A Note From the Editor-in-Chief

Fiscal Cliff Legislation Extends Key International Exceptions

The American Taxpayer Relief Act of 2012 (H.R. 8) (“2012 Tax Act”) extended two important temporary exceptions to the definition of Subpart F foreign personal holding company income (FPHCI): look-through treatment for certain payments between related controlled foreign corporations (CFCs) and the exception for active financing income. These exceptions were extended for two years (but available only for 2013 for a calendar year CFC unless it changes its tax year).

Generally, dividends, interest, rents and royalties received or accrued by a CFC constitute FPHCI. Certain gains from property, net currency and commodities gains, and income equivalent to interest also are included within the definition of FPHCI.\(^1\)

The 2012 Tax Act extended Code Sec. 954(c)(6), which provides that FPHCI generally does not include dividends, interest, rents and royalties received or accrued from a related CFC. For example, interest received by a finance CFC on a loan to a related CFC that earns only non–Subpart F sales or services income would not be FPHCI. Foreign holding companies can receive dividends from subsidiaries without current taxation under Subpart F. The exception also applies to intellectual property companies that earn royalties from related operating CFCs.\(^2\)

The Code states that the look-through exception applies to the extent a payment is attributable or properly allocable to income of the payor CFC that is not Subpart F income. Notice 2007-9 reverses this to provide that the exception does not apply to the extent such payment reduces Subpart F income of the payor.\(^3\) This modification allows payments that give rise to losses to qualify for the exception.\(^4\) Nevertheless, to the extent the loss gives rise to a qualified deficit that may be used to offset the payor CFC’s Subpart F income or Subpart F income of another CFC, the exception would not apply.\(^5\)

The definition of “dividend” includes all amounts treated as a dividend under Code Sec. 301(c)(1). This accommodates restructuring transactions without the use of disregarded entities where the payments are treated as dividends, e.g., under Code Sec. 304 (acquisitions of related-party stock) or Code Sec. 356(a)(2) (boot-in reorganizations).\(^6\)

With Code Sec. 954(c)(6), disregarded entities are unnecessary to prevent payments between related CFCs from being treated as FPHCI. Accordingly, separate CFCs may be used to qualify for the Subpart F same-country exceptions for sales and services income, avoid the Subpart F branch rules, avoid gains

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\(^{2}\) With Code Sec. 954(c)(6), disregarded entities are unnecessary to prevent payments between related CFCs from being treated as FPHCI. Accordingly, separate CFCs may be used to qualify for the Subpart F same-country exceptions for sales and services income, avoid the Subpart F branch rules, avoid gains.
under Code Sec. 987, and avoid averaging low- and high-taxed earnings pools with finance structures.  

The 2012 Tax Act also extends the exception for active financing income provided in Code Sec. 954(h) (AFE). Under that provision, FPHCI does not include qualified banking or financing income of an eligible CFC. A CFC that qualifies for this exception may pay dividends, interest, rents and royalties to a related CFC and such payments should qualify for the Code Sec. 954(c)(6) look-through exception.

A CFC is eligible for the AFE if it is predominantly engaged in the active conduct of a banking, financing or similar business and conducts substantial activity with respect to such business. The essential requirements are that the CFC is primarily a lending or financing entity conducting business with unrelated persons (70-percent gross income test), or the CFC is engaged in banking activities or securities activities and is licensed to engage in such business. The substantial activity test requires that the CFC conduct material activities related to its financing or banking business and must conduct substantially all of the activities that give rise to its financing or banking income.

The exception applies only with respect to income derived by an eligible CFC that is qualified banking or financing income. Income meets this standard if the following four requirements are satisfied: (1) the income is derived in the active conduct of a banking, financing or similar business by an eligible CFC or qualified business unit (“QBU”) of such eligible CFC; (2) the income is derived from transactions with customers outside the United States; (3) substantially all of the activities in connection with the transactions are conducted directly by the CFC or QBU in its home country; and (4) the income is treated as earned by such CFC or QBU in its home country for purposes of such country’s tax laws. Whether banking or financing income qualifies for the exception is determined separately for a CFC and each QBU of the CFC.

Additional requirements must be satisfied when income is derived from transactions with customers located outside of the CFC’s or QBU’s home country, i.e., income from cross-border transactions. Income from transactions with customers located in a country other than the home country of the CFC or QBU will qualify for the exception only if the CFC or QBU conducts substantial activity in its respective home country. In addition, for a lending or financing business, more than 30 percent of the active financing income must be derived from transactions with unrelated persons located in the CFC’s or QBU’s home country.

The provisions are effective for tax years of foreign corporations beginning before January 1, 2014, and for tax years of U.S. shareholders with or within which such tax years of such foreign corporations end. For calendar year CFCs, the exception applies through the end of December of 2013. For fiscal year CFCs, the exception applies through the end of the fiscal year ending in 2014.

Calendar-year taxpayers may consider adopting a November 30 tax year for their CFCs (or certain CFCs) which would extend the effective date of the exceptions for 11 months. Code Sec. 898(c) permits a CFC to adopt a tax year that ends one month before the majority U.S. shareholder’s tax year.

ENDNOTES

1 Code Sec. 954(c).  
2 This exception is much broader than the permanent exception provided by Code Sec. 954(c)(3) (related-person/same-country exception). See Yoder, New Subpart F Related CFC Look-Thru Exception, 35 Tax Mgmt. Int’l J. 415 (2006). Notice 2007-9, 2007-1 CB 401. This approach is consistent with the related-person/same-country exception. Code Sec. 954(c)(3)(B); Reg. §1.954-2(b)(4)(iii)(B); (5)(ii).  
3 Under Code Sec. 267(a)(3), interest on a related-person loan is deductible only when paid (unless the corresponding interest income is included in Subpart F income). If Code Sec. 954(c)(6) applies, interest is excluded from the CFC’s income, which apparently causes the payor CFC not to receive a current deduction for interest accrued but not paid during the year.  
6 See Yoder, Living Without Code Sec. 954(c)(6), J. Int’l Tax’n, Jan.–Feb. 2011, at 3.  
7 Income qualifying for this exception from FPHCI also is excluded from the definition of foreign-base company services income. Code Sec. 954(e) (last sentence).  
8 Active rents and royalties received from unrelated persons may also qualify for another exception. Code Sec. 954(c)(2)(A).  
9 See Proposed Reg. §1.898-3(a)(2) & -4(a) (2). See Rev. Proc. 2006-45, IRB 2006-45, 851, for the procedures for changing a tax year (change is automatic if certain requirements are satisfied); Rev. Proc. 2007-64, IRB 2007-42, 818, §4.02 (CFC changing to a one-month deferral year need not conform its financial statements or reports to creditors). If the tax years of fewer than all CFCs are changed, additional questions can arise.