Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service
Process Unit – Audit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Individual Outbound	–	–
Volume	11	Foreign Corporations	**Level 1 UIL**	9433
Part	11.1	Individual with an Investment in a CFC	**Level 2 UIL**	9433.01
Chapter	11.1.1	Taxability of Income from the CFC	**Level 3 UIL**	9433.01-01
Sub-Chapter	11.1.1.2	Subpart F Income	–	–

Unit Name	Computing Foreign Base Company Income for US Individual Shareholders

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Process Overview

Computing Foreign Base Company Income for US Individual Shareholders
Process Description
U.S. shareholders of controlled foreign corporations (“CFCs”) may have to include amounts in income under IRC 951(a)(1)(A) (“subpart F inclusions”) when the controlled foreign corporation (“CFC”) earns certain types of income, even if the CFC does not distribute any of the income to the U.S. shareholder. (See the IPS Unit on Determination of U.S. Shareholders and CFC Status and another IPS Unit on Subpart F Overview.) There are many steps involved in calculating a subpart F inclusion, the first of which is to calculate the CFC’s foreign base company income (“FBCI”). In order to calculate a CFC’s FBCI, the examiner first determines the CFC’s gross income items that comprise FBCI, which are: (i) foreign personal holding company income (“FPHCI”); (ii) foreign base company (“FBC”) sales income; (iii) FBC services income; and (iv) FBC oil related income. Next, the aggregate amount of FBCI and IRC §953 insurance income is adjusted by the de minimis and full inclusion rules. The “adjusted gross FBCI” is then reduced by deductions properly allocable to each item of FBCI income. Finally, where applicable, the section 952(c) limitation and the high tax exception are applied, which may further reduce the amount of FBCI taken into account when computing a subpart F inclusion. This Unit will cover the general rules for computing FBCI but will not cover IRC 953 insurance income applicable to inclusions of subpart F income. This subject and additional details on the many exceptions to FBCI will be covered by future IPS Units.

Determination of Process Applicability

Computing Foreign Base Company Income for US Individual Shareholders

While examining a tax return of a U.S. individual, the examiner may identify the ownership of a CFC that has one or more items of gross income from FPHCI or FBC sales, services, or oil related income. In such a case, the examiner will need to apply the steps described in this IPS Process Unit to compute the CFC's FBCI, as an initial step to determining the U.S. shareholder's subpart F inclusion.

As mentioned on the previous slide, computing the FBCI of a CFC involves aggregating its gross items of FBCI; applying the de minimis, full inclusion, and high tax exception rules; and taking into account properly allocable deductions.

Criteria	Resources	6103 Protected Resources
▪ Determine whether the CFC has any items of FPHCI or FBC sales, services, or oil related income. These items may be reported on Form 5471, Schedule C, Lines 3-8 and/or Schedule I, Line 1, the detail computation of which comes from Worksheet A. In any event, supporting documentation for the determination of FBCI should be requested from the taxpayer to verify the accuracy of the computation.	▪ IRC 954, Foreign Base Company Income ▪ Bittker & Lokken Federal Taxation of Income, Estates and Gifts 69.4 – 69.9	

Summary of Process Steps

Computing Foreign Base Company Income for US Individual Shareholders	
Step 1	Aggregate the CFC's FPHCI and FBC sales, services, and oil related income.
Step 2	Apply the de minimis and full inclusion rules.
Step 3	Reduce the income by the properly allocable deductions
Step 4	Remove any income subject to the high tax exception.

Step 1

Computing Foreign Base Company Income for US Individual Shareholders
Step 1: Aggregate the CFC's FPHCI and FBC sales, services, and oil related income.
The examiner will need to identify the CFC's items of FPHCI and FBC sales, services, and oil related income. These items of income are defined and discussed in various IPS Practice Transaction, Process and Concept Units. In the aggregate, these items are referred to in the regulations as "Gross FBCI."

Considerations	Resources	6103 Protected Resources
▪ The examiner should perform the necessary audit steps to confirm the accuracy and completeness of the amounts of FPHCI and FBC sales, services, and oil related income calculated by the shareholder in order to determine the correct amount of the CFC's subpart F income reported on Form 5471.	▪ IRC 954(c), (d), (e), & (g), FPHCI, Foreign Base Company Sales Income, Foreign Base Company Services Income, Foreign Base Company Oil Related Income ▪ IPS Practice Unit, *"Definition of FPHCI and the common exceptions*", in process as of 7/15.	
▪ The examiner should evaluate the applicability of any special rules and exceptions for FPHCI and FBC sales, services, and oil related income, such as the same country exception and the CFC manufacturing exception applicable to FBC sales income. These exceptions, as well as other special rules and exceptions are covered in detail in other IPS Practice Units.	▪ IRC 954(c)(2), (3) & (6), FPHCI Exceptions for Certain Amounts, FPHCI Certain Income Received from Related Persons, FPHCI Look-thru Rule for Related Control Foreign Corporations ▪ IRC 954(h) & (i), Special Rule for Income Derived in the Active Conduct of Banking, Financing, or Similar Businesses, Special Rule for Income Derived in the Conduct of Insurance Business	

Step 1 (cont'd)

Computing Foreign Base Company Income for US Individual Shareholders
Step 1: Aggregate the CFC's FPHCI and FBC sales, services, and oil related income.
The examiner will need to identify the CFC's items of FPHCI and FBC sales, services, and oil related income. These items of income are defined and discussed in various IPS Practice Transaction, Process and Concept Units. In the aggregate, these items are referred to in the regulations as "Gross FBCI."

Considerations	Resources	6103 Protected Resources
	▪ Treas. Reg. 1.954-3(a)(4), Property Manufactured or Produced by the Controlled Foreign Corporation. ▪ Treas. Reg. 1.954-4(d), Foreign Based Company Services Income Excluded Items ▪ IPS Practice Unit, *"Definition of FPHCI and the common exceptions*", in process as of 7/15.	

Step 2

Computing Foreign Base Company Income for US Individual Shareholders
Step 2: Adjust the income by the de minimus and full inclusion rules.
The examiner must apply the de minimis and full inclusion rules in order to compute the “Adjusted Gross FBCI.”

Considerations	Resources	6103 Protected Resources
▪ Under the de minimis rule, if the sum of a CFC’s Gross FBCI and gross insurance income (as determined under IRC 953) for the tax year is less than the lesser of 5% of gross income or $1,000,000, then none of the CFC’s gross income for the tax year will be treated as FBCI or insurance income. ▪ Example: A CFC’s gross income for a particular year is $15 million, and its gross FBCI and insurance income is $700,000. In this case, the de minimis threshold is $750,000 (lesser of $1 million or 5% of $15 million). Because $700,000 is less than $750,000, none of the CFC’s $15 million gross income shall be treated as FBCI or insurance income.	▪ IRC 954(b)(3)(A), De Minimis Rule ▪ Treas. Reg. 1.954-1(b)(1)(i), De Minimis Test	

Step 2 (cont'd)

Computing Foreign Base Company Income for US Individual Shareholders
Step 2: Adjust the income by the de minimis and full inclusion rules.
The examiner must apply the de minimis and full inclusion rules in order to compute the "Adjusted Gross FBCI."

Considerations	Resources	6103 Protected Resources
! **CAUTION**: (1) CFCs having a functional currency other than the U.S. dollar shall translate the $1,000,000 threshold using the exchange rate provided under IRC §989(b)(3). (2) Anti-abuse rule: For purposes of applying the de minimis test, the income of two or more CFCs 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.	▪ Treas. Reg. 1.954-1(b)(1)(i)(B), Currency Translation ▪ Treas. Reg. 1.954-1(b)(4)(i), Anti-abuse Rule	

Step 2 (cont'd)

Computing Foreign Base Company Income for US Individual Shareholders
Step 2: Adjust the income by the de minimis and full inclusion rules.
The examiner must apply the de minimis and full inclusion rules in order to compute the "Adjusted Gross FBCI."

Considerations	Resources	6103 Protected Resources
▪ Under the full inclusion rule, if the sum of a CFC's Gross FBCI and gross insurance income for the tax year is more than 70% of gross income, subject to the high foreign taxes exception and allocable deductions (discussed in Step 3 and 4), then all of the CFC's gross income for the tax year will be treated as FBCI or insurance income. ▪ Example: Same as the last example, except the gross FBCI and insurance income is $12 million, which is 80% of the total gross income of $15 million. Because this percentage is greater than 70% of the total gross income, all $15 million of the CFC's gross income for the tax year will be treated as FBCI or insurance income. (Caution: See Treas. Reg. 1.954-1(d)(6) for special rules re: subpart F income exclusion.)	▪ IRC 954(b)(3)(B), Foreign Base Company Income and Insurance Income in Excess of 70 Percent of Gross Income ▪ Treas. Reg. 1.954-1(b)(1)(ii), Seventy Percent Full Inclusion Test	

Step 2 (cont'd)

Computing Foreign Base Company Income for US Individual Shareholders
Step 2: Adjust the income by the de minimis and full inclusion rules.
The examiner must apply the de minimis and full inclusion rules in order to compute the "Adjusted Gross FBCI."

Considerations	Resources	6103 Protected Resources
▪ Gross income included in "adjusted FBCI" because the full inclusion test is met is termed "full inclusion foreign base company income," and constitutes a separate category of adjusted gross FBCI for the purposes of allocating and apportioning deductions discussed in Step 3.	▪ Treas. Reg. 1.954-1(b)(2), Character of Gross Income Included in Adjusted Gross Foreign Base Company Income	
▪ The examiner should determine whether the sum of the CFC's Gross FBCI (computed in Step 1) and gross insurance income meets either the de minimis or full inclusion thresholds. If so, the Gross FBCI must be adjusted accordingly to arrive at Adjusted Gross FBCI.	▪ IRC 954(b)(3)(A) & (B), De Minimis Rule, Foreign Base Company Income and Insurance Income in Excess of 70 Percent of Gross Income ▪ Treas. Reg. 1.954-1(b)(1)(i) & (ii), De Minimis Test, Seventy Percent Full Inclusion Test	

Step 3

Computing Foreign Base Company Income for US Individual Shareholders
Step 3: Reduce the income by the properly allocable deductions.
The examiner should evaluate the deductions claimed by the taxpayer to offset FPHCI and FBC sales, services, and oil related income. Those deductions that are properly allocable to such income, done on an item by item rather than an aggregate basis, will reduce Adjusted Gross FBCI to arrive at "Net FBCI."

Considerations	Resources	6103 Protected Resources
▪ The examiner should evaluate the deductions claimed against FBCI in much the same way as deductions claimed against any other type of income (e.g., accuracy, timing, amount, existence, and occurrence of the deduction; whether the deduction is ordinary and necessary; etc.).	▪ IRC 162, Trade or Business Expenses ▪ Deductible and Capital Expenditures IPG Website	
▪ The examiner should evaluate whether the deductions are properly allocable to FBCI, as only those amounts that are properly allocable may reduce Adjusted Gross FBCI to arrive at Net FBCI. ▪ Once the gross amount of each item of FBCI is determined under Treas. Reg. §1.954-1(c)(1)(iii), deductions should be accounted for in the following manner: 1. Expenses not related to all gross income as a class shall be allocated and apportioned under the principles of IRC §§861, 864 and 904(d).	▪ IRC 954(b)(5), Deductions to be Taken into Account ▪ IRC 904(d), Limitation on Credit ▪ Treas. Reg. 1.954-1(c)(1)(i), Deductions Against Gross Foreign Base Company Income ▪ Treas. Reg. 1.954-1(c)(1)(iii), Items of Income	

Step 3 (cont'd)

Computing Foreign Base Company Income for US Individual Shareholders
Step 3: Reduce the income by the properly allocable deductions.
The examiner should evaluate the deductions claimed by the taxpayer to offset FPHCI and FBC sales, services, and oil related income. Those deductions that are properly allocable to such income, done on an item by item rather than an aggregate basis, will reduce Adjusted Gross FBCI to arrive at "Net FBCI."

Considerations	Resources	6103 Protected Resources
2. Foreign personal holding company income that is passive within the meaning of IRC §904 (determined before the application of the high-taxed income rule of Treas. Reg. §1.904-4(c)) is reduced by related person interest expense allocable to passive income under Treas. Reg. §1.904-5(c)(2). 3. The amount of each item of FBCI income is reduced by other expenses allocable and apportionable to such income under the principles of IRC §§ 861, 864 and 904(d).	▪ IRC 954(b)(5), Deductions to be Taken into Account ▪ IRC 904(d), Limitation on Credit ▪ Treas. Reg. 1.954-1(c)(1)(i), Deductions Against Gross Foreign Base Company Income ▪ Treas. Reg. 1.954-1(c)(1)(iii), Items of Income	

Computing Foreign Base Company Income for US Individual Shareholders
Step 3: Reduce the income by the properly allocable deductions.
The examiner should evaluate the deductions claimed by the taxpayer to offset FPHCI and FBC sales, services, and oil related income. Those deductions that are properly allocable to such income, done on an item by item rather than an aggregate basis, will reduce Adjusted Gross FBCI to arrive at "Net FBCI."

Considerations	Resources	6103 Protected Resources
▪ Example: A CFC earns $50,000 of gross rental income (determined to be FPHCI) and $700,000 of gross FBC services income. The CFC deducted $5,000 of property taxes allocable to rent and $200,000 of expenses allocable to services income. These deductions are verified by the examiner as properly allocable to their respective revenue sources. The CFC's Net FBCI is $545,000.		
CONSULTATION: The examiner may consult with the IIC Outbound FTC IPN for assistance with the proper allocation and apportionment of deductions.	▪ IIC Outbound FTC IPN Website ▪ Allocation & Apportionment Rules	

Step 4

Computing Foreign Base Company Income for US Individual Shareholders
Step 4: Reduce the income by any items for which high tax exception is claimed.
The examiner should evaluate whether the rules under IRC §952(c) or the high tax exception are applicable, and reduce “Net FBCI” to arrive at “Adjusted Net FBCI” accordingly. Limitations of current earnings and profits under IRC §952(c) will be fully explained in a future IPS Unit.

Considerations	Resources	6103 Protected Resources
▪ The examiner should evaluate whether any net items of FPHCI or FBC sales or services income are subject to an effective rate of foreign tax greater than 90% of the highest marginal U.S. corporate tax rate (note that oil related income does not fall under the high tax exception). If so, the income will not be treated as FBCI if the taxpayer claims the high tax exception. IRC 954 (b)(4).	▪ IRC 954(b)(4), Exception for Certain Income Subject to High Foreign Taxes ▪ Treas. Reg. 1.954-1(d), Computation of Adjusted Net Foreign Base Company Income or Adjusted Net Insurance Income	
▪ Note that if the amount of income included in subpart F income for the tax year is reduced by IRC §952(c) earnings and profits (“E & P”) limitation, the amount of income that is a net item of income is determined after applying the rules of IRC §952(c)(1), i.e., a determination of whether a net item of income qualifies for the high tax exception is made after applying the rules of IRC §952(c)(1).	▪ Treas. Reg. 1.954-1(a)(5), Adjusted Net Foreign Base Company Income ▪ Treas. Reg. 1.954-1(d)(4)(ii), Coordination with Earnings and Profits Limitation	

Computing Foreign Base Company Income for US Individual Shareholders
Step 4: Reduce the income by any items for which high tax exception is claimed.
The examiner should evaluate whether the rules under IRC §952(c) or the high tax exception are applicable, and reduce "Net FBCI" to arrive at "Adjusted Net FBCI" accordingly. Limitations of current earnings and profits under IRC §952(c) will be fully explained in a future IPS Unit.

Considerations	Resources	6103 Protected Resources
▪ The high tax exception is not mandatory; the taxpayer may elect the exception on an item by item basis. However, if the taxpayer elects the exception for any of its passive FPHCI as defined in Treas. Reg. 1.954-1(c)(1)(iii)(B), the taxpayer must elect the exception for all of its passive FPHCI (i.e., the exception is "all or nothing" with respect to FPHCI).	▪ IRC 954(b)(4), Exception for Certain Income Subject to High Foreign Taxes ▪ Treas. Reg. 1.954-1(c)(1)(iii)(B), Passive Foreign Personal Holding Company Income ▪ Treas. Reg. 1.954-1(d)(4)(i), Consistency Rule	

Step 4 (cont'd)

Computing Foreign Base Company Income for US Individual Shareholders
Step 4: Reduce the income by any items for which high tax exception is claimed.
The examiner should evaluate whether the rules under IRC §952(c) or the high tax exception are applicable, and reduce "Net FBCI" to arrive at "Adjusted Net FBCI" accordingly. Limitations of current earnings and profits under IRC §952(c) will be fully explained in a future IPS Unit.

Considerations	Resources	6103 Protected Resources
▪ Example: Assume that a CFC earns $1,000 of interest income (not the type described in in IRC 881(c)) and $500 of dividend income, both of which are considered FPHCI. In cases in which the CFC meets the high tax exception under IRC §954(b)(4) and wants to elect this exception, it must make this election for both the interest income and dividend income.		
▪ Notwithstanding the full inclusion rule discussed in Step 2, full inclusion FBCI will be excluded from subpart F income if more than 90% of the adjusted gross FBCI and insurance income of a CFC (determined without regard to the full inclusion test) is attributable to net amounts excluded from subpart F income by reason of an election to apply the high tax exception.	▪ Treas. Reg. 1.954-1(d)(6), Coordination of Full Inclusion and High Tax Exception Rules	
▪ The high tax exception does not apply to portfolio interest (described in IRC 881(c)) or to oil related income.	▪ Treas. Reg. 1.954-1(d)(1), Application of High Tax Exception	

Other Considerations / Impact to Audit

Computing Foreign Base Company Income for US Individual Shareholders

Considerations	Resources
▪ Early in the audit process, the examiner should determine the CFC's current year E&P, whether the CFC is engaged in transactions that generate items of FBCI, and whether there are foreign tax credits available to offset any potential subpart F inclusion related to the FBCI. This will allow the examiner to determine the potential net tax adjustment related to the CFC's FBCI.	▪ IRC 954(c), (d), (e), & (g), FPHCI, Foreign Base Company Sales Income, Foreign Base Company Services Income, Foreign Base Company Oil Related Income ▪ IRC 952, Subpart F Income Defined ▪ IRC 904, Limitation on Credit ▪ IRC 962, Election by Individuals to be Subject to Tax at Corporate Rates
▪ Since FBCI is a component of the potential subpart F inclusion of the U.S. shareholder, the examiner should review the E&P for each CFC, as a subpart F inclusion generally is limited to a CFC's current year E&P. However, special rules apply in cases in which a subpart F inclusion is limited by E&P, pursuant to which the excluded income may be subject to recharacterization as subpart F income in a future tax period. Again, limitations of current earnings and profits under IRC §952(c) will be explained fully in a future IPS Unit.	▪ IRC 952(c), Limitation

Training and Additional Resources

Chapter 11.1.1 Taxability of Income from the CFC		
Type of Resource	**Description(s) and/or Instructions for Accessing**	**References**
Prerequisite Reading	▪ Westlaw subscription or hard copy	▪ Bittker & Lokken Federal Taxation of Income, Estates and Gifts 69.1- 69.10 ▪ Transactional Unit Subpart F Overview
Internal Revenue Code and Treasury Regulations	▪ Online or hard copy	▪ IRC 954, Foreign Base Company Income ▪ Treas. Reg. 1.954-1, Foreign Base Company Income
Academic and analytical treatises	▪ Westlaw subscription or hard copy	▪ Bittker & Lokken Federal Taxation of Income, Estates and Gifts 69.9 ▪ Kuntz & Peroni – U.S. Int'l Tax Para B3.05 ▪ BNA Tax Management Foreign Income Series Portfolio 928-3rd (CFCs - Foreign Base Company Income (Other than FPHCI))
Internal Revenue Manual	▪ IRWeb	▪ IRM 4.61.7, Controlled Foreign Corporations

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
E&P	Earnings and Profits
FBC	Foreign Base Company
FBCI	Foreign Base Company Income
FPHCI	Foreign Personal Holding Company Income
FTC	Foreign Tax Credit
IPG	Industry Practice Group
IPN	International Practice Network
IPS	International Practice Service
IRC	Internal Revenue Code
PTI	Previously Taxed Income

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Index of Related Issues

Issue	Associated UIL(s)	References
This unit provides steps for determining when penalties may apply if Form 5471 is filed late, substantially incomplete, or not filed at all by Category 4 and 5 filers.	▪ 9433.01-02	▪ *Failure to File Form 5471 – Category 4 & 5 Filers – Monetary Penalty,* FEN/9433.01_06(2013)
Determination of U.S. Shareholders and CFC Status	▪ 9433.01-01	▪ *Determination of U.S. Shareholders and CFC Status, F*EN/9433.01_03(2013)
Subpart F Overview	▪ 9433.01-01	▪ *Overview of Subpart F*, FEN/9433.01_09(2013)
Subpart F Overview	▪ 9412	▪ *Subpart F Overview*, DPL/CU/V_2_01(2013)