
Foreign Personal Holding Company Income: Mastering Subpart F Inclusions and Deemed Dividend Rules

May 11, 2017

Overview

- Foreign Personal Holding Company Income (“FPHCI”) – Sec. 954(c) – Generally
- FPHCI – Section 954(c) – Application
- Exception – Active Rents/ Royalties

FPHCI Generally

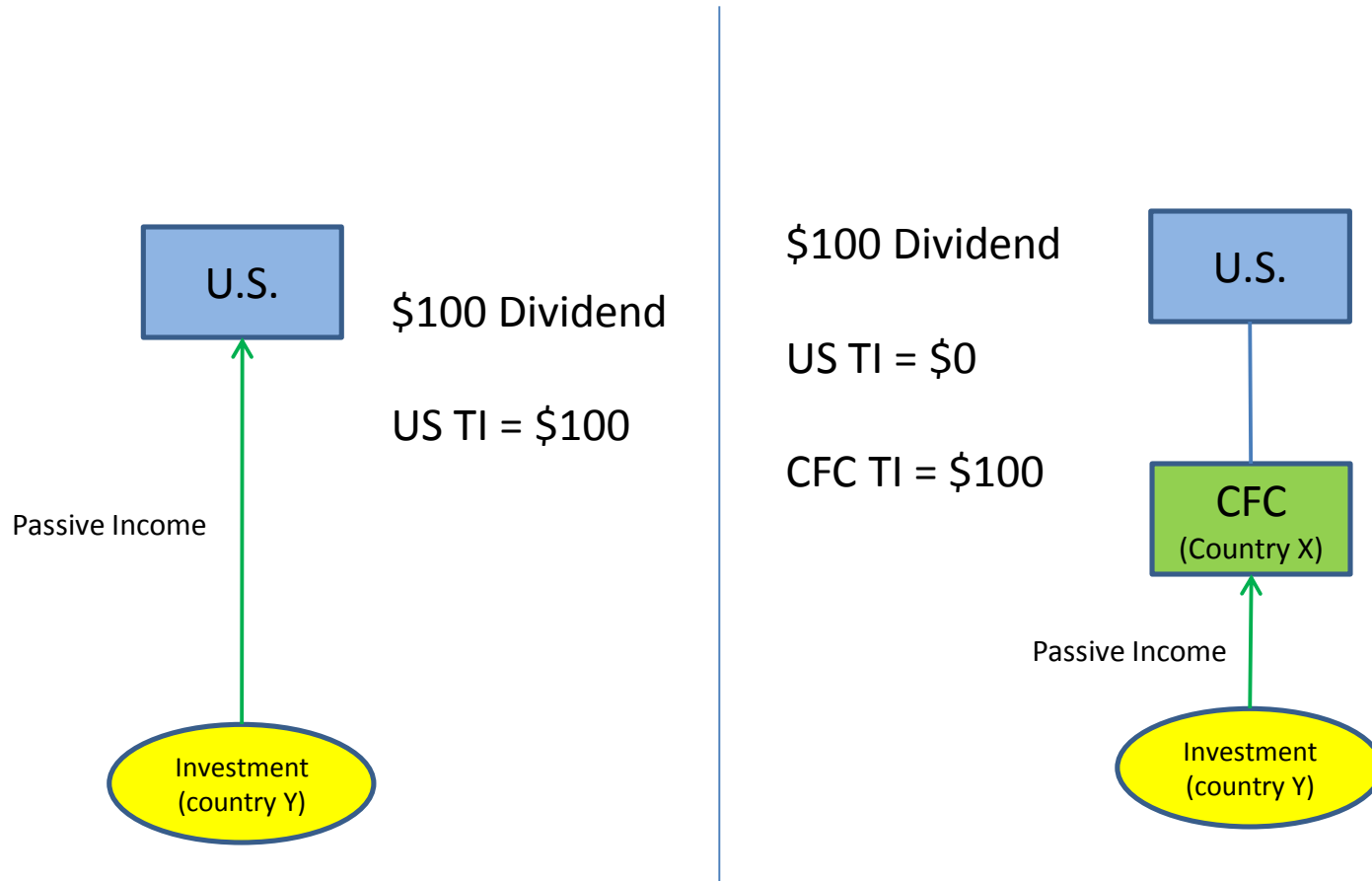
U.S. Tax System - Generally

- Taxation – How are Corporations Taxed?
 - U.S. Resident - Worldwide Income.
 - Non-Resident - Taxable on certain types of U.S. Source Income (U.S. Trade or Business/ ECI; PE; FDAP; FIRPTA)
- Corporate tax residency – When is a corporation a “U.S. Person”?
 - Corporation – Residency determined by place of incorporation. Sec. 7701(a)(30); Sec. 7701(a)(4).
- Income Recognition: When is income earned by a foreign subsidiary corporation recognized by a U.S. parent corporation?
 - When funds repatriated via a dividend (subject to exceptions)
 - Allows for “deferral” of U.S. income tax

Subpart F

- Foreign Personal Holding Company. Sec. 954(c).
 - Typically passive income such as dividends, interest, royalties, etc.
- Foreign Base Company Sales Income. Sec. 954(d).
 - Purchase or sale of property from related party that is: (1) manufactured, produced, extracted outside the country where the CFC is incorporated, and (2) sold outside the country where CFC incorporated.
- Foreign Base Company Services Income. Sec. 954(e).
 - Services performed: (1) for or on behalf of related party; (2) outside of CFC country of incorporation.
- Investment of CFC earnings in US property. Sec. 956.

FPHCI



FPHCI – Sec. 954(c) Inclusions

- **(A) Dividends, etc.: Dividends, interest, royalties, rents, and annuities.**
- **(B) Certain property transactions**
- **(C) Commodities transactions**
- **(D) Foreign currency gains**
- **(E) Income equivalent to interest**
- **(F) Income from notional principal contracts**
- **(G) Payments in lieu of dividends**
- **(H) Personal service contracts**

FPHCI Application

FPHCI - Application

- Controlled Foreign Corporation (“CFC”)
 - Sec. 951(a).

- Passive Foreign Investment Company (“PFIC”).
 - Sec. 1297(b).

Controlled Foreign Corporations

- What is a CFC?
 - U.S. Shareholders own more than 50% of vote *or* value. Sec. 957(a).

- What is a U.S. Shareholders?
 - U.S. Person with 10% or more of vote. Sec. 951(b).

Controlled Foreign Corporation

- **Indirect Ownership – Sec. 958(a)(2).**
 - stock owned, directly or indirectly, by or for a ***foreign corporation, foreign partnership***, or foreign trust or foreign estate (within the meaning of section [7701 \(a\)\(31\)](#)) shall be considered as being *owned proportionately by its shareholders*, partners, or beneficiaries. **Sec. 958(a)(2).**
- **Constructive Ownership. 958(b).**
 - section [318\(a\)](#) shall apply to the extent that the effect is to *treat any United States person as a United States shareholder* within the meaning of section [951 \(b\), ...](#)), *or to treat a foreign corporation as a controlled foreign corporation* under section [957](#), except that—
 - **(1)** In applying paragraph (1)(A) of section [318 \(a\)](#), stock owned by a nonresident alien individual (other than a foreign trust or foreign estate) shall not be considered as owned by a citizen or by a resident alien individual.
 - **(2)** In applying subparagraphs (A), (B), and (C) of section [318 \(a\)\(2\)](#), if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote.
 - **(3)** In applying subparagraph (C) of section [318 \(a\)\(2\)](#), the phrase “10 percent” shall be substituted for the phrase “50 percent” used in subparagraph (C).
 - **(4)** Subparagraph (A), (B), and (C) of section [318 \(a\)\(3\)](#) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person.

Controlled Foreign Corporation

Sec. 318

(a) General rule For purposes of those provisions of this subchapter to which the rules contained in this section are expressly made applicable—

(1) Members of family (A) In general An individual shall be considered as owning the stock owned, directly or indirectly, by or for—

- **(i)** his spouse (other than a spouse who is legally separated from the individual under a decree of divorce or separate maintenance), and
- **(ii)** his children, grandchildren, and parents.
- **Except** - stock owned by a nonresident alien individual shall not be considered as owned by a citizen or by a resident alien individual

(2) Attribution from partnerships, estates, trusts, and corporations

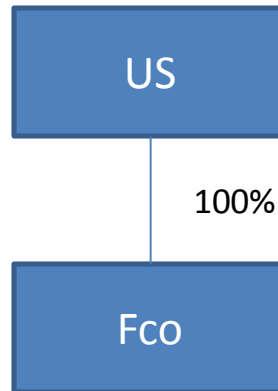
- **(A) From partnerships and estates** Stock owned, directly or indirectly, by or for a partnership or estate shall be considered as owned proportionately by its partners or beneficiaries; [see below if more than 50% ownership].
- **(C) From corporations** If ~~50~~ **[10]percent or more in value** of the stock in a corporation is owned, directly or indirectly, by or for any person, such person shall be considered as owning the stock owned, directly or indirectly, by or for such corporation, in that proportion which the value of the stock which such person so owns bears to the value of all the stock in such corporation. [SEE BELOW if own more than 50%].
- **Except:** if a partnership, estate, trust, or corporation owns, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock entitled to vote of a corporation, it shall be considered as owning all the stock entitled to vote.
- **Except:** for Section (C) of section [318 \(a\)\(2\)](#), the phrase “10 percent” shall be substituted for the phrase “50 percent” used in subparagraph (C).

(3) Attribution to partnerships, estates, trusts, and corporations

- **(A) To partnerships and estates** Stock owned, directly or indirectly, by or for a partner or a beneficiary of an estate shall be considered as owned by the partnership or estate.
- **(C) To corporations** If 50 percent or more in value of the stock in a corporation is owned, directly or indirectly, by or for any person, such corporation shall be considered as owning the stock owned, directly or indirectly, by or for such person.
- **Except:** [318 \(a\)\(3\)](#) shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person.

CFC - Example 1

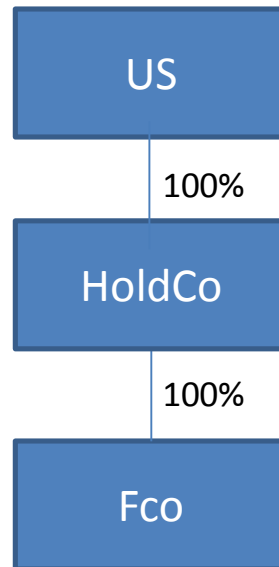
ForeignCo is wholly owned by USCo



US Shareholders [Sec. 951(b)] owns greater than 50% vote/ value. Sec. 957(a).

CFC - Example 2

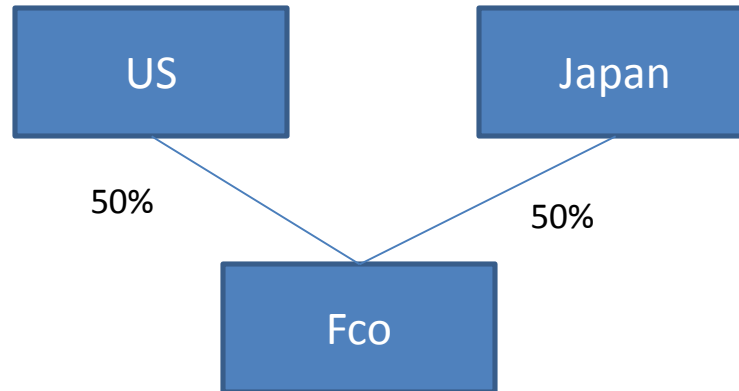
ForeignCo is wholly owned by HoldCo, a foreign corporation. HoldCo is wholly owned by USCo.



- Stock owned by foreign corp treated as owned proportionately by its shareholders. Sec. 958(a)(2).
- USP deemed to own 100% of Fco for determining CFC status.

CFC - Example 3

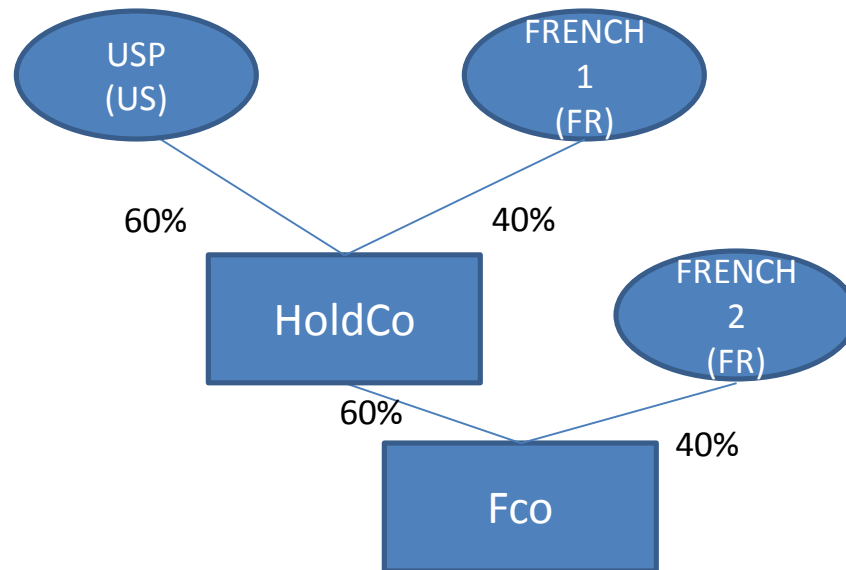
USCo and JapanCo each own exactly 50% of FCo's common stock.



- Not a CFC.
 - US Shareholder owns 50%; need greater than 50% ownership. Sec. 957(a).

CFC - Example 4

USP owns 60 shares of HoldCo stock. French Resident 1 owns the remaining 40 shares. HoldCo owns 60 shares of Foreign Co stock. French Resident 2 owns the remaining 40 shares.



- USP = US Person; all other shareholders foreign.
- USP = US Shareholder – owns 10% or more vote – here 36% of Fco (60% * 60%). Sec. 958(a)(2).
- Sec. 318 attribution rules apply.
 - Sec. 958(b)(3) – if corp owns more than 50% or more of other corp, then treated as owning 100%.

Subpart F - Exceptions

Exceptions:

General Exceptions from Subpart F – Sec. 954(b).

- High tax exception – effective tax rate of CFC at 90% of max U.S. corporate tax rate (31.5%). Sec. 954(b)(4).
- *De minimis* rule - FBCI is less than: Sec. 954(b)(3).
 - 5% of gross income; and
 - \$1M
- All SubF. § 954(b)(3)(B), if a CFC's foreign base company income exceeds 70% of its gross income, then all of the CFC's gross income will be treated as Subpart F income.

Foreign Personal Holding Company Income.

- Sec. 954(c)(2) – Active Rent/ Royalty - rent or royalty income is not FPHCI if it is derived by the CFC in the active conduct of a trade or business and is received from an unrelated person.
- Sec. 954(c)(3) - Same Country Exception.
- Sec. 954(c)(6) – passive income from related CFC; related CFC generated active business income.



PFIC Definition

Definition. Sec. 1297.

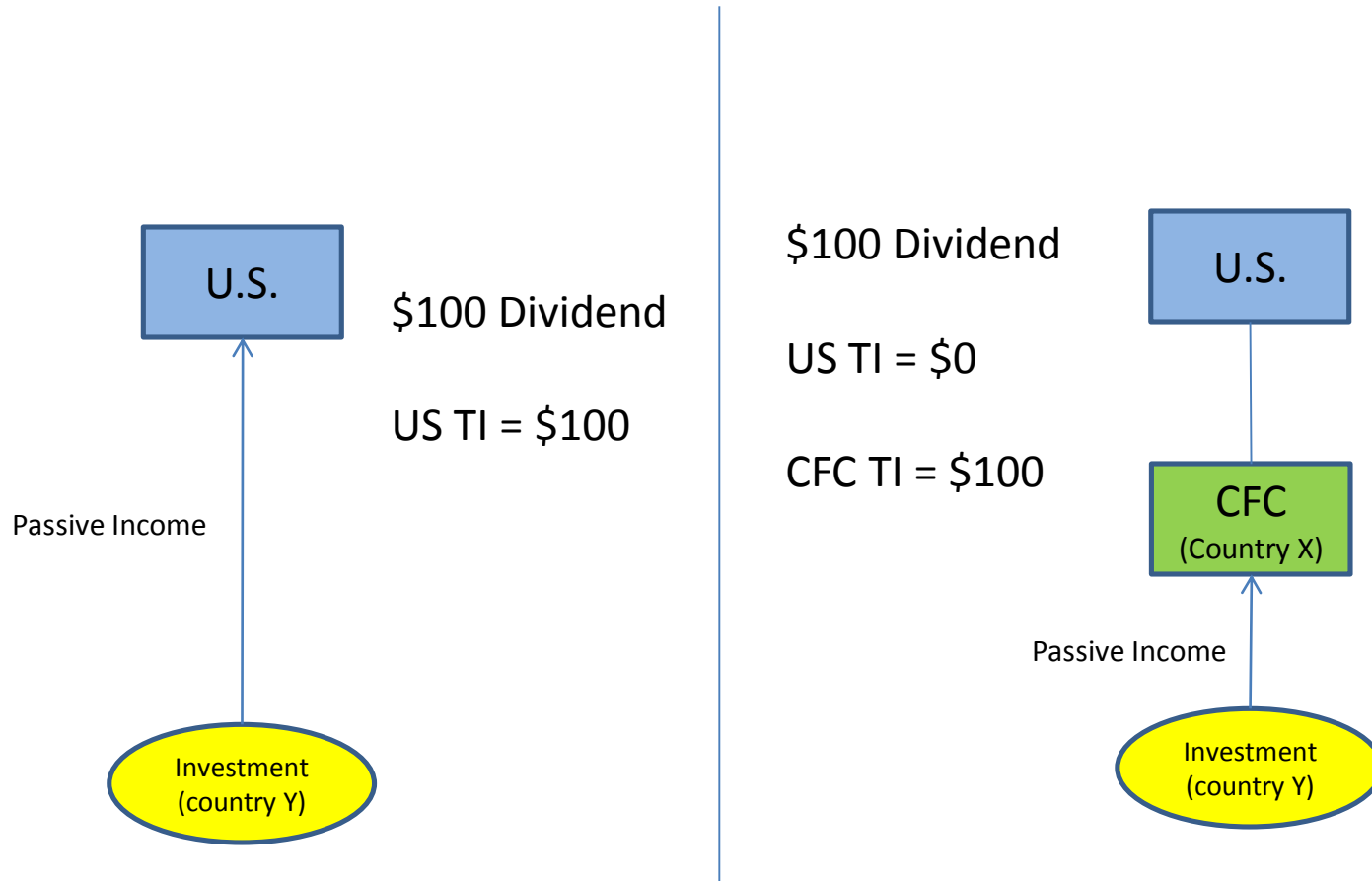
- (a) In general: For purposes of this part, except as otherwise provided in this subpart, the term “passive foreign investment company” means any foreign corporation if—
 - (1) **75 percent** or more of the gross **income** of such corporation for the taxable year is passive income, or
 - (2) the average percentage of **assets** (as determined in accordance with subsection (e)) held by such corporation during the taxable year which produce passive income or which are held for the production of passive income is at least **50 percent**.

PFIC Definition

Definition. Sec. 1297.

- (b) Passive income: For purposes of this section—
- (1) In general ...the term “passive income” means any income which is of a kind which would be foreign personal holding company income as defined in section 954 (c).

PFIC



PFIC

Purpose of PFIC Regime.

- Stop deferral and Income re-characterization of offshore investment
- Prior to PFIC – US Person could:
 - Invest offshore
 - Accumulate tax-deferred income
 - Sell and recognize gain at long-term capital gains rate

Income Test

Income Test:

- 75 percent or more of gross income is from passive sources
 - Sec. 954(c) - Personal Holding company ("FPHC") Income
 - Dividends, Interest, Royalties, Rents, Annuities
- Inapplicability of certain CFC exclusions:
 - If income would not have been exempt from Sub F from an exception other than under Sec. 954(c), would still be passive for PFIC purposes
 - Example – high tax exception under Sec. 954(b)(4); de minimis exception under Sec. 954(b)(3).
- Exception if “active” rental or royalty income. Sec. 954(c).

Asset Test

Asset Test:

- Average percentage of passive income producing assets held during the year equals or exceeds 50 percent of total assets.
 - Applied on gross basis;
 - Average of assets at end of quarter
 - Cash is a “passive” asset

Look Through Rules

- **Common Look Through Rules:**
- Sec. 1297(c) – 25% Subsidiary Look Through. If Foreign Corp owns at least 25% of other foreign corp; look through to assets of lower tier corp to determine PFIC status.
- Sec. 1297(b)(2)(C) – Related Person Look Through. interest, a dividend, or a rent or royalty, which is received or accrued from a related person (within the meaning of section 954(d)(3)) to the extent such amount is properly allocable (under regulations prescribed by the Secretary) to income of such related person which is not passive income.
- Sec. 1298(b)(7) - Treatment of certain foreign corporations owning stock in 25-percent owned domestic corporation - 25% Domestic Corporation Look Through. for purposes of determining whether such foreign corporation is a passive foreign investment company, any qualified stock held by such domestic corporation shall be treated as an asset which does not produce passive income (and is not held for the production of passive income) and any amount included in gross income with respect to such stock shall not be treated as passive income.

Common Exceptions

Common Exceptions

- Sec. 1297(d) – CFC/PFIC overlap rule. If a US Shareholder of CFC and a PFIC, CFC rules control.
 - CFC – Controlled Foreign Corporation. U.S. Shareholders own more than 50% of vote or value. Sec. 957
 - U.S. Shareholder: U.S. person with 10% or more of vote. Sec. 951(b).
- Sec. 1298(b)(2). Start up year exception. Not treated as PFIC if only a PFIC in start up year, and not a PFIC in 2 successive years.
- Sec. 1298(b)(3). Change of business exception.

PFIC

Sec. 1298(b)(1). Once a PFIC, always a PFIC rule.

- Excess Distribution Regime Applies until PFIC Taint “Purged”
 - Even If PFIC Tests Not Met in Year of Excess
 - Applies even if no longer a PFIC.

- Deemed Sale Election – To Purge Taint
 - Treated As Sold For FMV
 - Gain = Excess Distribution
 - Basis Adjustment For Gain
 - Loss Not Recognized

PFIC

Sec. 1291 Fund.

- Tax and Interest Charge
- Gain/Distribution allocated over the entire holding period
- Tax imposed at highest rate in effect for each year in holding period
- Interest charge for “unpaid” tax

PFIC

Spotting a PFIC.

- Offshore Corporation
- Passive Income/ Assets.
- US Person is a shareholder.
 - But - not a US Shareholder of a CFC.

FPHCI

Rents/Royalties

Active Rent/ Royalty Exception

Sec. 954(c)(2)(A).

- Foreign personal holding company income shall not include **rents and royalties** which are derived in the **active conduct of a trade or business** and which are **received from a person other than a related person** (within the meaning of subsection (d)(3)).

Active Royalty Exception

Treas. Reg. 1.954-2(d); 1.954-2T - Active Royalties.

Royalties will be considered for purposes of paragraph (b)(6) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation (the licensor) from licensing—

- **[ACTIVE DEVELOPER]** Property that the licensor:
 - through its own officers or staff of employees,
 - has developed, created, or produced, or property that the licensor has acquired and, through its own officers or staff of employees, added substantial value to, but only so long as the licensor, through its officers or staff of employees, is regularly engaged in the development, creation, or production of, or in the acquisition and addition of substantial value to, property of such kind; or
- **[ACTIVE MARKETER]** Property that is licensed as a result of the performance of marketing functions by such licensor:
 - through its own officers or staff of employees located in a foreign country or countries,
 - if the licensor, through its officers or staff of employees, maintains and operates an organization either in such foreign country or in such foreign countries (collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.
 - Substantial = facts circumstances test
 - Safe Harbor = active licensing expense = 25% of adjusted licensing profit.

Active Royalty Exception

Treas. Reg. 1.954-2(d); 1.954-2T - Active Royalties.

- Substantial = facts circumstances test
 - Safe Harbor = active licensing expense = 25% of adjusted licensing profit.
- “Active licensing expenses” means the deductions incurred (by that organization) that are properly allocable to royalty income and that would be deductible as trade or business expenses to the licensor (if a U.S. corporation).
 - However, these deductions do not include
 - (i) deductions for compensation for personal services rendered by shareholders of the lessor or persons related to the licensor
 - (ii) deductions for rent paid or accrued,
 - (iii) deductions that are generally allowable under Sec. 162 and would be specifically allowable to the lessor (if the lessor were a domestic corporation) under any other Code section,
 - (iv) deductions for payments made to agents or independent contractors relating to the licensed property, and
 - (v) deductions for CST payments or PCT payments.
 - CSA – payments made not considered by “own” officers or employees.
- “Adjusted licensing profit” means the licensor's gross income from royalties, reduced by the sum of
 - (1) royalties it paid or incurred with respect to that income plus
 - (2) amounts that would be allocable to that income as trade or business deductions if the licensor were a U.S. corporation, plus
 - (3) amounts paid to agents or independent contractors with respect to that income.

Active Rental Exception

- **Active Rental Exception Rule:** Rents will be considered for to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation (the lessor) from leasing any of the following—
 - **Manufactured or add substantial value.** Property that the lessor, through its own officers or staff of employees, has manufactured or produced, or property that the lessor has acquired and, through its own officers or staff of employees, added substantial value to, but only if the lessor, through its officers or staff of employees, is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;
 - **Regularly perform substantial management and operational functions.** Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;
 - **Use of property in active trade or business, lease property temporarily while not in use.** Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or
 - **Perform marketing function that is substantial in relation to rental income and carried on by employees in foreign country.** Property that is leased as a result of the performance of marketing functions by such lessor through its own officers or staff of employees located in a foreign country or countries, if the lessor, through its officers or staff of employees, maintains and operates an organization either in such country or in such countries (collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.
- **Substantiality.** For purposes of this rule, whether the activities of the taxpayer are substantial in relation to the amount of rents; safe harbor test.

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