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- (ii) Exceptions.
- (A) Rents or royalties paid out of adjusted foreign base company income or insurance income.
- (B) Property used in part in the controlled foreign corporation's country of incorporation.
- (6) Exclusion of rents and royalties derived in the active conduct of a trade or business.
- (c) Excluded rents.
- (1) Active conduct of a trade or business.
- (2) Special rules.
 - (i) Adding substantial value.
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- (3) Examples.
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§ 1.954-1 Foreign base company income.

(a) *In general*—(1) *Purpose and scope.* Section 954 and §§ 1.954-1 and 1.954-2 provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952. Subpart F income is included in the

gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and thus is subject to current taxation under section 1, 11 or 55 of the Internal Revenue Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957.

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

- (i) Foreign personal holding company income, as defined in section 954(c);
- (ii) Foreign base company sales income, as defined in section 954(d);
- (iii) Foreign base company services income, as defined in section 954(e);
- (iv) Foreign base company shipping income, as defined in section 954(f); and
- (v) Foreign base company oil related income, as defined in section 954(g).

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

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

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

Code and elsewhere in the Income Tax Regulations means adjusted net foreign base company income, unless otherwise provided.

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

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

of this section, and the high tax exception of paragraph (d) of this section, for example, do not apply to such amounts.

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

- (1) 5 percent of gross income; or
- (2) \$1,000,000.

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

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

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

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

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

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

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

(ii) *Presumption*. Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to prevent income from being treated as foreign base company income or insurance income under the de minimis test of paragraph (b)(1)(i) of this section if the corporations are related persons, as defined in paragraph (b)(4)(iii) of this section, and the corporations are described in paragraph (b)(4)(ii)(A), (B), or (C) of this section. This presumption may be rebutted by proof to the contrary.

(A) The activities carried on by the controlled foreign corporations, or the

assets used in those activities, are substantially the same activities that were previously carried on, or assets that were previously held, by a single controlled foreign corporation. Further, the United States shareholders of the controlled foreign corporations or related persons (as determined under paragraph (b)(4)(iii) of this section) are substantially the same as the United States shareholders of the one controlled foreign corporation in a prior taxable year. A presumption made in connection with the requirements of this paragraph (b)(4)(ii)(A) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of §1.367(a)-6T(g)(2) if carried on directly by a United States person.

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

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

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b). In determining for purposes of this

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

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

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

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

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

(ii) However, under these facts, the requirements of paragraph (b)(4)(i) of this section are met unless the presumption of paragraph (b)(4)(ii) of this section is successfully rebutted. The sum of the foreign base company income of the controlled foreign cor-

porations is \$1,194,000. Thus, the amount of gross foreign base company income of each controlled foreign corporation will not be reduced by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(c) *Computation of net foreign base company income—(1) General rule.* The net foreign base company income of a controlled foreign corporation (as defined in paragraph (a)(4) of this section) is computed under the rules of this paragraph (c)(1). The principles of

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§ 1.904-5(k) shall apply where payments are made between controlled foreign corporations that are related persons (within the meaning of section 954(d)(3)). Consistent with these principles, only payments described in § 1.954-2(b)(4)(ii)(B)(2) may be offset as provided in § 1.904-5(k)(2).

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

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

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

(C) Third, foreign personal holding company income that is passive within the meaning of section 904 (determined before the application of the high-taxed income rule of § 1.904-4(c)) is reduced by related person interest expense allocable to passive income under § 1.904-5(c)(2); such interest must be further allocated and apportioned to items described in paragraph (c)(1)(iii)(B) of this section.

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

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

(iii) *Items of income—(A) Income other than passive foreign personal holding*

company income. A single item of income (other than foreign personal holding company income that is passive) is the aggregate amount from all transactions that falls within a single separate category (as defined in § 1.904-5(a)(1)), and either—

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

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

(ii) Gain from certain property transactions;

(iii) Gain from commodities transactions;

(iv) Foreign currency gain; or

(v) Income equivalent to interest; or

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

(i) Foreign base company sales income;

(ii) Foreign base company services income;

(iii) Foreign base company shipping income;

(iv) Foreign base company oil related income; or

(v) Full inclusion foreign base company income.

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

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

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

company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any net item of such income that qualifies for the high tax exception provided by section 954(b)(4) and this paragraph (d). Any item of income that is foreign base company oil related income, as defined in section 954(g), or portfolio interest, as described in section 881(c), does not qualify for the high tax exception. See paragraph (c)(1)(iii) of this section for the definition of the term *item of income*. For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see §1.904-4(c). A net item of income qualifies for the high tax exception only if—

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

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

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

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

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

(3) *Taxes paid or accrued with respect to an item of income—(i) Income other than passive foreign personal holding company income.* The amount of foreign

income taxes paid or accrued with respect to a net item of income (other than an item of foreign personal holding company income that is passive) for purposes of section 954(b)(4) and this paragraph (d) is the United States dollar amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a United States shareholder under section 951(a)(1)(A) (determined, in the case of a United States shareholder that is an individual, as if an election under section 962 has been made, whether or not such election is actually made). For this purpose, in accordance with the regulations under section 960, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a). The amount of foreign income taxes paid or accrued with respect to a net item of income, determined in the manner provided in this paragraph (d), will not be affected by a subsequent reduction in foreign income taxes attributable to a distribution to shareholders of all or part of such income.

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

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

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

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

Example. During its 1995 taxable year, CFC, a controlled foreign corporation, earns royalty income, net of taxes, of \$100 that is foreign personal holding company income. CFC has no expenses associated with this royalty income. CFC pays \$50 of foreign income taxes with respect to the royalty income. For 1995, CFC has current earnings and profits of \$50. CFC's subpart F income, as determined prior to the application of this paragraph (d), exceeds its current earnings and profits. Thus, under paragraph (d)(4)(ii) of this section, the amount of CFC's only net item of income, the royalty income, will be limited to \$50. The remaining \$50 will be subject to re-characterization in a subsequent taxable year under section 952(c)(2). Because the amount of foreign income taxes paid with respect to this net item of income is \$50, the effective rate of tax on the item, for purposes of this paragraph (d), is 50 percent (\$50 of taxes/\$50 net item + \$50 of taxes). Accordingly, an election under paragraph (d)(5) of this section may be made to exclude the item of income from the computation of subpart F income.

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

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

quired by applicable administrative pronouncements; or

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

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

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

Example 1. (i) *Items of income.* During its 1995 taxable year, controlled foreign corporation CFC earns from outside its country of operation portfolio dividend income of \$100 and interest income, net of taxes, of \$100 (consisting of a gross payment of \$150 reduced by a third-country withholding tax of \$50). For purposes of illustration, assume that CFC incurs no expenses. None of the income is taxed in CFC's country of operation. The dividend income was not subject to third-country withholding taxes. Pursuant to the operation of section 904, the interest income is high withholding tax interest and the dividend income is passive income. Accordingly, pursuant to paragraph (c)(1)(iii) of this section, CFC has two net items of income—

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

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

(i) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(1) of this *Example 1*. Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F income under the rules of this paragraph (d). Foreign tax of \$50 would be deemed paid under section 960 with respect to the net item of income described in paragraph (i)(2) of this *Example 1*. Therefore, the effective rate of foreign tax is 33 percent (\$50 of creditable taxes paid, divided by \$150, consisting of the net item of foreign base company income (\$100) plus creditable taxes paid thereon (\$50)). The highest rate of tax specified in section 11 for the 1995 taxable year is 35 percent. Accordingly, the net item of income described in paragraph (i)(2) of this *Example 1* may be excluded from subpart F income if an election under paragraph (d)(5) of this section is made, since it is subject to foreign tax at an effective rate that is greater than 31.5 percent (90 percent of 35 percent). However, for purposes of section 904(d), it remains high withholding tax interest.

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

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

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

(ii) Each item is taxed at an effective rate greater than 31.5 percent. The net item of income described in paragraph (i)(1) of this *Example 2*: foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 2*: foreign tax (\$50) divided by sum (\$150) of income item (\$100) plus creditable tax thereon (\$50) equals 33 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either or both of the net items of income described in paragraphs (i)(1) and (2) of this *Example 2* from subpart F income. If no election is made the items would be included in the subpart F income of *CFC*.

Example 3. (i) The facts are the same as in *Example 1*, except that the \$100 of portfolio dividend income is subject to a third-country withholding tax of \$50, and the \$150 of interest income is from sources within *CFC's* country of operation, is subject to a \$10 in-

come tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (c)(1)(iii)(B) of this section they constitute separate items of income pursuant to the application of the grouping rules of § 1.904-4(c). Accordingly, *CFC* has two net items of income for purposes of this paragraph (d)—

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

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

(ii) The item described in paragraph (i)(1) of this *Example 3* is taxed at an effective rate greater than 31.5 percent, but Item 2 is not. The net item of income described in paragraph (i)(1) of this *Example 3*: foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of this *Example 3*: foreign tax (\$10) divided by sum (\$150) of net item of income (\$140) plus creditable tax thereon (\$10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude the net item of income described in paragraph (i)(1) of this *Example 3* but not the net item of income described in paragraph (i)(2) of this *Example 3* from subpart F income.

Example 4. The facts are the same as in *Example 3*, except that the \$150 of interest income is subject to an income tax of \$50 in *CFC's* country of operation. Accordingly, *CFC's* items of income are the same as in *Example 3*, but both items are taxed at an effective rate greater than 31.5 percent. The net item of income described in paragraph (i)(1) of *Example 3*: foreign tax (\$50) divided by sum (\$100) of net item of income (\$50) plus creditable tax thereon (\$50) equals 50 percent. The net item of income described in paragraph (i)(2) of *Example 3*: foreign tax (\$50) divided by sum (\$150) of net item of income (\$100) plus creditable tax thereon (\$50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(i) of this section, an election made by *CFC's* controlling United States shareholders must exclude from subpart F income both items of FPHC income under the high tax exception of section 954(b)(4) and this paragraph (d). The election may not be made only with respect to one item.

Example 5. The facts are the same as in *Example 1*, except that *CFC* earns \$5 of portfolio dividend income and \$150 of interest income. In addition, *CFC* earns \$45 for performing consulting services within its country of operation for unrelated persons. *CFC's* gross foreign base company income for 1995 of \$155 (\$150 of gross interest income and \$5 of portfolio dividend income) is greater than 70 percent of its gross income of \$200. Therefore, under the full inclusion test of paragraph

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

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

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

(ii) *Expenses.* For the current taxable year, *CFC* has expenses of \$500. This amount includes \$8 of interest paid to a related person that is allocable to foreign personal holding

company income under section 904, and \$2 of other expense that is directly related to foreign personal holding company income. Another \$20 of expense is directly related to foreign base company sales. The remaining \$470 of expenses is allocable to general limitation income that is not foreign base company income or insurance income.

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

(iv) *Taxes.* Foreign income tax of \$30 is considered imposed on the interest income under the rules of section 954(b)(4), this paragraph (d), and § 1.904-6. Foreign income tax of \$14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904-6. Foreign income tax of \$177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4), this paragraph (d), and § 1.904-6. For the taxable year of *CFC*, the maximum United States rate of taxation under section 11 is 35 percent.

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

Step 1—Determine gross income:

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

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

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

(5) Five percent of gross income (.05 × line (1))	50
(6) Seventy percent of gross income (.70 × line (1))	700

<p>(7) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the de minimis test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or \$1,000,000) (if the amount on this line 7 is zero, proceed to Step 8)</p> <p>(8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6))</p> <p><i>Step 4—Compute net foreign base company income:</i></p> <p>(9) Expenses directly related to adjusted gross foreign base company sales income</p> <p>(10) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income</p> <p>(11) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904</p> <p>(12) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by lines (10) and (11))</p> <p>(13) Net foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (3) reduced by line (9))</p> <p>(14) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (12) plus line (13))</p> <p><i>Step 5—Compute net insurance income:</i></p> <p>(15) Net insurance income under section 953</p> <p><i>Step 6—Compute adjusted net foreign base company income:</i></p> <p>(16) Foreign income tax imposed on net foreign personal holding company income (as determined under section 954(b)(4) and this paragraph (d))</p> <p>(17) Foreign income tax imposed on net foreign base company sales income (as determined under section 954(b)(4) and this paragraph (d))</p> <p>(18) Ninety percent of the maximum United States corporate tax rate</p>	<p>150</p> <p>150</p> <p>20</p> <p>2</p> <p>8</p> <p>90</p> <p>30</p> <p>120</p> <p>0</p> <p>30</p> <p>14</p> <p>31.5%</p>	<p>(19) Effective rate of foreign income tax imposed on net foreign personal holding company income (\$90 of interest) under section 954(b)(4) and this paragraph (d) (line (16) divided by line (12))</p> <p>(20) Effective rate of foreign income tax imposed on \$30 of net foreign base company sales income under section 954(b)(4) and this paragraph (d) (line (17) divided by line (13))</p> <p>(21) Net foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (12) if line (19) is greater than line (18))</p> <p>(22) Net foreign base company sales income subject to a high foreign tax under section 954(b)(4) and this paragraph (d) (zero, or line (20) if line (20) is greater than line (18))</p> <p>(23) Adjusted net foreign base company income after applying section 954(b)(4) and this paragraph (d) (line (14), reduced by the sum of line (21) and line (22))</p> <p><i>Step 7—Compute adjusted net insurance income:</i></p> <p>(24) Adjusted net insurance income</p> <p><i>Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):</i></p> <p>(25) Earnings and profits for the current year</p> <p>(26) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (25) over the sum of lines (23) and (24)); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year</p> <p>(27) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1)</p> <p>(28) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (23), line (24), and the lesser of line (26) or line (27))</p> <p>(29) Amount of prior year's deficit to be recharacterized as subpart F income in later years under section 952(c) (excess of line (27) over line (26))</p>	<p>33%</p> <p>47%</p> <p>90</p> <p>30</p> <p>0</p> <p>0</p> <p>500</p> <p>500</p> <p>600</p> <p>500</p> <p>100</p>
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Example 2. (i) *Gross income.* CFC, a controlled foreign corporation, has gross income of \$1000 for the current taxable year. Of that \$1000 of income, \$720 is interest income that is included in the definition of foreign personal holding company income under section

954(c)(1)(A) and § 1.954-2(b)(1)(ii), is not income from trade or service receivables described in section 864(d)(1) or (6), or portfolio interest described in section 881(c), and is not excluded from foreign personal holding company income under any provision of section 954(c) and § 1.954-2 or section 952(b). The remaining \$280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954 (c), (d), (e), (f), or (g) or 953, and is foreign source general limitation income for purposes of section 904(d)(1)(I).

(ii) *Expenses.* For the current taxable year, *CFC* has expenses of \$650. This amount includes \$350 of interest paid to related persons that is allocable to foreign personal holding company income under section 904, and \$50 of other expense that is directly related to foreign personal holding company income. The remaining \$250 of expenses is allocable to services income other than foreign base company income or insurance income.

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

(iv) *Taxes.* Foreign income tax of \$120 is considered imposed on the \$720 of interest income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904-6. Foreign income tax of \$2 is considered imposed on the services income under the rules of section 954(b)(4), paragraph (d) of this section, and § 1.904-6. For the taxable year of *CFC*, the maximum United States rate of taxation under section 11 is 35 percent.

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

<i>Step 1—Determine gross income:</i>	
(1) Gross income	\$1000
<i>Step 2—Determine gross foreign base company income and gross insurance income:</i>	
(2) Gross foreign base company income and gross insurance income as defined in sections 954 (c), (d), (e), (f) and (g) and 953 (interest income)	720
<i>Step 3—Compute adjusted gross foreign base company income and adjusted gross insurance income:</i>	
(3) Seventy percent of gross income (.70 × line (1))	700

(4) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3))	1000
(5) Full inclusion foreign base company income under paragraph (b)(1)(ii) (line (4) minus line (2)) ..	280
<i>Step 4—Compute net foreign base company income:</i>	
(6) Expenses (other than related person interest expense) directly related to adjusted gross foreign personal holding company income	50
(7) Related person interest expense allocable to adjusted gross foreign personal holding company income under section 904	350
(8) Deductions allocable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c) of this section	250
(9) Net foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced by line (6) and line (7))	320
(10) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (5) reduced by line (8))	30
(11) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (9) plus line (10))	350
<i>Step 5—Compute net insurance income:</i>	
(12) Net insurance income under section 953	0
<i>Step 6—Compute adjusted net foreign base company income:</i>	
(13) Foreign income tax imposed on net foreign personal holding company income (interest)	120
(14) Foreign income tax imposed on net full inclusion foreign base company income	2
(15) Ninety percent of the maximum United States corporate tax rate	31.5%
(16) Effective rate of foreign income tax imposed on \$320 of net foreign personal holding company income under section 954(b)(4) and this paragraph (d) (line (13) divided by line (9))	38%

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

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

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

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

Step 7—Compute adjusted net insurance income:

(21) Adjusted net insurance income 0

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

(22) Adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1) of this section) (line (4) reduced by line (5)) 720

(23) Ninety percent of adjusted gross foreign base company income and adjusted gross insurance income (determined without regard to the full inclusion test of paragraph (b)(1)(ii) of this section) (90% of the amount on line (22)) 648

(24) Net foreign base company income and net insurance income excluded from subpart F income under section 954(b)(4), increased by the amount of expenses that reduced this income under section 954(b)(5) and paragraph (c) of this section (line (18) increased by the sum of line (6) and line (7)) 720

(25) Adjusted net full inclusion foreign base company income excluded from subpart F income under paragraph (d)(6) of this section (zero, or line (10) reduced by line (19) if line (24) is greater than line (23)) 30

(26) Adjusted net foreign base company income after application of paragraph (d)(6) of this section (line (20) reduced by line (25)) 0

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

(27) Earnings and profits for the current year 350

(28) Amount subject to being recharacterized as subpart F income under section 952(c)(2) (excess of line (27) over the sum of line (21) and line (26)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year 350

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

(30) Subpart F income as defined in section 952(a), assuming section 952(a)(3), (4), and (5) do not apply (the sum of line (21) and line (26) plus the lesser of line (28) or line (29)) 350

(31) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years under section 952(c) (excess of line (29) over line (28)) 250

(e) *Character of income*—(1) *Substance of the transaction.* For purposes of section 954, income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount that is designated as rent by the taxpayer but actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as rent but shall be characterized as income from the sale of property, royalties or income from services, as the case may be. Local law shall not be controlling in characterizing income.

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

its country of incorporation, also performs services outside its country of incorporation with respect to the property it sells, the sales income will be treated as foreign base company sales income and the services income will be treated as foreign base company services income for purposes of these rules.

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

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

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

(B) If income is foreign base company oil related income, pursuant to section 954(g), it shall not be considered insurance income or income in any other category of foreign base company in-

come, except as provided in paragraph (e)(4)(i)(A) of this section.

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

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

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

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

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

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

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

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

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

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

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

§ 1.954-2 Foreign personal holding company income.

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

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

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

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

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

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

(2) *Coordination of overlapping categories under foreign personal holding company provisions*—(i) *In general*. If any portion of income, gain or loss from a transaction is described in more than one category of foreign personal holding company income (as described in paragraph (a)(2)(ii) of this section), that portion of income, gain or loss is treated solely as income, gain or loss from the category of foreign personal holding company income with the highest priority.

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

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

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

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

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

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

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

(ii) *Special rules*—(A) *Anti-abuse rule*. If a principal purpose of a change in