a commodity business...if substantially all of the controlled foreign corporation’s business is as an active producer, processor,

merchant, or handler of commodities of like kind."* The emphasized language, which is not supported by either the statute or the legislative history, is inappropriate, as it could result in the unavailability of the qualified active sale exception to a controlled foreign corporation, all of whose business was as an active producer, processor, merchant or handler of two or more types of commodities. Consider, for example, a controlled foreign corporation, all of whose business was as an active merchant in gold (giving rise to 50% of the controlled foreign corporation's taxable income) and cotton (giving rise to the other 50% of taxable income). Because "substantially all" is defined in Temporary Regulations § 1.954-2T(f)(3)(iv) as 85% of taxable income, neither sales of gold nor of silver would be qualified active sales under the Temporary Regulations although such sales would appear to fall squarely within the intent of Section 954(c)(1)(C)(ii).

Accordingly, we recommend that the phrase "of like kind" be deleted from the first sentence of Temporary Regulations § 1.954-2T(f)(3)(i). Any concern that the qualified active sale exception not apply to sales of commodities of a kind with respect to which the controlled foreign corporation is not an active producer, processor, merchant or handler (such as an isolated sale of oil by the controlled foreign corporation in the above example) is addressed by the second sentence of Temporary Regulations § 1.954- 2T(f)(3)(i), which expressly provides that

* Emphasis added.

such sales are not qualified active sales.

In addition, some guidance as to what constitutes a “kind” of commodity would be useful. For example, are all agricultural commodities “of like kind”, or are grains one kind of commodity, oilseeds a second kind, beans a third kind, fibers a fourth kind, etc.?

3. <u>“Substantially All” Test</u>. The first sentence of Temporary Regulations § 1.954-2T(f)(3)(iv) provides that substantially all of a controlled foreign corporation’s business is an active commodities business “if the activities described in paragraph (f)(3)(iii) give rise to 85 percent of the taxable income” of the controlled foreign corporation. The quoted language needs to be clarified, because it is not clear in what sense the activities described in paragraph (f)(3)(iii) (which involve the incurring of various expenses) “give rise to” taxable income, which generally will arise only upon the sale of commodities. If paragraph (f)(3)(iii) is to be the benchmark for the substantially all test, then it may make more sense to refer to expenses, rather than taxable income, generated by such activities.

If the first sentence of Temporary Regulations § 1. 954-2T (f)(3)(iv) was not intended to refer to income arising from sales of commodities, then the meaning of the second sentence

(which states that for purposes of the first sentence, gains and losses from qualified hedging transactions are considered derived from the related qualified active sale) is unclear.* In any event, the second sentence should be redrafted to remove the present circularity (the outcome of the substantially all test depends in part on whether gains or losses are from qualified hedging transactions, which in turn depends (under Temporary Regulations § 1.954-2T(f)(4)(ii)) on whether the sales to which the
hedges relate are qualified active sales, which in turn depends (under Temporary Regulations § 1.954-2T(f)(3)(i)) on whether the substantially all test is met).

4. Qualified Hedges. The requirement in Temporary Regulations § 1.954-2T(f)(4)(ii) that a qualified hedging transaction relate to a qualified active sale is not supported by either the statute or the legislative history, which only require bona fide hedging transactions reasonably necessary to the conduct of any commodities business in the manner in which such business is customarily and usually conducted by others, and, accordingly, should be deleted.

In addition, Temporary Regulations § 1.954-2T(f)(4)(ii), which requires that qualified hedging trans-actions be “entered into primarily to reduce the risk of price change (but not the

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* Although this second sentence was apparently derived from certain statements made by Senators Dodd and Packwood, 132 Cong. Rec. S.8289 (June 24, 1986), it is not clear that Temporary Regulations § 1.954-2T(f)(3)(iv) as presently drafted fully reflects the intent expressed in those statements.

risk of currency fluctuations) with respect to commodities" should be changed to clarify that the parenthetical phrase does not apply in the case of hedges with respect to Section 1256 currency transactions (which are subject to the rules of Temporary Regulations § 1.954-2T(f) rather than Temporary Regulations § 1.954-2T(g)).

5. Coordination Rules. It would be useful to add to Temporary Regulations § 1.954-2T(f) a provision dealing with the coordination of Temporary Regulations §§ 1.9 54- 2T(f) and (g). Under the ordering rule of Temporary Regulations § 1.954-2T(a)(2)(ii), gains and losses attributable to Section 988 transactions are subject only to the rules of Temporary Regulations § 1.954-2T(g) and non-Section 988 currency transactions are subject only to the rules of Temporary Regulations § 1.954-2T(f). However, Temporary Regulations § 1.954-2T(g)(5) provides an election to treat Section 1256 gains and losses under the rules of Temporary Regulations § 1.954-2T(g) rather than Temporary Regulations § 1.954-2T(f); accordingly, Temporary Regulations § 1.954- 2T(f) should contain a cross-reference to Temporary Regulations § 1.954-2T(g)(5).

In addition, Temporary Regulations § 1.954- 2T(e)(1)(i) provides that Section 988(a)(1)(B) gains and losses are not foreign currency gains or losses subject to Temporary Regulations § 1.954-2T(g) but rather are property gains or losses subject to Temporary Regulations § 1.954- 2T(e). It is not clear why gains or losses that are excluded from the provisions of Temporary Regulations § 1.954-2T(g) should be subject to Temporary

Regulations § 1.954-2T(e) rather than Temporary Regulations § 1.954-2T(f).[*]

XIII. Foreign Currency Gains and Losses (Temporary Regulations § 1.954-2T(g))

1. General

Section 954(c)(1)(D) treats the excess of foreign currency (“FX”) gains over losses attributable to Section 988 transactions as an item of foreign personal holding company income subject to an exception for “any transaction directly related to the business needs of the controlled foreign corporation.” Any such FX gains or losses are excepted from treatment as “commodities transactions” described in Section 954(c)(1)(C).

We believe the Temporary Regulations are overly restrictive in construing the exception for business needs and, because of their extreme complexity and detailed new record keeping requirements necessary to obtain protection for transactions eligible for the business needs exception, effectively require all FX gains or losses to be treated as foreign personal holding company income.

The need for a narrow and constricted scope of the business needs exception in Section 954(c)(1)(D) is not apparent from the legislative history.[**] The concerns about mismatching of character, timing, and source of income or loss from FX

[*] Under the ordering rule of Temporary Regulations § 1.954-2T(a)(2)(iii), Temporary Regulations § 1.954- 2T(f) takes precedence over Temporary Regulations § 1.954-2T(e).

[**] See generally Blue Book at pp. 966, 976.

transactions which led to enactment of Section 988, or the shifting and manipulation of income, arguably do not apply to FX gains and losses of a controlled foreign corporation, since FX gains and losses arise from unpredictable changes in FX rates and do not provide the same opportunity for manipulation and shifting present in other categories of foreign personal holding company income added by the 1986 Act. Furthermore, exchange gains and losses were required under prior law to be taken into account on a mark-to-market basis under the so-called full Subpart F method for purposes of computing gross income and taxable income.[*] Any such gains or losses were then allocated between Subpart F income and non-Subpart F income according to the ratio of gross Subpart F and non-Subpart F income, or according to any other method deemed reasonable.[**] These rules were understandable, pragmatic, and workable. Indeed, we understand the mark-to-market rule is currently being considered by the National Office of the IRS in the context of Section 988 determinations for certain taxpayers? a modified gross income method of allocating interest deductions was permitted by Temporary Regulations § 1.861-9T(f)(3); and the asset method of allocation now generally required by Section 864(e) for purposes of allocating interest expense had been approved as recently as June 1988 by the National Office as "reasonable" under prior law.[***]

In view of the hyper-complexity of the Temporary Regulations (and the Regulations relating to the foreign tax credit), we believe substantial gains to administrability and compliance can be achieved without compromising any significant

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[*] Regulations §§ 1.952-2(c)(2)(v)(a), 1.964-l(e).

[**] Regulations § 1.952-2(c)(2)(v)(c).

[***] See PLR 8838034 (June 27, 1988).

concerns that may have been present under prior law by permitting U.S. shareholders of controlled foreign corporations to make the following election in lieu of complying with the specific rules of Temporary Regulations § 1.954-2T(g):

1. The full Subpart F method of tax accounting for FX gains or losses under Regulations § 1.964-1(e) could be adopted under procedures similar to those in Temporary Regulations § 1.861-9T(f)(3).

2. The excess of FX gains over losses would be allocated to the various categories of Subpart F and non-Subpart F income (as well as the various separate baskets) using an asset or modified gross income method.

2. Specific Comments

Temporary Regulations § 1.954-2T(g)(1) states that the excess of FX losses over gains is not within the definition of foreign personal holding company income and may not be allocated to, or otherwise reduce, foreign personal holding company income. This provision, as well as parallel provisions relating to other enumerated categories of foreign personal holding company income,* is clearly contrary to the statute and a substantial departure from prior law. Section 954(b)(5) provides that foreign personal holding company income and other categories of foreign base company income are reduced so as to take into account deductions properly allocable to such income. Although the statute authorizes the issuance of regulations on how

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* See, e.g., Temporary Regulations §§ 1.954-2T(f)(1) (relating to commodities transactions), and 1.954- 2T(e)(1) (relating to certain property transactions).

deductions are to be allocated, there is no indication in the legislative history that deductions and losses should be confined to the separate subcategory of foreign personal holding income. Indeed, Temporary Regulations § 1.861- 9T(b)(2), issued under the authority of Section 864(e), treats certain FX losses as “equivalent to interest” in taxable years beginning after December 31, 1988 and requires such amounts, even though allowed as an item other than interest, to be apportioned like interest.

Temporary Regulations § 1.954-2T(g)(2)(ii) implements the business needs exception for FX gain or loss clearly identified on the records of a controlled foreign corporation as being derived from a “qualified business transaction” or a “qualified hedging transaction.” The requirement of “clear identification” when combined with the restrictive definitions of a “qualified business transaction” and a “qualified hedging transaction” render the exception impractical for most taxpayers. A “qualified business transaction,” as defined in Temporary Regulations § 1.954-2T(g)(3), must meet three requirements: (i) it must not have investment or speculation as a significant purpose, (ii) it must not be attributable to property or an activity of a kind that gives rise to Subpart F income (other than FX gain), and (iii) it must be attributable to specified business transactions described in Temporary Regulations § 1.954-2T(g)(3)(ii). In general, qualified business transactions are confined to FX receivables or payables arising from the sale of inventory and similar property to customers by a controlled foreign corporation in the ordinary course of regular business operations or the rendition of services by the controlled foreign corporation in the ordinary course of regular business operations, the incurrence of debt for expenses properly included in the cost of goods sold under Section 471 or otherwise allocable or apportionable under Regulations § 1.861-8 to inventory and similar property. Although the Temporary Regulations include property "similar" to inventory, the decision of the Supreme Court in Arkansas Best as well as the technical requirements for inventory leave a broad range of ordinary income activity, not necessarily classified as provision of services, in an ambiguous state. For example, FX judgments, insurance recoveries, etc. all may produce ordinary income, but the FX gains and losses would appear to give rise to foreign personal holding company income.

The requirement that FX gains or losses be traced (through identification no later than the close of the fifth day after the day on which expenses are incurred) is simply unworkable. For example, the disposition of nonfunctional' currency gives rise to FX gain or loss under Section 988(c)(1)(b)(C) and the disbursement of any nonfunctional currency will thus give rise to a tracing requirement. Where nonfunctional currency is used for the payment of taxes, a further determination must be made as to whether the foreign tax payment is attributable to Subpart F income or not. Temporary Regulations § 1.954-2T(g)(3)(F).

The definition of a qualified hedging transaction is even more restrictive. Any forward contract, futures contract, option or similar financial instrument not marked-to-market at the close of the taxable year under Section 1256 gives rise to FX gain or loss unless:

(1) the transaction is "reasonably necessary" to the conduct of regular business operations in a manner in which such business operations are customarily and usually conducted by others,

(2) the transaction is entered into primarily to reduce the risk of currency fluctuations with respect to property or services sold or to be

sold or expenses incurred or to be incurred the trans-action that are qualified business transaction,

(3) the hedging transaction and the property or expense to which it relates is clearly identified before the close of the fifth day after the date entered into, and

(4) the amount of FX gain or loss attributable to a specific hedging transaction is clearly identifiable on the records of the controlled foreign corporation.*

Although not stated explicitly in the Temporary Regulations, the requirement of clearly identifying the amount of FX gain or loss attributable to a specific hedging transaction appears to require a daily computation of the FX gain or loss on the hedging transaction. See Temporary Regulations § 1.954-2T(a)(3)(Ex.4) (controlled foreign corporation manufacturing widgets required to separate out FX gain or loss on hedge contract where the underlying sale of inventory is cancelled before settlement of the FX forward).

Temporary Regulations § 1.954-2T(g)(5) includes an election for controlled foreign corporations that wish to avoid the requirement of tracing FX gains or losses. Under the election, a controlled foreign corporation can avoid the tracing rule if all FX gains or losses attributable to Section 988 transactions and Section 1256 FX contracts are included in foreign personal holding company income. This election will have very limited value given the basic requirement that a United States shareholder and its controlled foreign corporation treat all FX gains over losses as an item of Subpart F income for all related parties. Since items of foreign personal holding company

* Temporary Regulations § 1.954-2T(g)(4).

income are treated as passive income, the effect of the election would also be to treat all such items as passive income notwithstanding that the high-taxed exception in Section 904(d)(3) may be available if the foreign statutory rate exceeds 90% of the U.S. rate. Moreover, the effect of the election would apparently be to treat all FX positions as “passive assets” for purposes of determining a foreign corporation’s status as a passive foreign investment company.

XIV. Income Equivalent to Interest (Temporary Regulations § 1.954-2T(h))

1. Introduction; Commitment Fees. The 1986 Act added “income equivalent to interest” to foreign personal holding company income. Income equivalent to interest is defined in Section 954(c)(1)(E) as “Any income equivalent to interest, including income from commitment fees (or similar amounts) for loans actually made.” The legislative history provides relatively little additional guidance.[*]

The example set forth in the statute and legislative history is addressed in Temporary Regulations § 1.954-2T(h)(2)(Ex.1), which describes a situation in which a controlled foreign corporation receives a $2.00 commitment fee for promising to lend up to $500 at stated terms. The Example concludes that the entire $2.00 fee constitutes income equivalent to interest when the controlled foreign corporation makes an $80 loan.

[*] The Blue Book explanation provides, in its entirety, as follows: “The Act treats income equivalent to interest as foreign personal holding company income for Subpart F purposes. For this purpose, income equivalent to interest includes, for example, commitment fees for the actual lending of money.” Blue Book at 977.

This conclusion seems overly aggressive in light of the statute, which provides that commitment fees are to be treated as income equivalent to interest only for loans "actually" made. A better rule would be one which categorized as income equivalent to interest only that portion of the commitment fee which is attributable to actual borrowings.* Thus, in the above example, only $0.32 ($2.00 x ($80/$500)) would be treated as income equivalent to interest. In abusive situations, the commitment fee could be compared with a market rate in order to prevent taxpayers from inflating the amount of the lender's commitment.

Because of the brevity of the statute and the lack of assistance from the legislative history, guidance can only be provided by Regulations. The preamble states that the Temporary Regulations seek to define "income equivalent to interest" in a common-sense manner by comparing the income from the transaction in issue with income earned by lending money. This basis for comparison seems wholly appropriate.

Temporary Regulations §§ 1.954-2T(h)(1)(i) and (ii) broadly set forth the Service's attempt at formulating the common-sense approach referenced in the preamble. Temporary Regulations § 1.954-2T(h)(1)(i) provides that income equivalent to interest includes income derived from "an investment, or series of integrated transactions which include an investment, in which the payments, net payments, cash flows or return predominantly reflect the time value of money." This general rule adopts two principles found in loans of money: the requirement of an "investment," and payments which predominantly reflect the

* Cf. Temporary Regulations § 1.861-9T(b) (3) (ii) (Ex.), which, for purposes of allocating interest expense, breaks out the portion which is interest expense in the case of a loss on a sale of receivables.

time value of money. Thus, these general rules seem to keep fairly to the spirit of the statute. Temporary Regulations § 1.954- 2T(h)(1)(ii) provides that income equivalent to interest includes income derived from “transactions in which the payments or a predominant portion thereof are in substance for the use or forbearance of money, but are not generally treated as interest.”

Whatever guidance might be provided by these rules, however, is substantially undercut by the provision of the Temporary Regulations which provides that income equivalent to interest “includes, but is not limited to” income derived from transactions that are described in paragraphs (i) and (ii) of Temporary Regulations § 1.954-2T(h)(1). We suggest that this phrase be eliminated. If there are additional categories of transactions that are of concern, these should be specifically described in the regulations.

2. Swaps. The Temporary Regulations address several specific classes of transaction, including swaps. Appropriately, the Temporary Regulations provide that income equivalent to interest does not include income attributable to “notional principal contracts such as interest rate swaps, currency swaps, interest rate floor agreements, or similar contracts except to the extent that such contracts are part of an integrated transaction that gives rise to income equivalent to interest.” Notional principal contracts generally do not involve “investments” or the use or forbearance of money.

Temporary Regulations § 1.954-2T(h)(2)(Ex.3) suffers from factual problems which illustrate the difficulty posed in determining when a swap should be deemed part of an integrated transaction which includes an investment.

In the Example, a controlled foreign corporation purchases a $100, one-year, LIBOR-plus-one bond early in its 1988 taxable year. On January 1, 1989 the controlled foreign corporation enters into an interest rate swap with an unrelated third party whereby the controlled foreign corporation promises to pay LIBOR-plus-one times $100 on the last day of its 1989 taxable year, in return for which it will receive 10% of $100 on the same date. The Example states that these transactions should be integrated, with the result that the net $1.00 received by the controlled foreign corporation from the swap counterparty should be treated as income equivalent to interest.

The problem with integrating these transactions is that the swap is entered into well after the bond is purchased (in fact, if the controlled foreign corporation is a calendar-year taxpayer, the swap is entered into after the bond has matured), and the payment date on the swap is certainly after the date the controlled foreign corporation receives its interest on the bond. The Temporary Regulations are implying that just because the swap and the bond use the same floating rate, notional amount, and one-year term means the transactions should be integrated. Although we believe that integration is a good concept, the Temporary Regulations, and this Example, offer very little guidance as to which transactions should be integrated. The Temporary Regulations should set forth general rules which taxpayers can follow.

The final Regulations should also consider how the integration concept will apply when separate parts of a transaction are undertaken by related entities.* A U.S. corporation can easily use two controlled foreign corporations to accomplish what could be done in one. Without integration, a taxpayer could incur interest expense, which is an offset to foreign personal holding company income in the first controlled foreign corporation, and earn swap income which is not income equivalent to interest in the second controlled foreign corporation.

3. Payment for Services. Temporary Regulations § 1.954-2T(h)(5) provides that if payment for services is not made until more than 120 days after such services are performed, then a portion of such payment will be deemed to constitute income equivalent to interest, under the principles of Sections 483 and 1271 et seg. Aside from several technical issues addressed below, this rule flunks the Service’s guidelines for determining what is income equivalent to interest. The service provider has not made the investment required by Temporary Regulations § 1.954-2T(h)(1)(i), and it is doubtful that the predominant portion of the payments it receives are for the forbearance of money.

On a technical level, although reference is made to Sections 483 and 1271 et seg., the Temporary Regulations do not contain an analogous de minimis provision, and the selection of 120 days is far shorter than the time period provided in those other statutes. These two factors make it even less likely that the predominant portion of the payments will be for the forbearance of money. We recommend that this Temporary Regulation be omitted.

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* Certain of the Regulations under Section 864(e) so provide. Cf. Temporary Regulations § 1.861-9T(b)(2).

4. Sales of Property. The Temporary Regulations provide that income from the sale of property will generally not be treated as income equivalent to interest. Temporary Regulations § 1.954-2T(h)(2)(Ex.6) provides one example of a sale of property that does give rise to income equivalent to interest. In the example, a controlled foreign corporation purchases an unspecified commodity for $100 on the spot market and contemporaneously sells it forward for payment and delivery in three months for $104. The Example notes that there is no market risk involved and that the $4 of income predominantly reflects the time value of money. An investment can be found in the commodity itself.

Although it seems appropriate to treat the income derived from this "contango" relationship as income equivalent to interest, the Example leaves several important questions unanswered, and creates the potential for abuse.

Does the rule apply to all commodities from gold to pork bellies? While futures prices always reflect an element of the time value of money, the prices are often more strongly influenced by independent market forces.

What happens if the controlled foreign corporation had held the commodity for some period of time prior to entering into the forward sale? By using the word "contemporaneously" the Service opens itself up for arguments that a sale the next day, or the next week, does not give rise to income equivalent to interest.

5. Factoring Income. Temporary Regulations § 1.954-2T(h)(3) provides that income equivalent to interest includes "factoring income." As factoring involves an investment and

payments which predominantly reflect the time value of money, treating factoring income as income equivalent to interest is appropriate.

Factoring income is defined as any income, other than stated interest, derived from the acquisition and collection or disposition of a factored receivable. Several exceptions are provided, including: Temporary Regulations § 1.954-2T(h)(3)(ii)(A), which excludes income treated as interest under Sections 864(d)(1) or (6) (relating to related person factoring income and loans of a controlled foreign corporation), even if such income is not treated as described in Section 864(d)(1) by reason of the same country exception of Section 864(d)(7), and Temporary Regulations § 1.954-2T(h)(3)(ii)(B), which excludes income derived from a factored receivable if payment for the receivable is made on or after the date on which stated interest begins to accrue, but only if the rate of stated interest equals or exceeds 120% of the Federal short-term rate (or analogous foreign-currency rate).

Both of these exceptions raise questions. First, is a loophole created by excluding related-person, same- country factoring income from the rules of both Section 864(d)(1) and Temporary Regulations § 1.954-2T(h)(3)?

Second, why is there an exception if the receivable is purchased after stated interest (at 120% of the Federal short-term rate) begins to accrue? If a controlled foreign corporation purchases a receivable with a face amount of $100 for $99, the $1 ultimately received should constitute income equivalent to interest, regardless of whether interest is being paid on the face amount. The original issue discount rules adopt this same approach. If a controlled foreign corporation is able to purchase a receivable which is bearing interest at greater than the Federal short-term rate for less than its face amount, the discount must reflect some degree of collection risk, which has always been treated as interest. This exception should be eliminated, and the necessary examples amended.

Several factoring income examples require changes. Temporary Regulations § 1.954-2T(h)(3)(iv)(Ex.1) describes a controlled foreign corporation which purchases a receivable with a face amount of $100 for $95. After 30 days the receivables bear stated interest equal to at least 120% of the applicable short-term rate. On Day 40 the controlled foreign corporation is said to collect $100 from the obligor. This Example should be revised to reflect the fact that stated interest will have been running for 10 days, and thus the controlled foreign corporation would collect more than $100 from the obligor. This change must also be reflected in Temporary Regulations § 1.9 54- 2T(h)(3)(iv)(Ex.4).

Temporary Regulations § 1.954-2T(h)(3)(iv)(Ex.5) describes the same controlled foreign corporation as in Example 1 selling the factored receivable to an unrelated party on Day 45 for $99, and having $4 of income equivalent to interest. Because factoring income does not include any stated interest, and since stated interest had been running for 15 days, a portion of the $4 is not income equivalent to interest, but interest.

6. Overlaps. Temporary Regulations § 1.954-2T(a)(2)(i) provides that overlaps between income equivalent to interest and gains derived from property, commodity or currency transactions are always to be resolved in favor of income equivalent to interest. In its present form, this priority rule would appear to create uncertainty rather than alleviate it. There is no indication in the legislative history that Section

954(c)(1)(E) was intended to affect the treatment of legitimate interest rate-sensitive businesses, such as securities and commodities dealers. Thus, to the extent the priority rule for income equivalent to interest suggests that such income can arise from transactions qualifying for specific exclusions under Sections 954(c)(1)(B), (C) or (D) (for example, active business gains from the sale of commodities), the rule incorrectly reflects Congressional intent and should be modified. Virtually any transaction by an active dealer in securities or commodities can be analyzed as containing an interest rate component: the Temporary Regulations should confirm that active business gains qualifying for a specific exclusion under Section 954(c)(1)(B), (C) or (D) are not subject to characterization as income equivalent to interest under Section 954(c)(1)(E).

XV. Definition of Controlled Foreign Corporation for Taxable Years Beginning After December 31, 198 6 (Temporary Regulations § 1.957-1T)

Temporary Regulations § 1.957-1T(a) amends prior Regulations § 1.957-1(a) to reflect the amendment to the definition of a controlled foreign corporation made by the 1986 Act -- that is, a controlled foreign corporation is any foreign corporation if more than 50% of either the total combined voting power of all classes of stock of the corporation entitled to vote, or the total value of the stock of the corporation is owned by U.S. shareholders. Prior to the 1986 Act there was only a voting power test.

The Temporary Regulations contain two typographical errors: (1) the reference should be to paragraph (a), not paragraph (b), in the second sentence of Temporary Regulations § 1.957-1T(a); and (2) the description of class B stock in

Temporary Regulations § 1.957-1T(c)(Ex. 8) should refer to “nonvoting” preferred, not “voting nonvoting preferred. Finally, prior Regulations § 1.957-l(c)(Ex.6) should be revised (or deleted) to reflect the new definition of a controlled foreign corporation.