

LB&I International Practice Service Transaction Unit

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| Unit Name | Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business |
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Issue and Transaction Overview

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Generally, the U.S. shareholder of a foreign corporation is able to defer taxation of the corporation's income until it has been distributed to the shareholder. However, in the case of a controlled foreign corporation (CFC), certain types of income are subject to current inclusion by the U.S. shareholder under section 951 of the Internal Revenue Code (IRC). One such type of income is Foreign Personal Holding Company Income (FPHCI), which includes income of a CFC such as dividends, interest, annuities, rents, royalties, and net gains or dispositions of property producing any of the foregoing types of income. The FPHCI rules seek to eliminate the inappropriate deferral of income where the investments are portfolio types of investments, or where the company is merely passively receiving investment income. In contrast, the deferral of taxation on these types of income is appropriate in the case of a CFC that is actively engaged in the conduct of a banking, financing or similar business since the very nature of the CFC's business and related activities transform what would ordinarily be viewed as passive or portfolio type income into active business income.

There are, consequently, exceptions to current inclusion. Under the "active financing exception" rules, FPHCI does *not* include income derived in the active conduct of a banking, financing or similar business. Specifically, the rules provide that FPHCI does not include the *qualified banking or financing income* (QBFI) of an *eligible CFC*. This unit's resources include a flowchart to aid examiners in gaining a conceptual understanding of the active financing exception. This unit covers the definition of eligible CFC, including discussion of the "predominantly engaged" and "substantial activity" tests, as well as the definition of QBFI as it applies to CFCs and qualified business units (QBUs). QBUs, which are defined in IRC § 954(h)(5)(d) by reference to IRC § 989(a), will be covered in detail in other Practice Units in the Foreign Currency IPN.

As there are currently no Treasury Regulations in this area, let's take a look at the comments of the Joint Committee on Taxation regarding the Active Financing Exception.

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Issue and Transaction Overview (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

According to the staff of the Joint Committee on Taxation, commenting on the first enactment of the “active financing exception” in 1997:

“The subpart F rules historically have been aimed at requiring current inclusion by the U.S. shareholders of income of a CFC that is either passive or easily moveable. ... Prior to the enactment of the... “1986 Act”, exceptions from foreign personal holding company income [FPHCI] were provided for income derived in the active conduct of a banking, financing, or similar business.... The Congress recognized that the 1986 Act's repeal of these exceptions may be viewed as causing the subpart F rules to apply to income that is neither passive nor easily moveable....

The Congress recognized that ... banking, financing, and similar businesses are businesses the active conduct of which involves the generation of income, such as interest and dividends, of a type that generally is treated as passive for purposes of subpart F. [In the active financing exception,] the Congress intended to delineate the income derived in the active conduct of such businesses, while retaining the anti-deferral rules of subpart F with respect to income not derived in the active conduct of these financial services businesses.”

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Transaction and Fact Pattern

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

| Diagram of Transaction | Facts |
|--|--|
| <pre> graph TD USP[USP] -- 100% --> CFC1[CFC1 (Country B)] USP -- 100% --> CFC2[CFC2 (Low Tax Country A)] CFC1 --> QBU[QBU (Country C)] </pre> <p>The diagram illustrates the ownership and operational structure. At the top is USP, which owns 100% of CFC1 (Country B) and 100% of CFC2 (Low Tax Country A). CFC1 is a lending/financing company that receives interest income and owns QBU (Country C), which is also a lending/financing company that receives interest income. CFC2 is a licensed bank that receives interest income.</p> | <ul style="list-style-type: none"> ▪ USP is the 100% owner of CFC1, a lending/financing company incorporated in Country B and CFC2, incorporated and licensed as a bank to do business in Low Tax Country A. ▪ CFC1 has a Qualified Business Unit (QBU), a lending/financing company in Country C. ▪ CFC1 receives interest income through its lending/financing activities. ▪ CFC2 receives interest income through its banking activities. ▪ QBU receives interest income through its lending/financing activities. <p>▪ In the fact pattern described, interest income is the sole source of income derived by CFC1, CFC2 and QBU. However, the examiner should note that a variety of other types of income such as services or lease income may potentially qualify for the active financing exception from FPHCI, provided the income is derived from banking or financing activities (i.e. as long as the requirements described in this Unit are met).</p> <p>Note: determination of QBU status is beyond the scope of this Unit and is covered in IPS Units in the Foreign Currency IPN.</p> |

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Effective Tax Rate Overview

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

ETR of Company

- The examiner should review the company's audited financial statements to determine the ETR for the years at issue and compare it to other companies in the same industry. The examiner should look for the total permanently reinvested offshore income (PRI).
- In the scenario illustrated in this Unit, the tax rate in Low Tax Country A (5%) is lower than the US rate (35%), so profits moved to Low Tax Country A are taxed at a rate that is 30 percentage points lower than the US rate.
- In the scenario illustrated in this Unit, the tax rate in Country B (30%) is lower than the US rate (35%), so profits moved to Country B are taxed at a rate that is 5 percentage points lower than the US rate.
- In the scenario illustrated in this Unit, the tax rate in Country C (30%) is lower than the US rate (35%), so profits moved to Country C are taxed at a rate that is 5 percentage points lower than the US rate.

ETR Impact of Adjustment

- Assuming (1) the E&P is PRI under Accounting Principles Board APB 23 (now codified as Accounting Standards Codification , ASC 740-30) and (2) the income of the CFC is not subject to taxation under Subpart F, the corporate group's worldwide ETR is reduced, which is important, especially for financial reporting purposes.
- An inclusion of FPHCI may increase the financial income tax expense of USP, resulting in higher ETR.

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Summary of Potential Issues


| Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business | |
|--|---|
| <u>Issue 1</u> | Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception. |
| <u>Issue 2</u> | Whether CFC2's interest income constitutes FPHCI or qualifies for the active financing exception. |
| <u>Issue 3</u> | Whether the interest income of QBU is eligible for the active financing exception. |

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All Issues, Step 1: Initial Factual Development

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

CFC1, CFC2, and QBU receive interest income, which would generally be characterized as FPHCI, resulting in a current inclusion to USP. However, the income may be excluded from FPHCI under the “active financing exception” depending on whether the CFCs are eligible entities and the income meets certain requirements.


| Fact Element | Resources | 6103 Protected Resources |
|--|---|--------------------------|
| <ul style="list-style-type: none"> ▪ CFC1, CFC2, and QBU receive interest income from unrelated parties within their home countries. This income should be identified on Form 5471 Schedule C. The examiner should also review Schedule M for possible related party interest income. <p> DECISION POINT : Consider whether any interest is received from related parties. If so, the examiner should consider IRC § 954(c)(6).</p> <ul style="list-style-type: none"> ▪ The examiner should request any functional analysis the taxpayer has done regarding the activities (e.g. “lending or finance business” or “substantial activity” discussed later). | <ul style="list-style-type: none"> ▪ Form 5471 ▪ Form 5471 Instructions ▪ Worldwide Tax and Legal Organizational Charts ▪ Business descriptions ▪ Functional analysis ▪ Internet search/TP website ▪ Contracts or loan agreements containing the critical facts of the transactions ▪ Information Document Request (IDR) to request details of taxpayer’s qualifications for the active financing exception | |

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All Issues, Step 1: Initial Factual Development (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

CFC1, CFC2, and QBU receive interest income, which would generally be characterized as FPHCI, resulting in a current inclusion to USP. However, the income may be excluded from FPHCI under the “active financing exception” depending on whether the CFCs are eligible entities and the income meets certain requirements.

| Fact Element | Resources | 6103 Protected Resources |
|---|--|--------------------------|
| <ul style="list-style-type: none"> ▪ The examiner should also issue an IDR to request the details of the taxpayer’s eligibility for the active financing exception. For example, how does the taxpayer meet the “eligible CFC” requirements; how does the income meet the “qualified banking or financing income” (QBFI) requirements (discussed later)? Compare this to the business descriptions (e.g. reported in the taxpayer’s 10-K or other documents) and taxpayer’s website. <p> DECISION POINT : Per IRC § 952(c)(1)(A), the examiner should consider the total amount of unrepatriated offshore E&P, as a current FPHCI inclusion is limited to this amount.</p> | <ul style="list-style-type: none"> ▪ Form 5471 ▪ Form 5471 Instructions ▪ Worldwide Tax and Legal Organizational Charts ▪ Business descriptions ▪ Functional analysis ▪ Internet search/TP website ▪ Contracts or loan agreements containing the critical facts of the transactions ▪ IDR to request details of taxpayer’s qualifications for the active financing exception | |

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Issue 1, Step 2: Review Potential Issues

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 1

Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception.

| Explanation of Issue | Resources | 6103 Protected Resources |
|---|---|--------------------------|
| <p>In order to qualify for the active financing exception from FPHCI, two basic elements are required (see <i>flowchart hyperlinked at right</i>).</p> <ul style="list-style-type: none"> ▪ Eligible CFC ▪ Qualified banking or financing income (QBFI) <p>An eligible CFC is one that is <i>predominantly engaged</i> in the active conduct of a banking, financing, or similar business and conducts <i>substantial activity</i> with respect to such business.</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Active Financing Exception Flowchart | |

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Issue 1, Step 2: Review Potential Issues (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 1

Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception.

| Explanation of Issue | Resources | 6103 Protected Resources |
|--|---|--------------------------|
| <p><i>Predominantly engaged:</i> A CFC will be treated as predominantly engaged in the active conduct of a banking, financing, or similar business, if it...</p> <ul style="list-style-type: none"> Derives more than 70% of its gross income directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers (Note: Congress intended that transactions with customers located in the U.S. not be taken into account for these purposes), Is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the U.S. (or is any other corporation not so licensed that is specified in the Regulations), or Is engaged in the active conduct of a securities business and is registered as a securities broker or dealer under Section 15(a) of the Securities Exchange Act of 1934 or is registered as a Government securities broker or dealer under section 15C(a) of such Act (or is any other corporation not so registered that is specified in the Regulations). | <ul style="list-style-type: none"> IRC § 951 IRC § 954(h) Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions Active Financing Exception Flowchart | |

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Issue 1, Step 2: Review Potential Issues (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 1

Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception.

| Explanation of Issue | Resources | 6103 Protected Resources |
|--|---|--------------------------|
| <p><i>Substantial activity.</i> A CFC is required to conduct substantially all of the activities necessary for the generation of income with respect to the business, which generally include:</p> <ul style="list-style-type: none"> ▪ Initial solicitation of customers (including vendors); ▪ Advising customers on financial needs, including funding and financial products; ▪ Providing financial and technical advice to customers; ▪ Designing or tailoring financial products to customers' needs; ▪ Negotiating terms with customers; ▪ Performing credit analysis on customers and evaluating non-credit risks; ▪ Providing related services to customers; | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Active Financing Exception Flowchart | |

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Issue 1, Step 2: Review Potential Issues (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 1

Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception.

| Explanation of Issue | Resources | 6103 Protected Resources |
|---|---|--------------------------|
| <ul style="list-style-type: none"> ▪ Making loans, entering into leases, extending credit or entering into other transactions with customers that generate income that would be considered derived in the active conduct of a banking, financing, or similar business; ▪ Collecting from customers; ▪ Performing remarketing activities (including sales) following termination of transactions with customers; ▪ Responding to customers' failure to satisfy their obligations under transactions, including enforcement or renegotiation of terms, liquidation of collateral, foreclosure, and/or institution of litigation; and ▪ Holding collateral for transactions with customers. <p>Note: back-office functions (such as accounting for income or loss, recordkeeping, and routine communications with customers) should not be taken into account in determining whether the substantial activity requirement is satisfied.</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Active Financing Exception Flowchart | |

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Issue 1, Step 2: Review Potential Issues (cont'd)

| Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business | | |
|--|---|--------------------------|
| Issue 1 | | |
| Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception. | | |
| Explanation of Issue | Resources | 6103 Protected Resources |
| <p>QBFI is income of an eligible CFC that:</p> <ul style="list-style-type: none"> ▪ Is derived in the active conduct of a banking, financing, or similar business by the CFC; AND ▪ Is derived from transactions with customers outside the US <i>and</i> substantially all of the activities in connection with which are conducted directly by the CFC in its home country, AND ▪ Is treated as earned by such CFC in its home country for purposes of such country's tax laws. <p>However, none of the income will be QBFI unless more than 30 percent of the CFC's gross income is derived directly from the active and regular conduct of a lending or finance business from transactions with unrelated, home country customers.</p> <p>Note: the income of a QBU is NOT considered for purposes of determining a CFC's QBFI, but the activities of a QBU may be considered for purposes of the substantial activity requirement in determining whether the CFC is an eligible CFC.</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Active Financing Exception Flowchart | |

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Issue 1, Step 3: Additional Factual Development

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business


Issue 1

Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception.

| Fact Element | Resources | 6103 Protected Resources |
|--|---|--------------------------|
| <ul style="list-style-type: none"> ▪ The examiner should determine whether CFC1 is an eligible CFC, i.e. whether CFC1 meets both the “predominantly engaged” and “substantial activity” tests. (Note: Issue 1 does NOT address QBU’s income or activities; see discussion at Issue 3) ▪ <i>Predominantly engaged</i>: CFC1 is neither a licensed bank nor a registered securities dealer. As such, the examiner should determine whether CFC1 derives more than 70% of its gross income directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers | <ul style="list-style-type: none"> ▪ The examiner should review the tax income statement along with any supporting journals and ledgers to determine whether the taxpayer meets the mechanical 70% test described in Step 2. ▪ The income statement should also reflect the various lending or financing activities in which the taxpayer is engaged. The examiner should compare the activities to those listed in IRC § 954(h)(4). The examiner should also consider any local regulations that may restrict the activities of the CFC. | |

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Issue 1, Step 3: Additional Factual Development (cont'd)

| Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business | | |
|---|---|--------------------------|
| Issue 1 | | |
| Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception. | | |
| Fact Element | Resources | 6103 Protected Resources |
|  <p>CONSULTATION: If any of the interest received by CFC1 is from related parties, the examiner should contact a transfer pricing specialist to determine whether the interest is arms length. An adjustment to the interest income of the CFC would affect the mechanical 70% test for being “predominantly engaged” in a banking, financing or similar business.</p> <p><i>Substantial activity:</i> The examiner should determine whether CFC1 meets the substantial activity test described in Step 2.</p> | <ul style="list-style-type: none"> ▪ During the initial factual development the examiner should have reviewed Schedule M for any related party transactions. ▪ The examiner should review functional analysis obtained during the initial factual development and interview the taxpayer regarding the business activities. The examiner should confirm the activities are not back-office functions. | |


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Issue 1, Step 3: Additional Factual Development (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 1

Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception.

| Fact Element | Resources | 6103 Protected Resources |
|---|---|--------------------------|
|  <p>DECISION POINT : Even if CFC1 is determined to be an eligible CFC, <i>none</i> of its income will be QBFI unless more than 30% of its gross income is from the active, regular conduct of a lending/finance business from transactions with unrelated, home country customers.</p> | <ul style="list-style-type: none"> ▪ During the initial factual development, the examiner should have obtained contracts or loan agreements containing the critical facts of the transactions. The examiner may consider a sample if records are voluminous. ▪ The examiner should review the contracts or agreements, along with the tax income statement, to determine the nature of the transactions, the location of the customers, and whether the 30% threshold is met. | |

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Issue 1, Step 3: Additional Factual Development (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 1

Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception.

| Fact Element | Resources | 6103 Protected Resources |
|---|--|--------------------------|
| <ul style="list-style-type: none"> ▪ The examiner should determine whether the interest income of CFC1 is QBFI, i.e. whether the income is... <ul style="list-style-type: none"> – Derived in the active conduct of a banking, financing or similar business by CFC1? – Derived from transactions with customers outside the U.S.? – Derived from activities substantially all of which are conducted directly by CFC1 in Country B? – Treated as earned by CFC1 in Country B for purposes of that country's tax laws? ▪ <i>Reminder.</i> QBU's income is NOT considered for purposes of determining CFC1's QBFI. | <ul style="list-style-type: none"> ▪ Based on earlier factual development, the examiner should be satisfied as to questions 1 and 2. ▪ The examiner should interview the taxpayer and review position descriptions, secondment agreements, travel logs, etc. to determine the nature and location of the activities that are performed by CFC1's employees. ▪ The examiner should review copies of Country B tax returns to determine how the interest income is treated for purposes of that country's tax laws. | |

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Issue 1, Step 4: Develop Arguments

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 1

Whether CFC1's interest income constitutes FPHCI or qualifies for the active financing exception.

| Explanation of Approach | Resources | 6103 Protected Resources |
|---|--|--------------------------|
| <p>The factual development should have included a review of the notes from taxpayer interviews and/or functional analysis of the taxpayer's business activities.</p> <p>If CFC1 is an eligible CFC and the interest income is QBFI, then the interest income will qualify for the "active financing exception" under IRC § 954(h).</p> <p>If CFC1 is not an eligible CFC or its income is not QBFI, calculate the amount of the CFC1's FPHCI and USP's current income inclusion (see UIL 9412.05 General Subpart F Computational Issues), and be sure to consider FTC implications (e.g. some indirect foreign tax credit offset – see UIL 9413).</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ Bittker & Lokken Fundamentals of International Taxation 69.4.10 ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Active Financing Exception Flowchart | |

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Issue 2, Step 2: Review Potential Issues

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 2

Whether CFC2's interest income constitutes FPHCI or qualifies for the active financing exception.

| Explanation of Issue | Resources | 6103 Protected Resources |
|--|---|--------------------------|
| <p>In order to qualify for the active financing exception from FPHCI, the requirements previously discussed in Issue 1, Step 2 must be met.</p> <p>To review the definition of <i>eligible CFC</i>, refer to Issue 1 Step 2 Slide 10.</p> <p>To review the definition of <i>predominantly engaged</i>, refer to Issue 1 Step 2 Slide 11.</p> <p>No regulations have been issued with respect to the “predominantly engaged” test, but the legislative history states that Congress intended the requirements for the active conduct of a banking business include the requirements for foreign banks under Prop. Treas. Reg. § 1.1296-4.</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Prop. Treas. Reg. § 1.1296-4 ▪ Active Financing Exception Flowchart | |

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Issue 2, Step 2: Review Potential Issues (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 2

Whether CFC2's interest income constitutes FPHCI or qualifies for the active financing exception.

| Explanation of Issue | Resources | 6103 Protected Resources |
|---|---|--------------------------|
| <p>Under the requirements for foreign banks in Prop. Treas. Reg. § 1.1296-4, a foreign bank must be licensed or authorized to accept deposits from residents of its home country and conduct banking activities in its home country (such as lending, factoring, banking and trust services, issuing letters of credit, and arranging foreign exchange transactions).</p> <p>To review the definition of <i>substantial activity</i>, refer to Issue 1 Step 2 Slide 12.</p> <p>To review the definition of <i>QBFI</i>, refer to Issue 1 Step 2 Slide 14.</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Prop. Treas. Reg. § 1.1296-4 ▪ Active Financing Exception Flowchart | |

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Issue 2, Step 3: Additional Factual Development

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 2

Whether CFC2's interest income constitutes FPHCI or qualifies for the active financing exception.

| Fact Element | Resources | 6103 Protected Resources |
|--|---|--------------------------|
| <ul style="list-style-type: none"> ▪ The examiner should determine whether CFC2 is an eligible CFC, i.e. whether CFC2 meets both the “predominantly engaged” and “substantial activity” tests. ▪ Predominantly engaged. The examiner should determine whether CFC2 is engaged in the active conduct of a banking business and is an institution licensed to do business as a bank in the United States (or is any other corporation not so licensed which is specified by the Secretary in regulations). | <p>If there is any doubt as to CFC2's status as a licensed bank, issue an IDR to request a copy of the licensure to confirm. If necessary, the examiner may also submit a treaty or TIEA request, contact a tax attaché (http://lmsb.irs.gov/international/dir_treaty/eoi_overseas/TaxAttacheContactInformation.asp), research banking requirements for the country in question, or visit National Information Center's website (http://www.ffiiec.gov/nicpubweb/nicweb/SearchForm.aspx).</p> | |

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| Deferral Planning | Foreign Personal Holding Company Issues | Active Financing Exception | N/A |

Issue 2, Step 3: Additional Factual Development (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 2

Whether CFC2's interest income constitutes FPHCI or qualifies for the active financing exception.

| Fact Element | Resources | 6103 Protected Resources |
|--|--|--------------------------|
| <ul style="list-style-type: none"> Since CFC2 is licensed in Country A, not in the U.S., and since regulations have not been issued to specify what other corporations might qualify, the examiner should determine whether CFC2 meets the foreign bank requirements described in Step 2. <i>Substantial activity.</i> The examiner should determine whether CFC2 meets the substantial activity test described in Step 2. | <ul style="list-style-type: none"> The examiner should review functional analysis obtained during the initial factual development and interview the taxpayer regarding the business activities. The examiner should confirm the activities are not back-office functions. | |

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Issue 2, Step 3: Additional Factual Development (cont'd)

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 2

Whether CFC2's interest income constitutes FPHCI or qualifies for the active financing exception.

| Fact Element | Resources | 6103 Protected Resources |
|--|---|--------------------------|
| <ul style="list-style-type: none"> ▪ The examiner should determine whether the interest income of CFC2 is QBFI, i.e. whether the income is: <ul style="list-style-type: none"> – Derived in the active conduct of a banking, financing or similar business by CFC2? – Derived from transactions with customers outside the U.S.? – Derived from activities substantially all of which are conducted directly by CFC2 in Country A? – Treated as earned by CFC2 in Country A for purposes of that country's tax laws? | <ul style="list-style-type: none"> ▪ Based on earlier factual development, the examiner should be satisfied as to questions 1 and 2. ▪ The examiner should interview the taxpayer and review position descriptions, secondment agreements, travel logs, etc. to determine the nature and location of the activities that are performed by CFC2's employees. ▪ The examiner should review copies of Low Tax Country A tax returns or other substantiation to determine how the interest income is treated for purposes of that country's tax laws.. | |

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| Deferral Planning | Foreign Personal Holding Company Issues | Active Financing Exception | N/A |

Issue 2, Step 4: Develop Arguments

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 2

Whether CFC2's interest income constitutes FPHCI or qualifies for the active financing exception.

| Explanation of Approach | Resources | 6103 Protected Resources |
|--|--|--------------------------|
| <p>The factual development should have included a review of notes from taxpayer interviews, functional analysis of the taxpayer's business activities, and licensure of the bank.</p> <p>If CFC2 is an eligible CFC and the interest income is QBFI, then the interest income will qualify for the "active financing exception" under IRC § 954(h).</p> <p>If CFC2 is not an eligible CFC or its income is not QBFI, calculate the amount of CFC1's FPHCI and USP's current income inclusion (see UIL 9412.05 General Subpart F Computational Issues), and be sure to consider FTC implications (e.g. some indirect foreign tax credit offset – see UIL 9413).</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ Bittker & Lokken Fundamentals of International Taxation 69.4.10 ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Active Financing Exception Flowchart | |


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| Deferral Planning | Foreign Personal Holding Company Issues | Active Financing Exception | N/A |

Issue 3, Step 2: Review Potential Issues

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 3

Whether the interest income of QBU is eligible for the active financing exception.

| Explanation of Issue | Resources | 6103 Protected Resources |
|--|---|--------------------------|
|  <p>CONSULTATION: For assistance in determining status as a QBU, consult with the Foreign Currency IPN.</p> <p>Qualified banking or financing income of an eligible CFC or QBU of such CFC is determined separately for the CFC and each QBU, taking into account, in the case of an eligible CFC, only items of income, gain, deduction, loss or other items, as well as activities, of such CFC that are not properly allocable to any QBUs.</p> <p>Similarly, in the case of a QBU, qualified banking or financing income is determined by taking into account such applicable items (e.g. income and activities) that are properly allocable to such QBU.</p> <p>If the QBFI requirements are satisfied, the exceptions apply to income that is derived from transactions with customers located in the CFC's home country. In addition, the exceptions apply to income that is derived by a QBU of an eligible CFC from transactions with customers located in the QBU's home country.</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Active Financing Exception Flowchart | |

| Volume | Part | Chapter | Sub-Chapter |
|-------------------|---|----------------------------|-------------|
| Deferral Planning | Foreign Personal Holding Company Issues | Active Financing Exception | N/A |

Issue 3, Step 3: Additional Factual Development

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 3

Whether the interest income of QBU is eligible for the active financing exception.

| Fact Element | Resources | 6103 Protected Resources |
|---|---|--------------------------|
| <ul style="list-style-type: none"> ▪ For purposes of Issue 3, we assume that the examiner has determined to his/her satisfaction that CFC1 is an eligible CFC. ▪ The examiner should determine whether the interest income of QBU is QBFI, i.e. whether the income is: <ul style="list-style-type: none"> – Derived in the active conduct of a banking, financing or similar business by QBU? – Derived from transactions with customers outside the U.S.? – Derived from activities substantially all of which are conducted directly by QBU in Country C? – Treated as earned by QBU in Country C for purposes of that country’s tax laws? | <ul style="list-style-type: none"> ▪ Based on earlier factual development, the examiner should be satisfied as to CFC1’s status as an eligible CFC. ▪ The examiner should interview the taxpayer and review position descriptions, secondment agreements, travel logs, etc. to determine the nature and location of the activities that are performed by CFC1’s employees. ▪ The examiner should review copies of Country C tax returns to determine how the interest income is treated for purposes of that country’s tax laws. | |

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| Deferral Planning | Foreign Personal Holding Company Issues | Active Financing Exception | N/A |

Issue 3, Step 4: Develop Arguments

Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business

Issue 3

Whether the interest income of QBU is eligible for the active financing exception.

| Explanation of Approach | Resources | 6103 Protected Resources |
|--|--|--------------------------|
| <p>The factual development should have included a review of notes from taxpayer interviews and/or functional analysis of the QBU’s business activities.</p> <p>Assuming CFC1 is an eligible CFC and the interest income of QBU is QBFI, QBU’s interest income will qualify for the “active financing exception” under IRC § 954(h).</p> <p>If CFC1 is not an eligible CFC or QBU’s income is not QBFI, calculate the amount of QBU/CFC1’s FPHCI and USP’s corresponding current income inclusion (see UIL 9412.05 General Subpart F Computational Issues), and be sure to consider FTC implications (e.g. some indirect foreign tax credit offset – see UIL 9413).</p> | <ul style="list-style-type: none"> ▪ IRC § 951 ▪ IRC § 954(h) ▪ Staff of Joint Comm. on Tax’n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) ▪ Bittker & Lokken Fundamentals of International Taxation 69.4.10 ▪ TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions ▪ Active Financing Exception Flowchart | |

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| Deferral Planning | Foreign Personal Holding Company Issues | Active Financing Exception | N/A |

Training and Additional Resources

Chapter 2.3.3 Active Financing Exception

| Type of Resource | Description(s) and/or Instructions for Accessing | References |
|---------------------------------|---|--|
| White Papers / Guidance | <ul style="list-style-type: none"> Refer to Committee Report listed at right | <ul style="list-style-type: none"> Staff of Joint Comm. on Tax'n, 105th Cong., 2d Sess., General Explanation of Tax Legislation Enacted in 1998 at 243-265 (Comm. Print 1998) |
| Reference Materials - Treatises | <ul style="list-style-type: none"> Reading materials | <ul style="list-style-type: none"> Bittker & Lokken Fundamentals of International Taxation 69.4.10 TMFEDPORT No. 6220-1st: CFCs – Foreign Personal Holding Company Income XIII. Special Exceptions |

| Volume | Part | Chapter | Sub-Chapter |
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| Deferral Planning | Foreign Personal Holding Company Issues | Active Financing Exception | N/A |

Glossary of Terms and Acronyms

| Acronym | Definition |
|---------|--|
| CFC | Controlled Foreign Corporation |
| ETR | Effective Tax Rate |
| FPHCI | Foreign Personal Holding Company Income |
| FTC | Foreign Tax Credit |
| IDR | Information Document Request |
| PRI | Permanently Reinvested (Offshore) Income |
| QBFI | Qualified Banking or Financing Income |
| QBU | Qualified Business Unit |
| TIEA | Tax Information Exchange Agreement |

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Index of Related Issues

| Issue | Associated UIL(s) | References |
|--|-------------------|-----------------|
| General Subpart F Computational Issues | 9412.05 | To be developed |
| FTC Management | 9413 | To be developed |
| Foreign Currency | 9470 | To be developed |