Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I Concept Unit
Knowledge Base – International

Library Level	Number	Title
Shelf		Individual Outbound
Book	11	Foreign Entities: Foreign Corporations (Individual Outbound)
Chapter	11.1	Individuals with Investments in a Controlled Foreign Corporation (CFC)
Section	11.1.1	Taxability of Income from the CFC
Subsection	11.1.1.2	Subpart F Income

Unit Name	Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Primary UIL Code	9433.01-01	Income from the CFC

Document Control Number (DCN)	FEN/C/11_01_01_02-03
Date of Last Update	01/29/18

Table of Contents

(View this PowerPoint in "Presentation View" to click on the links below)

Definition of Foreign Personal Holding Company Income and the Common Exceptions

U.S. shareholders of a controlled foreign corporation (CFC) may have to include amounts in income under IRC 951(a)(1)(A) (subpart F inclusions) when the CFC earns certain types of income, even if the CFC does not distribute any of the income to the U.S. shareholder. 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), a component of subpart F income.

This Practice Unit discusses a category of FBCI called foreign personal holding company income (FPHCI). IRC 954(c).

FPHCI generally includes a CFC's income from interest, dividends, rents, royalties, annuities, net gains on certain property transactions, net gains from commodities transactions, net gains from foreign currency transactions, income equivalent to interest, income from notional principal contracts (NPC), payments in lieu of dividends, and amounts received under certain personal service contracts.

In order for FPHCI to be included by a U.S. person in gross income as a subpart F inclusion, the following criteria must first be satisfied:

1. The U.S. person must be a U.S. shareholder as defined in IRC 951(b).
2. The foreign corporation must be a CFC as defined in IRC 957(a).
3. The CFC must have FPHCI.

See the Practice Unit "Determination of U.S. Shareholders and CFC Status" for details.

! **CAUTION**: This Practice Unit discusses categories of FPHCI and some exceptions to the general rules. There are other provisions which may cause items of FPHCI to be included or excluded from FBCI (and thus from subpart F income). These are discussed in other Practice Units, such as "Computing Foreign Base Company Income for U.S. Individual Shareholders."

Detailed Explanation of the Concept

Definition of Foreign Personal Holding Company Income and the Common Exceptions

FPHCI is a category of foreign base company income under subpart F income. FPHCI generally includes passive types of income such as interest, dividends, rents, royalties and sales of property held for investment. There are many exceptions to this general rule.

Analysis	Resources
General Rule:	
▪ If the ownership criteria under IRC 957 is met with respect to a foreign corporation, taking into account IRC 951(b) (definition of United States shareholder) and IRC 958 (rules for constructive ownership), the foreign corporation is a CFC. Once this is established, if the CFC earned FPHCI during the year, a U.S. shareholder is required to include its pro-rata share of the CFC's FPHCI in income currently.	▪ IRC 951(b) ▪ IRC 957 ▪ IRC 958
▪ Example 1*:* U.S. individual shareholder owns 51% of CFC located in country X. CFC earned interest income in its bank account in country X. The U.S. shareholder is required to include in income currently its pro-rata share of the CFC's FPHCI (interest).	
Dividends, Interest, Rents, Royalties and Annuities Exceptions:	
▪ Generally, dividends, interest, annuities, rents and royalties received by a CFC are FPHCI. However, the following are some of the exceptions.	▪ IRC 954(c)(1)(A)
▪ Look-Thru Exception: Under IRC 954(c)(6), dividends, interest, rents, and royalties are NOT FPHCI if they are (1) received from another CFC that is a related person and (2) attributable or properly allocable to income of the related CFC that is neither subpart F income nor income effectively connected with the conduct of a U.S. trade or business.	▪ IRC 954(c)(6) ▪ Notice 2007-9

Back to Table of Contents

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Dividends, Interest, Rents, Royalties and Annuities Exceptions (cont'd):	
▪ See Notice 2007-9 for additional guidance on the application of the look–thru exception. This exception does not apply to interest, rents, or royalties to the extent the item creates (or increases) a deficit that may reduce the subpart F income of the payor (the related CFC) or another controlled foreign corporation. IRC 954(d)(3) provides that a person is a related person of a CFC if the person controls or is controlled by the CFC, or if the person and the CFC are controlled by the same person. Here, control means direct or indirect ownership of more than 50 percent of the vote or value of a corporation or more than 50 percent of the value of a partnership, trust, or estate.	▪ Notice 2007-9 – Look-thru Rule for Related Controlled Foreign Corporations ▪ IRC 954(c)(6)(B) ▪ IRC 954(d)(3) ▪ Treas. Reg. 1.954-1(f)
! **CAUTION**: The look-thru rule was first effective for tax years of CFCs beginning after December 31, 2005 and before January 1, 2009. It has since been extended on multiple occasions and is currently effective for tax years of CFCs beginning before January 1, 2020.	
▪ Example 2: U.S. individual shareholder owns 100 percent of Swiss Co. and 100 percent of French Co.; Swiss Co. and French Co. are related CFCs. While French Co. engages in an active business in France, Swiss Co. functions as the financing company for the U.S. shareholder's worldwide group. French Co. earns $100 of income from its active trade or business in taxable year 2013 and pays $30 of interest to Swiss Co. The $30 is not FPHCI to Swiss Co. because we look through the interest payment to the underlying trade or business income of French Co., which is not subpart F income.	▪ IRC 954(c)(6)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Dividends, Interest, Rents, Royalties and Annuities Exceptions (cont'd):	
▪ Example 3: Assume the same facts as the above example except that French Co. earns \$80 of income from an active business and \$20 of interest income from an unrelated borrower. French Co. has \$20 of passive FPHCI to which the \$30 of related person interest expense (French Co.'s interest payment to Swiss Co.) should first be allocated. French Co.'s subpart F income has been reduced to \$0, and \$20 of the interest income received by Swiss Co. is properly allocable to the subpart F income of French Co. Therefore, only \$10 of the interest income received by Swiss Co. is excluded from Swiss Co.'s FPHCI under IRC 954(c)(6).	▪ IRC 954(c)(3) ▪ Treas. Reg. 1.954-2(b)(4) ▪ Treas. Reg. 1.954-2(b)(5) ▪ IRC 952(c)
▪ Same Country Exception: Under IRC 954(c)(3) and Treas. Reg. 1.954-2(b)(4), dividend or interest income is excluded from FPHCI if (1) the CFC receives it from a corporation that is a related person and is organized under the laws of the same foreign country as the CFC and (2) the payor uses a "substantial part" of its assets in a trade or business in that foreign country (such as manufacturing). For this purpose, "substantial" means more than 50 percent of the average value of the CFC's assets. See Treas. Reg. 1.954-2(b)(4)(iv).	▪ Treas. Reg. 1.954-2(b)(4)(iv)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Dividends, Interest, Rents, Royalties and Annuities Exceptions (cont'd): ▪ This exception also applies when the CFC receives rents and royalties from a corporation which is a related person for the use of, or the privilege of using, property within the foreign country under the laws of which the CFC is created or organized. See Treas. Reg. 1.954-2(b)(5). However, the exception does not apply to any dividends, interest, rents, or royalties to the extent it reduces the payor's subpart F income or creates (or increases) a deficit which under IRC 952(c) may reduce the subpart F income of the payor corporation or another CFC. The exception also doesn't apply to any dividend with respect to any stock which is attributable to earnings and profits of the distributing corporation accumulated during any period during which the person receiving the dividend did not hold the stock directly or indirectly. ▪ Example 4: U.S. shareholder owns more than 50 percent of both CFC1 and CFC2, which are organized in the same foreign country X. CFC1 and CFC2 are related persons under IRC 954(d)(3). CFC1 manufactures goods in country X and CFC2 owns stock of and makes loans to CFC1. Dividends and interest paid by CFC1 to CFC2 are excluded from CFC2's FPHCI because of the same country exception of IRC 954(c)(3). However, under IRC 954(c)(3)(B), the same country exclusion does not apply if any part of the interest and/or dividend paid by CFC1 to CFC2 reduces CFC1's subpart F income, or creates or increases a deficit that may reduce CFC1's subpart F income or that of another CFC. Note**:** The payor corporation does not need to be a CFC, as long as the relationship defined under IRC 954(d)(3) exists.	▪ Treas. Reg. 1.954-2(b)(4)(iv) ▪ Treas. Reg. 1.954-2(b)(5) ▪ IRC 952(c) ▪ IRC 954(d)(3) ▪ IRC 954(c)(3)(B)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
<u>Dividends, Interest, Rents, Royalties and Annuities Exceptions (cont'd)</u>:	
▪ Active Rents and Royalties Exception (and/or Active Leasing and Active Licensing Exceptions): Under IRC 954(c)(2)(A), if rents or royalties are derived from a CFC's active trade or business and are NOT received from a related person (as defined in IRC 954(d)(3)), then the receipts do not constitute FPHCI. Treas. Reg. 1.954-2(c) and (d) provide guidance for determining whether rents and royalties are derived in the active conduct of a trade or business.	▪ IRC 954(c)(2)(A) ▪ IRC 954(d)(3) ▪ Treas. Reg. 1.954-2(c) ▪ Treas. Reg. 1.954-2 (d)
▪ Example 5: CFC A is regularly engaged in the production of office machines which it sells or leases to others, and also services. The rental income received by CFC A is derived in the active conduct of a trade or business since it manufactures the office machines. Therefore, the active rents and royalties income exception applies, and the rental income is not FPHCI under IRC 954(c)(2)(A).	▪ Treas. Reg. 1.954-2(c)(3), Example 1
▪ Example 6: CFC B, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility, employees of CFC B who are scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, that ultimately result in the issuance of patents that it sells or licenses. For purposes of IRC 954(c)(2)(A), royalties received by CFC B for the privilege of using patented rights that it developed as a result of such research activity are derived in the active conduct of a trade or business, and the royalties are therefore excluded from FPHCI, for as long as CFC B is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind.	▪ Treas. Reg. 1.954-2(d)(1)(i) ▪ Treas. Reg. 1.954-2(d)(3), Example 1

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Dividends, Interest, Rents, Royalties and Annuities Exceptions (cont'd): ▪ Example 7*:* The facts are the same as Example 6, except instead of developing patents through its workforce, CFC B receives royalties for the use of patents that it purchases and licenses to others without adding any value to the patents. CFC B generally consummates royalty agreements on purchased patents as a result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of CFC B that CFC B has acquired rights under a patent and is interested in licensing its rights. ▪ CFC B, however, does not maintain and operate an organization in a foreign country that is regularly engaged in the business of marketing the purchased patents. CFC B's royalties are not considered derived in the active conduct of a trade or business, thus the royalties do not qualify for the active rents and royalties exception under IRC 954(c)(2)(A).	▪ Treas. Reg. 1.954-2(d)(1)(ii) ▪ Treas. Reg. 1.954-2(d)(3), Example 2 ▪ IRC 954(c)(2)(A)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Definition of Foreign Personal Holding Company Income and the Common Exceptions</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Dividends, Interest, Rents, Royalties and Annuities Exceptions (cont'd)</u>:

▪ Export Financing Interest Exception: Pursuant to IRC 954(c)(2)(B) and Treas. Reg. 1.954-2(b)(2), FPHCI shall not include any interest which is derived in the conduct of a banking business and which is export financing interest (as defined in IRC 904(d)(2)(G)). Export financing interest is interest earned by the CFC in a banking business from financing sales for use or consumption outside of the United States of goods produced in the United States by a related person.

▪ A CFC derives interest in the conduct of a banking business "if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan."

! CAUTION: The banking activities referred to here are different from the Exception for Active Banking or Financing Income, which will be discussed later.</td><td>▪ IRC 954(c)(2)(B)
▪ IRC 904(d)(2)(G)
▪ Treas. Reg. 1.954-2(b)(2)
▪ Treas. Reg. 1.954-2(b)(2)(iii)</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Certain Property Transactions:	
▪ Pursuant to IRC 954(c)(1)(B) and Treas. Reg. 1.954-2(e), FPHCI generally includes the excess of gains over losses from sales and exchanges during the taxable year of the following types of property: (1) property that gives rise to FPHCI in the form of dividends, interest, royalties, rents or annuities, (2) an interest in a trust, partnership, or real estate mortgage investment conduit and (3) property that generates no income, including for example, diamonds held for investment, options, forwards and futures.	▪ IRC 954(c)(1)(B) ▪ Treas. Reg. 1.954-2(e)
▪ Inventory Exception: FPHCI does not include gain or loss from the sale or exchange of any property which, in the hands of the CFC, is property described in IRC 1221(a)(1), such as inventory.	▪ Treas. Reg. 1.954-2(e)(1)(ii)(A) ▪ IRC 1221(a)(1)
▪ Dealer Property Exception: FPHCI does not include gain or loss from the disposition of property that is considered dealer property.	▪ IRC 954(c)(2)(C) ▪ Treas. Reg. 1.954-2(e)(1)(ii)(B)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Certain Property Transactions (cont'd): ▪ Active Business /Sale Exception**:** FPHCI does not include gain or loss from the sale or exchange of property that generates rents or royalties derived in the active conduct of a trade or business from persons that are not related persons with respect to the CFC. ▪ Example 8: Assume CFC A in Example 5 sells for a gain an office machine that it had manufactured and previously leased. This gain is not FPHCI because the rental income received by CFC A was derived in the active conduct of a trade or business. ▪ Example 9: Assume in Example 6, CFC B sells a patent for a gain that it had developed and licensed. This gain is not FPHCI because the royalties received from the patent were derived in the active conduct of a trade or business.	▪ IRC 954(c)(2)(A) ▪ Treas. Reg. 1.954-2(e)(1)(ii)(C)
! **CAUTION:** See Treas. Reg. 1.954-1(c)(1)(ii) for the treatment of losses in excess of gains.	▪ Treas. Reg. 1.954-1(c)(1)(ii)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Commodities Transactions:	
▪ Pursuant to IRC 954(c)(1)(C), FPHCI generally includes the excess of gains over losses from commodities transactions. Treas. Reg.1.954-2(f)(2)(i) defines commodity to include tangible personal property of a kind that is actively traded or with respect to which contractual interests are actively traded. According to Treas. Reg.1.954-2(f)(2)(ii), commodity transaction means the "purchase or sale of a commodity for immediate (spot) delivery or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, or an over-the-counter market, or in a transaction effected between private parties outside of any market." Thus, transactions involving physical commodities as well as transactions involving contractual interests in commodities are commodities transactions.	▪ IRC 954(c)(1)(C) ▪ Treas. Reg. 1.954-2(f)(2)(i) – (ii)
▪ Qualified Active Sale Exception: Active business gains and losses from sales of commodities are excluded if "substantially all" of the CFC's commodities are stock in trade, inventory, depreciable property used in a trade or business, or supplies of a type regularly used or consumed in a trade or business (such as property described in IRC 1221(a)(1), (2), or (i8)). See IRC 954(c)(1)(C)(ii). For example, assume the CFC is solely involved in the sale of commodities as a producer, processor, merchant or handler of commodities. In this case, it is likely gain from the sale of the commodities would not be FPHCI. On the other hand, if the CFC merely holds the commodities for investment or speculation, the qualified active sale exception does not apply.	▪ IRC 954(c)(1)(C)(ii) ▪ Treas. Reg. 1.954-2(f)(1)(ii) ▪ Treas. Reg. 1.954-2(f)(2)(iii)

Back to Table of Contents

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Definition of Foreign Personal Holding Company Income and the Common Exceptions</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Commodities Transactions (cont'd)</u>:

▪ A CFC satisfies the "substantially all" requirement if gross receipts from qualified active sales and qualified hedging transactions are at least 85 percent of all gross receipts. See Treas. Regs. 1.954-2(f)(1)(ii) and 1.954-2(f)(2)(iii). Note that this exception does not apply to gain or loss from the sale of contractual interests in commodities.

! CAUTION: The regulations do not currently reflect amendments to IRC 954(c)(1)(C)(ii) made in 2004; nevertheless, many of the concepts in the regulations remain relevant under the amendments.

▪ Example 10: CFC X is engaged in the active business of processing aviation fuel. In taxable year 2013, CFC X generated $1 million of gross sales of aviation fuel and $50,000 of qualified hedging transactions for a total of $1,050,000. Total gross receipts for the taxable year were $1,200,000. CFC X met the "qualified active sale exception" because $1,050,000 is at least 85 percent of total gross receipts of $1,200,000 (substantially all test). Consequently, CFC X can exclude the $1,050,000 from FPHCI in taxable year 2013.</td><td>▪ Treas. Reg. 1.954-2(f)(1)(ii)
▪ Treas. Reg. 1.954-2(f)(2)(iii)

▪ IRC 954(c)(1)(C)(ii)</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Commodities Transactions (cont'd): ▪ Qualified Hedging Transaction Exception: Gains and losses are excluded from the FPHCI category for commodities transactions if they "arise out of commodity hedging transactions." See IRC 954(c)(1)(C)(i). A commodity hedging transaction is a "transaction with respect to a commodity" that is a "hedging transaction" and that "is clearly identified as such." See IRC 954(c)(5)(A). For these purposes, a hedging transaction generally is a transaction entered into in the normal course of the CFC's trade or business, primarily to manage a risk of price changes or currency fluctuations with respect to ordinary property and property described in IRC 1231(b) that the CFC holds or expects to hold. ▪ Property is ordinary if gain or loss on a sale or exchange of it could not be capital gain or loss, regardless of how long the CFC holds it before selling or exchanging it. Property described in IRC 1231(b) includes depreciable property held by the CFC for more than one year for use in a trade or business. The transaction must be clearly identified as a hedging transaction in accordance with the IRC 1221(a)(7) hedge identification requirements. ! **CAUTION**: The regulations do not currently reflect amendments to IRC 954(c)(1)(C)(i) made in 2004.	▪ IRC 954(c)(1)(C)(i) ▪ IRC 954(c)(5)(A) ▪ IRC 1231(b) ▪ IRC 1221(a)(7)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Commodities Transactions (cont'd):	
▪ Example 11: Alumino is a CFC located in country A. Alumino manufactures and sells machinery in country B using aluminum and component parts purchased from third parties that contain significant amounts of aluminum. Alumino conducts its manufacturing business in a manner in which such business is customarily and usually conducted by others.	▪ Treas. Reg. 1.954-2(f)(2)(v)(C), Example 1
▪ To protect itself against increases in the price of aluminum used in the machinery it manufactures, Alumino enters into futures purchase contracts for the delivery of aluminum. Alumino clearly identifies the futures purchase contracts as a hedging transaction in accordance with IRC 1221(a)(7). Accordingly, any gain or loss on such aluminum futures purchase contracts is excluded from the FPHCI category for commodities transactions.	▪ IRC 1221(a)(7)
! **CAUTION**: See Treas. Reg. 1.954-1(c)(1)(ii) for the treatment of losses in excess of gains from commodities transactions.	▪ Treas. Reg. 1.954-1(c)(1)(ii)
Foreign Currency Gains:	
▪ FPHCI generally includes the excess of foreign currency gains over losses for the taxable year from IRC 988 transactions (such as transactions in currencies other than the CFC's functional currency) other than transactions directly related to the business needs of the CFC. See IRC 954(c)(1)(D). Congress added this category of FPHCI in 1986 because it "believed that income from trading in foreign currencies represents the type of income that can easily be routed through a CFC in a tax haven jurisdiction." See S. Rep. No. 313 at 364.	▪ IRC 988 ▪ IRC 954(c)(1)(D) ▪ S. Rep. No. 313 at 364 (1987)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Definition of Foreign Personal Holding Company Income and the Common Exceptions</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>Foreign Currency Gains (cont'd)</u>:

▪ Business Needs Exception: Foreign currency gains or losses from IRC 988 transactions that are directly related to business needs of the CFC are excluded from the FPHCI category for foreign currency gains. Treas. Reg. 1.954-2(g)(2)(ii)(B) states that a gain or loss is directly related to a CFC's business needs if (1) it arises from a transaction entered into, or property held for use, in the "normal course" of its trade or business (other than a trade or business of trading foreign currency), (2) the transaction or property "does not itself" yield subpart F income other than foreign currency gain or loss, (3) it does not arise from a transaction described in IRC 988(c)(1)(B)(iii) (such as forwards, futures, options and other similar financial instruments) and (4) it is "clearly determinable from" the CFC's records as being derived from such transactions or property.

▪ Moreover, gain or loss from a bona fide hedging transaction, as defined by Treas. Reg. 1.954-2(a)(4)(ii), with respect to a transaction or property that satisfies the "business needs" requirements above also qualifies as directly related to business needs. Finally, if a CFC is a "regular dealer" in property, as defined by Treas. Reg. 1.954-2(g)(2)(ii)(C), foreign currency gain or loss from property held "in its capacity as a dealer" is directly related to business needs.</td><td>▪ Treas. Reg. 1.954-2(g)(2)(ii)(B)
▪ IRC 988(c)(1)(B)(iii)
▪ Treas. Reg. 1.954-2(a)(4)(ii)
▪ Treas. Reg. 1.954-2(g)(2)(ii)(C)</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Foreign Currency Gains (cont'd): ▪ Example 12: CFC1 and CFC2 are controlled foreign corporations located in country B, and are members of the same controlled group. CFC1 is engaged in the active conduct of a trade or business that does not produce any subpart F income. CFC2 serves as the currency coordination center for the controlled group, aggregating currency risks incurred by the group and entering into hedging transactions that transfer those risks outside of the group. Pursuant to this arrangement, and to hedge the currency risk on a non-interest bearing receivable incurred by CFC1 in the normal course of its business, on day 1, CFC1 enters into (and properly identifies as a hedging transaction) a forward contract to sell Japanese Yen to CFC2 in 30 days. CFC2 enters into a forward contract to sell Yen to unrelated bank X on day 30. CFC2 is not a regular dealer in Yen spot and forward contracts, and the Yen is not the functional currency for either CFC1 or CFC2. ▪ Because the forward contract entered into by CFC1 to sell Yen hedges a transaction entered into in the normal course of CFC1's business that does not give rise to subpart F income, it qualifies as a bona fide hedging transaction as defined in Treas. Reg. 1.954-2(a)(4)(ii). Therefore, CFC1's foreign exchange gain or loss from the forward contract will not be treated as FPHCI gain or loss. ▪ Because the forward contract to purchase Yen was entered into by CFC2 in order to assume currency risks incurred by CFC1, it does not qualify as a bona fide hedging transaction. Thus, foreign exchange gain or loss recognized by CFC2 from that forward contract will be FPHCI.	▪ Treas. Reg. 1.954-2(a)(4)(ii) ▪ Treas. Reg. 1.954-2(g)(2)(ii)(D)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Definition of Foreign Personal Holding Company Income and the Common Exceptions</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>
<u>Foreign Currency Gains (cont'd)</u>:

▪ Because CFC2 entered into the forward contract to sell Yen in order to hedge currency risks of CFC1, that forward contract also does not qualify as a bona fide hedging transaction. Thus, CFC2's foreign currency gain or loss arising from that forward contract will be FPHCI.

<u>Income Equivalent to Interest</u>:

▪ Pursuant to IRC 954(c)(1)(E), FPHCI generally includes income equivalent to interest. This category of FPHCI is meant to include items of income that do not fall within the FPHCI interest category but that are economically similar to interest.

▪ Under Treas. Reg. 1.954-2(h)(2), income equivalent to interest includes interest that is derived from:
– A transaction or series of related transactions in which the payments, net payments, cash flows, or return predominantly reflect the time value of money,
– Transactions in which the payments (or a predominant portion thereof) are, in substance, for the use or forbearance of money,
– Notional principal contracts (see Treas. Reg. 1.954-2(h)(3)),
– Certain factoring transactions (see Treas. Reg. 1.954-2(h)(4)),
</td><td>
▪ IRC 954(c)(1)(E)

▪ Treas. Reg. 1.954-2(h)(2)
▪ Treas. Reg. 1.954-2(h)(3)
▪ Treas. Reg. 1.954-2(h)(4)
</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Definition of Foreign Personal Holding Company Income and the Common Exceptions</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td>
<u>Income Equivalent to Interest (cont'd)</u>:

– Conversion transactions to the extent gain realized with respect to the transaction is treated as ordinary income under IRC 1258,
– The performance of services in certain cases where payment is deferred (see Treas. Reg. 1.954-2(h)(5)),
– The commitment by a lender to provide financing, if any portion of such financing is provided,
– Transfers of debt securities subject to IRC 1058.

! CAUTION: Generally, the various exceptions discussed earlier that apply to interest income for FPHCI purposes do not apply to this category of FPHCI. However, for purposes of the IRC 954(c)(6) look-thru exception, factoring income that is considered income equivalent to interest is treated as interest.
</td><td>
▪ IRC 954(c)(6)
▪ IRC 1258
▪ Treas. Reg. 1.954-2(h)(5)
▪ IRC 1058
</td></tr>
</table>

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
<u>Income from Notional Principal Contract</u>:	
▪ Pursuant to IRC 954(c)(1)(F), FPHCI generally includes net income from notional principal contracts (NPC). An NPC generally means a contract that provides for payments determined by reference to an index (such as interest rates, commodities or currencies) by one party to another in exchange for specified consideration or a promise to pay similar amounts. See Treas. Reg. 1.446-3(c). Any item of income, gain, deduction or loss from an NPC entered into for purposes of hedging any item of FPHCI previously discussed in this Practice Unit is not considered to fall within the NPC income category of FPHCI but rather the type of FPHCI the NPC hedges. See IRC 954(c)(1)(F)(ii).	▪ IRC 954(c)(1)(F) ▪ Treas. Reg. 1.446-3(c) ▪ IRC 954(c)(1)(F)(ii)
▪ Regular Dealer Exception: Generally, gain or loss derived from NPCs is excluded from the NPC income category of FPHCI if the CFC is a regular dealer (as defined in Treas. Reg. 1.954-2(a)(4)(iv)) in NPCs and the NPCs are entered into in the ordinary course of the CFC's trade or business as a dealer (the NPCs are dealer property as defined in Treas. Reg. 1.954-2(a)(4)(v)).	▪ Treas. Reg. 1.954-2(a)(4)(iv) ▪ Treas. Reg. 1.954-2(a)(4)(v)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Personal Service Contracts: ▪ Pursuant to IRC 954(c)(1)(H), FPHCI generally includes amounts received under a contract under which a CFC furnishes or will furnish personal services if (1) the contract designates the individual who is to perform the services by name or by description or a person other than the CFC has a right to designate the individual who is to perform the services and (2) the individual who has performed, is to perform, or may be designated (by name or by description) as the one to perform the services owns at least 25 percent of the CFC's outstanding stock, by value, directly or indirectly, at some time during the taxable year. In addition, amounts received on a sale or other disposition of such a contract fall within the personal service contracts income category of FPHCI. ▪ Example 13: A CFC enters into a contract with a third party to provide financial consulting services. The contract stipulates that the CFC will designate Bob Smith as the individual who will perform the services. Bob Smith owns 30 percent of the CFC. Income received under this contract by the CFC is FPHCI. If the CFC sells the contract to another party, the amount received on the sale is also FPHCI.	▪ IRC 954(c)(1)(H)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
Exception for Active Banking or Financing Income: ▪ Pursuant to IRC 954(h), qualified banking or financing income of an eligible CFC will not constitute FPHCI. Generally, an eligible CFC is one that is predominantly engaged in the active conduct of a banking, financing or other similar business and conducts substantial activity with respect to that business. A corporation is "predominantly engaged" if it is engaged in a banking business and is a licensed bank in the United States, engaged in the active conduct of a securities business and is a registered securities broker or dealer, or more than 70 percent of its gross income is directly from the active and regular conduct of a lending or finance business with customers that are not related persons. See IRC 954(h)(2)(B). The definition of a lending or finance business is provided in IRC 954(h)(4). ▪ To meet the exception, an eligible CFC or its qualified business unit (QBU) must earn qualified banking or financing income which essentially is active banking or financing income derived from customers outside the United States where substantially all the activities generating the income are conducted by the corporation (or its QBU) in its home country and its income is treated as earned by the CFC (or QBU) in its home country under the local tax law. See IRC 954(h)(3)(A). CFCs that are eligible for this exception because they are considered predominantly engaged in an active banking or financing business by reason of meeting the "more than 70 percent gross income" threshold must also derive more than 30 percent of income from the active conduct of a lending or financing business with unrelated customers located in the CFC's home country in order for the CFC's income to be treated as qualified banking or financing income. See IRC 954(h)(3)(B).	▪ IRC 954(h) ▪ IRC 954(h)(2)(B) ▪ IRC 954(h)(4) ▪ IRC 954(h)(3)(A) ▪ IRC 954(h)(3)(B)

Detailed Explanation of the Concept (cont'd)

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Analysis	**Resources**
<u>Exception for Active Insurance Income</u>: ▪ Pursuant to IRC 954(i), qualified insurance income of a qualified insurance company will not constitute FPHCI. A qualified insurance company is defined under IRC Section 953(e). Qualified insurance income means investment income derived from a qualified insurance company from the investment of certain reserves or assets allocable to exempt contracts. The exclusion only applies to investment income received from someone other than a related person as defined under IRC Section 954(d)(3).	▪ IRC 954(i) ▪ IRC 954(i)(2)

Detailed Explanation of the Concept (cont'd)

<table>
<tr><th colspan="2">Definition of Foreign Personal Holding Company Income and the Common Exceptions</th></tr>
<tr><th>Analysis</th><th>Resources</th></tr>
<tr><td><u>FPHCI Ordering Rule</u>:

▪ Pursuant to Treas. Reg. 1.954-2(a)(2), income that potentially falls within more than one category of FPHCI is generally classified as income in the category with the highest order of priority, as follows:

− Dividends, interest, rents, royalties and annuities,
− Income equivalent to interest,
− Foreign currency gain or loss,
− Gain or loss from commodities transactions,
− Gain or loss from certain property transactions.

▪ Example 14: Assume a CFC derives gain from a foreign currency futures contract. In this case, the gain is first tested under the "foreign currency gain or loss" category, even though it might also qualify as FPHCI under the commodities category.</td><td>▪ Treas. Reg. 1.954-2(a)(2)</td></tr>
</table>

Index of Referenced Resources

Definition of Foreign Personal Holding Company Income and the Common Exceptions
IRC 904(d)(2)(G)
IRC 951
IRC 952(c)
IRC 954
IRC 957
IRC 958
IRC 988
IRC 1058
IRC 1221
IRC 1231(b)
IRC 1258
Treas. Reg. 1.446-3(c)
Treas. Reg. 1.954-1
Treas. Reg. 1.954-2
Notice 2007-9 – Look-thru Rule for Related Controlled Foreign Corporations
S. Rep. No. 313 at 364 (1987)

Training and Additional Resources

Definition of Foreign Personal Holding Company Income and the Common Exceptions	
Type of Resource	**Descriptions**
Saba Meeting Sessions	▪ *Foreign Personal Holding Company Income* – 2015 Saba Meeting
White Papers / Guidance	▪ IRM 4.61.7.17 - *Foreign Personal Holding Company Income Defined* ▪ IRM 4.61.7.18 - *Foreign Personal Holding Company Income Guidelines*
Databases / Research Tools	▪ *Bittker & Lokken Fed. Tax'n Inc*, Est and Gift Para 69.4

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
FBCI	Foreign Base Company Income
FPHCI	Foreign Personal Holding Company Income
IRC	Internal Revenue Code
NPC	Notional Principal Contracts
QBU	Qualified Business Unit

Index of Related Practice Units

Associated UILs	Related Practice Unit	DCN
9433.01-01	*Computing Foreign Base Company Income for U.S. Individual Shareholders*	FEN/P/11_01_01_02-02 (formerly FEN/9433.01_11(2016))
9433.01-01	*Determination of U.S. Shareholder and CFC Status*	FEN/T/11_01_01_01-01 (formerly FEN/9433.01_03(2013)b)
9433.01-01	*Overview of Subpart F Income for U.S. Individual Shareholders*	FEN/T/11_01_01_02-01 (formerly FEN/9433.01_09(2013)b)