



Internal Revenue Service

DEPARTMENT OF THE TREASURY

LB&I International Practice Service Concept Unit

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Sub-Chapter	N/A	N/A		

Unit Name	Subpart F Overview
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Deferral Planning	N/A	N/A	N/A

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General Overview

Subpart F Overview

One type of entity through which foreign operations may be conducted is a foreign corporation. A major tax advantage of using a foreign corporation to conduct foreign operations is income tax deferral: generally, U.S. tax on the income of a foreign corporation is deferred until the income is distributed as a dividend or otherwise repatriated by the foreign corporation to its U.S. shareholders.

Prior to the enactment of Subpart F, many U.S. taxpayers achieved deferral of U.S. tax on certain kinds of movable income, such as dividends, interest, rents and royalties, by earning such income through foreign corporations. In addition, by placing these corporations in low- or no-tax jurisdictions, U.S. taxpayers were able to ensure the income was taxed at a very low rate (until it was repatriated to the U.S.) significantly reducing their overall tax liability. Congress determined that this type of deferral was inappropriate and reacted by enacting Subpart F.

The Subpart F provisions eliminate deferral of U.S. tax on some categories of foreign income by taxing certain U.S. persons currently on their pro rata share of such income earned by their controlled foreign corporations (CFCs). This approach is based on the principles underlying the United States' taxing jurisdiction. In general, the United States does not tax a foreign corporation if the foreign corporation neither receives U.S.-source income nor engages in U.S.-based activities. However, the U.S. does generally tax all income, wherever derived, of U.S. persons. The Subpart F rules operate by treating a U.S. shareholder of a CFC as if it actually received its proportionate share of certain categories of the corporation's current earnings and profits (E&P). The U.S. shareholder is required to report this income currently in the United States whether or not the CFC actually makes a distribution (I.R.C. § 951(a)).

Subpart F, therefore, does not purport to tax the CFC. Rather, its rules apply only to a U.S. person who owns, directly or indirectly, 10% or more of the voting stock of a foreign corporation that is controlled by U.S. shareholders. The provisions of Subpart F are exceedingly intricate and contain numerous general rules, special rules, definitions, exceptions, exclusions and limitations, which require careful consideration (and are covered in various Practice Units, and not in this Concept Building Block). This Concept Building Block is a General Overview of the basic provisions of Subpart F.

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Deferral Planning	N/A	N/A	N/A

General Overview (cont'd)

Subpart F Overview

Under Subpart F, certain types of income earned by a CFC are taxable to the CFC's U.S. shareholders in the year earned even if the CFC does not distribute the income to its shareholders in that year. Subpart F operates by treating the shareholders as if they had actually received the income from the CFC. The income of a CFC that is currently taxable to its U.S. shareholders under the Subpart F rules is referred to as "Subpart F income." Under I.R.C. § 951(a), a U.S. shareholder is required to include in income currently its pro rata share of the CFC's Subpart F income ("Subpart F inclusion"). The Subpart F inclusion will generally bring an indirect foreign tax credit with it under I.R.C. § 960. Note that the Subpart F inclusion is *not* a dividend and consequently does not qualify for the lower rate of tax under I.R.C. § 1(h)(11). See *Rodriguez v. Commr.*, Fifth Circuit Court of Appeals, July 5, 2013, 2013 TNT 130-11 and Notice 2004-70.

There are many categories of Subpart F income . In general, it consists of movable income. For example, a major category of Subpart F income is Foreign Base Company Income (FBCI), as defined under I.R.C. § 954(a), which includes foreign personal holding company income, or FPHCI, which consists of investment income such as dividends, interest, rents and royalties. Other forms of FBCI includes income received by a CFC from the purchase or sale of personal property involving a related person (i.e. foreign base company sales income, or FBCSI) and from the performance of services by or on behalf of a related person (i.e. foreign base company services income, or FBC Services Income). Note the rules for investments of earnings in U.S. property, FBC Oil Related Income, and FBC Insurance Income are not discussed in this Concept Building Block.

The Subpart F rules were first enacted as part of the Revenue Act of 1962. Since then, they have been amended numerous times. In particular, the Tax Reform Act of 1986 significantly expanded the coverage of Subpart F. Congress' continuing effort to define the parameters of Subpart F is evidence that Subpart F's policy -- denial of tax deferral for movable income earned through a CFC formed in a low- or no-tax country – remains as viable today as when the rules were first enacted in 1962.

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Deferral Planning	N/A	N/A	N/A

Relevant Key Factors

Subpart F Overview

Key Factors

There are three basic requirements under I.R.C. § 951(a) for the applicability of the Subpart F rules to a U.S. person that owns an interest in a foreign corporation:

- The U.S. person must be a U.S. shareholder.
- The foreign corporation must be a CFC.
- The CFC must have Subpart F income.

Three key categories of Subpart F income are...

- FBCSI
- FBC Services Income
- FPHCI

Note that Subpart F income also includes insurance income (§ 952(a)(1)), FBC oil related income (§ 954(a)(5)), international boycott income (§ 952(a)(3)), certain illegal bribes and kickbacks (§ 952(a)(4)), income from certain blacklist countries (§ 952(a)(5)), and investment of earnings in U.S. property (§ 951(a)(1)(b) and § 956); however these income items are not covered in this Concept Unit.

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Relevant Key Factors (cont'd)

Subpart F Overview

Key Factors

Common Exceptions/Exclusions:

- *Inclusion limited to current E&P* – the amount included in a USSH's taxable income is limited to the CFC's undistributed E&P (just as an actual distribution would be a dividend only to the extent of the CFC's undistributed E&P). § 952(c)(1)(A)
- *De minimis rule* – if the sum of FCSI and insurance income is less than the lesser of 5% of gross income or \$1M, none of the CFC's income is FBCI or insurance income. § 954(b)(3)(A)
- *High tax exception* – an item of income taxed at more than 90% of the highest US rate (i.e. 35% X 90% = 31.5%) is not FBCI or insurance income. § 954(b)(4)
- *Same country manufacturing exception from FBCSI* – income from property manufactured (by anyone) in the CFC's country of incorporation is not FBCSI. § 954(d)(1)(A)
- *Same country sales/use exception from FBCSI* – income from property sold for use, consumption or disposition within the CFC's country of incorporation is not FBCSI. § 954(d)(1)(B)
- *CFC manufacturing exception from FBCSI* – income from sale of property that the CFC itself manufactures (anywhere) is not FBCSI. Treas. Reg. § 1.954-3(a)(4)
- *Active financing exception from FPHCI* – qualified income derived by a CFC that is predominantly engaged in the active conduct of a banking, financing or similar business is not FPHCI. § 954(h)
- *Look through exception from FPHCI* – certain income received from a related CFC and allocable or attributable to income that is neither Subpart F nor Effectively Connected Income (ECI), as defined under § 864(c), is not FPHCI. § 954(c)(6)
- *Same country exception from FPHCI* – certain income received from a related CFC incorporated in the same country that uses a substantial part of its assets in a trade or business in that country is not FPHCI. § 954(c)(3)

 **CAUTION:** These exceptions/exclusions involve a variety of complex requirements and are summarized very briefly here for information purposes only. Review the IPS Practice Units that cover each of the exceptions/exclusions for a more comprehensive discussion.

Volume	Part	Chapter	Sub-Chapter
Deferral Planning	N/A	N/A	N/A

Detailed Explanation of the Concept

Subpart F Overview

Analysis	Resources	6103 Protected Resources
<p>A foreign corporation is a CFC for a particular year if on any day during such year <i>U.S. shareholders</i> own (1) more than 50% of the total combined voting power of all classes of the corporation's stock entitled to vote (voting test), or (2) more than 50% of the total value of all classes of the corporation's stock (value test). I.R.C. § 957</p> <p>A U.S. shareholder is a U.S. person who owns 10% or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation. I.R.C. § 957(c) defines the term "U.S. person" for purposes of Subpart F by referencing the definition in I.R.C. § 7701(a)(30), which defines a U.S. person as any of the following: U.S. citizen/resident, domestic partnership, domestic corporation, or any estate/trust that is not a foreign estate/trust as defined in I.R.C. § 7701(a)(31).</p>		

Volume	Part	Chapter	Sub-Chapter
Deferral Planning	N/A	N/A	N/A

Detailed Explanation of the Concept (cont'd)

Subpart F Overview		
Analysis	Resources	6103 Protected Resources
<p><i>FBCSI</i></p> <p>One of the abuses that Subpart F is intended to prevent is U.S. shareholders using their CFCs to shift sales income from the U.S. to foreign jurisdictions to avoid U.S. tax. The FBCSI rules of Subpart F address this abuse.</p> <p>When a CFC buys/sells tangible personal property (1) from/to (or on behalf of) a <i>related person</i> and the property is (2) manufactured, produced, constructed, grown, or extracted <i>outside</i> the CFC's country of incorporation and the property is purchased/sold (3) for use, consumption or disposition <i>outside</i> the CFC's country of incorporation, the income from the sale of the property by the CFC is FBCSI, a type of Subpart F income. § 954(d). The U.S. shareholder(s) of the CFC may have a subpart F inclusion.</p>		

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Deferral Planning	N/A	N/A	N/A

Detailed Explanation of the Concept (cont'd)

Subpart F Overview		
Analysis	Resources	6103 Protected Resources
<p><i>FBC Services Income</i></p> <p>Another area of abuse is where a service corporation is separated from the activities of a related corporation and organized in another country primarily to obtain a lower rate of tax for the service income. Subpart F addresses this abuse by requiring the U.S. shareholder to include its pro-rata share of the CFC's FBC Services Income in income currently.</p> <p>FBC Services Income consists of income derived by a CFC in connection with the performance outside the CFC's country of incorporation of technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services for or on behalf of any <i>related person</i>. § 954(e)</p>		

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Deferral Planning	N/A	N/A	N/A

Detailed Explanation of the Concept (cont'd)

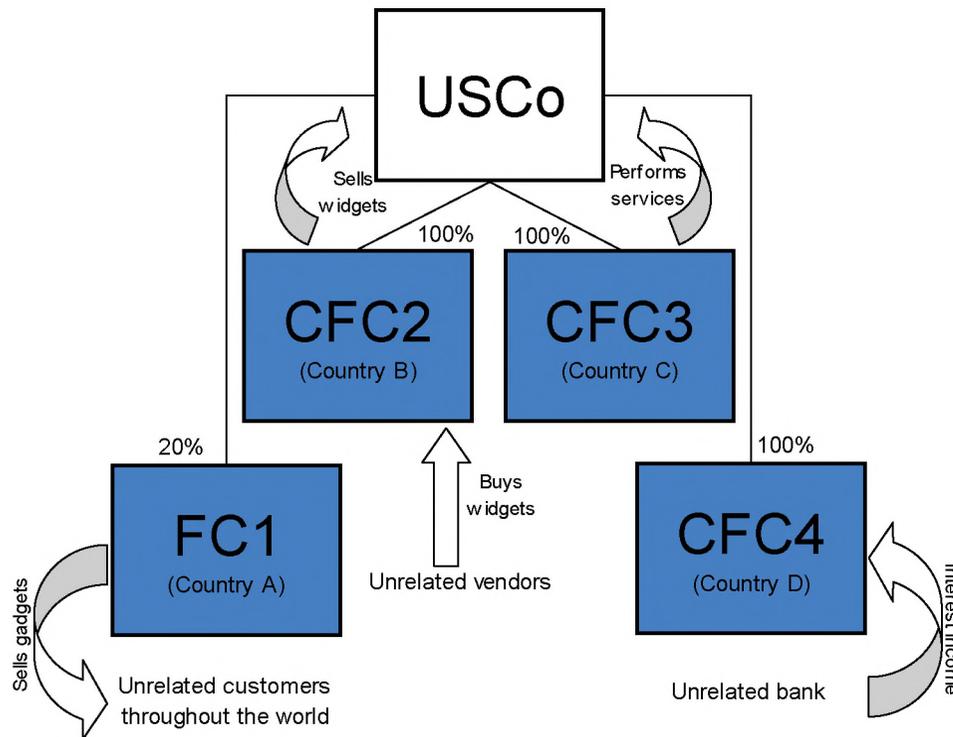
Subpart F Overview		
Analysis	Resources	6103 Protected Resources
<p><i>FPHCI</i></p> <p>When Congress enacted Subpart F, it recognized the need for U.S. businesses with active business operations abroad to be on equal competitive footing from a tax standpoint with other operating businesses in the same countries. However, where a CFC has portfolio types of investments, or where the CFC is merely passively receiving investment income, there is no competitive justification to defer the tax until the income is repatriated. As such, the provisions of Subpart F require a U.S. shareholder to include its pro-rata share of the CFC's FPHCI in income currently.</p> <p>FPHCI generally includes a CFC's income from dividends, interest, annuities, rents, royalties, and net gains on dispositions of property producing any of the foregoing types of income (as well as several other types of income not covered in this Concept Unit – see separate Practice Unit on FPHCI). § 954(c)</p>		

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Deferral Planning	N/A	N/A	N/A

Examples of the Concept

Subpart F Overview

Examples



- USCo owns 20% of FC1 in Country A, 100% of CFC2 in Country B, 100% of CFC3 in Country C, and 100% of CFC4 in Country D.
- FC1 sells gadgets to unrelated customers around the world.
- CFC2 purchases widgets from unrelated parties (who manufacture the widgets outside of Country B) and sells them (without any further modification or manufacturing) to USCo.
- CFC3 performs services for USCo outside of Country C (the services are completely unrelated to the sales of gadgets or widgets).
- CFC4 earns interest on cash deposited in an unrelated bank.

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Deferral Planning	N/A	N/A	N/A

Examples of the Concept (cont'd)

Subpart F Overview

Examples

USCo owns at least 10% of the total combined voting power of all classes of stock entitled to vote in FC1 (in this case USCo owns 20%), therefore USCo is a “U.S. shareholder” of FC1 as defined in I.R.C. § 951(b). However, assuming *all* U.S. shareholders do **not** own more than 50% of (1) the total combined voting power of all classes of stock entitled to vote or (2) the total value of the stock of FC1, FC1 is not a CFC (this would be the case if, for example, all other owners of FC1 are foreign persons, unrelated to USCo). Consequently, USCo will not have a Subpart F inclusion as a result of any of FC1’s income (from the sale of gadgets or anything else FC1 does).

CFC2, CFC3 and CFC4 are each owned 100% by USCo and are therefore CFCs as defined in I.R.C. § 957(a).

With respect to the sale of widgets by CFC2, CFC2 will have FBCSI and USCo will have a Subpart F inclusion assuming the widgets are sold for use or consumption outside Country B (because they are sold to a related person and manufactured outside of Country B).

With respect to the income from services performed by CFC3 for USCo, CFC3 will have FBC Services Income and USCo will have a Subpart F inclusion (because the services are performed for a related person and outside Country C).

With respect to the interest income earned by CFC4 from the unrelated bank, CFC4 will have FPHCI and USCo will have a Subpart F inclusion.

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Deferral Planning	N/A	N/A	N/A

Training and Additional Resources

Subpart F Overview		
Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	<ul style="list-style-type: none"> ▪ FY10 IBC CPE Subpart F. 	<ul style="list-style-type: none"> ▪ International Current Topics in Subpart F
White Papers / Guidance	<ul style="list-style-type: none"> ▪ IRM 4.61.7 	<ul style="list-style-type: none"> ▪ IRM 4.61.7 Controlled Foreign Corporations
Podcasts / Videos	<ul style="list-style-type: none"> ▪ FY2011 CPE 	<ul style="list-style-type: none"> ▪ Training - FY2011 CPE ▪ Training Deferral Planning CPE July 2011
Other Training Materials	<ul style="list-style-type: none"> ▪ IE Phase Training materials and accompanying pre-reads 	<ul style="list-style-type: none"> ▪ On-the-Job Training for International Examiners (IE) - Subpart F ▪ Phase I IE Training Subpart F Module ▪ Phase III IE Training Subpart F Module ▪ CAP Subpart F Compliance Activities

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Deferral Planning	N/A	N/A	N/A

Training and Additional Resources (cont'd)

Subpart F Overview		
Type of Resource	Description(s) and/or Instructions for Accessing	References
Reference Material – Treatises	<ul style="list-style-type: none"> ▪ Other reading material 	<ul style="list-style-type: none"> ▪ Kuntz & Peroni US International Taxation B3.05 ▪ Bittker & Lokken Fundamentals of International Taxation 65.8.2 ▪ Bittker & Lokken Fundamentals of International Taxation 69.2 ▪ TMFEDPORT No. 926-3rd CFCs General Overview ▪ TMFEDPORT No. 928-3rd: CFCs - Foreign Base Company Income (Other than FPHCI) ▪ TMFEDPORT No. 6220-1st: CFCs - Foreign Personal Holding Company Income

Volume	Part	Chapter	Sub-Chapter
Deferral Planning	N/A	N/A	N/A

Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporations
E&P	Earnings and Profits
ECI	Effectively Connected Income
FBC	Foreign Base Company
FBCI	Foreign Base Company Income
FBCSI	Foreign Base Company Sales Income
FC	Foreign Corporation
FPHCI	Foreign Personal Holding Company Income
IE	International Examiner
USC	U.S. Corporation

Volume	Part	Chapter	Sub-Chapter
Deferral Planning	N/A	N/A	N/A

Index of Related Issues

Issue	Associated UIL(s)	References
FBC Oil Related Income	9412.04-01	To be developed
General Subpart F Computational Issues	9412.05	To be developed
FTC Management	9413	To be developed
§ 956 – Investment in U.S. Property	9414.01	To be developed
Determination of CFC Status	9435.01-01	To be developed
Information Gathering	9460	To be developed