Internal Revenue Service
DEPARTMENT OF THE TREASURY

LB&I International Practice Service Concept Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Business Outbound	–	–
Volume	2	Deferral Planning	**Level 1 UIL**	9412
Part	2.3	Foreign Personal Holding Company Income	**Level 2 UIL**	9412.03
Chapter	N/A	N/A	**Level 3 UIL**	
Sub-Chapter	N/A	N/A		

Unit Name	Concepts of Foreign Personal Holding Company Income

Document Control Number (DCN)	DPL/CU/P_2.3_13(2016)
Date of Last Update	02/29/2016

Note: This document is not an official pronouncement of law, and cannot be used, cited or relied upon as such. Further, this document may not contain a comprehensive discussion of all pertinent issues or law or the IRS's interpretation of current law.

Table of Contents

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

General Overview

Concepts of Foreign Personal Holding Company Income (FPHCI)

A U.S. shareholder of a foreign corporation generally is not subject to tax on the income of the corporation until the shareholder receives a distribution from the corporation. However, under subpart F, certain types of income earned by a controlled foreign corporation (CFC) are currently included in the income of the CFC's U.S. shareholders even if the CFC does not distribute the income to its shareholders in that year.

One such type of income is Foreign Personal Holding Company Income (FPHCI), which generally includes income of a CFC such as dividends, interest, royalties, rents, annuities, and net gains on dispositions of property producing any of the foregoing types of income* unless an exception or exclusion from FPHCI (discussed later in this unit) applies. When Congress enacted subpart F, it recognized the need to maintain active American business operations abroad on equal competitive footing with other operating businesses in the countries where the American-controlled businesses were operating. 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.

*FPHCI also includes net gains from certain commodities transactions, net foreign currency gains, income equivalent to interest, income from notional principal contracts, payments in lieu of dividends, and income from certain personal service contracts, all of which are beyond the scope of this unit.

NOTE: FPHCI of a CFC results in a current income inclusion for the U.S. shareholder(s) under IRC 951 ("subpart F inclusion"). That is, the CFC has FPHCI (a type of subpart F income), and as a result, the U.S. shareholder has a subpart F inclusion. However, income of the U.S. shareholder(s) itself is not FPHCI, even if received from the CFC. For example, if a CFC received royalties, the CFC may have FPHCI, and the U.S. shareholder(s) may have a subpart F inclusion, but if the U.S. shareholder(s) itself receives royalties from the CFC, the U.S. shareholder(s) has royalty income, not FPHCI or a subpart F inclusion.

General Overview (cont'd)

Concepts of FPHCI

Common Exceptions/Exclusions:

- Same country exception – 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. IRC 954(c)(3).
- Look-thru rule – certain income received from a related CFC and allocable or attributable to income that is neither subpart F nor effectively connected income (ECI) is not FPHCI. IRC 954(c)(6).
- Active financing exception – qualified income derived by a CFC that is predominantly engaged in the active conduct of a banking, financing, or similar business is not FPHCI. IRC 954(h).
- Active leasing/licensing exception – certain rents/royalties received from unrelated parties by a CFC in the active conduct of a trade of business are not FPHCI. IRC 954(c)(2), Treas. Reg. 1.954-2(b)(6), 1.954-2(c), and 1.954 -2(d).
- Insurance income exclusion – certain investment income received from unrelated parties by a CFC in a qualified insurance business is not FPHCI. IRC 954(i).

! **CAUTION:** These exceptions/exclusions to FPHCI involve a variety of complex requirements and are summarized very briefly here for information purposes only. Other exceptions may apply and are beyond the scope of this unit. For a more comprehensive discussion, review the references cited above and related IPS Practice Units.

Relevant Key Factors

Concepts of FPHCI

Key Factors

As discussed in the General Overview, FPHCI includes dividends, interest, royalties, rents, and a variety of other income items, and the rules for FPHCI provide for several different exceptions, which are covered in more detail in separate IPS Practice Units. In order to determine whether to apply the FPHCI rules and corresponding exceptions, generally the following key factors must be addressed with respect to the CFC:

1. The character of the income (i.e., dividends, interest, royalties, rents, etc.).
2. The relationship, if any, between the recipient of the income and the payor of the income (IRC 954(d)(3)).

These factors can be determined by performing a functional analysis and reviewing relevant contracts.

CONSULTATION: Note that transactions between related parties may implicate not only IRC 954 but also IRC 482 because FPHCI and transfer pricing are not mutually exclusive. The examiner should consult with the Transfer Pricing Practice or Income Shifting IPN regarding any potential transfer pricing issues.

Concepts of FPHCI
FPHCI includes dividends, interest, royalties, rents, annuities, net gains from certain property transactions, net gains from certain commodities transactions, net foreign currency gains, interest equivalents, income from notional principal contracts, payments in lieu of dividends, and income from certain personal service contracts.

Analysis	Resources
1. The character of the income (i.e., dividends, interest, royalties, rents, etc.). Before considering whether the FPHCI rules apply to a given fact pattern, the examiner must determine the proper character of the income derived by the CFC. The examiner should review relevant contracts/transaction agreements, as well as the activities and conduct of the parties to the transaction. Income will be characterized based on the substance of the transaction(s) without regard to the designation given to the income by the parties involved. For example, a review of the facts and circumstances surrounding a purported rental agreement may reveal that the substance of the arrangement is, in fact, a sales transaction. In this case, the FPHCI rules would not apply, but the examiner should consider whether the Foreign Base Company Sales Income (FBCSI) rules may apply. **CONSULTATION:** If the character of the income derived in the transaction(s) is uncertain, the examiner should consult with the FTC Mgt. IPN or relevant IPG for assistance and, if necessary, with counsel (e.g. reviewing contracts/agreements).	▪ Treas. Reg. 1.954-1(e)(1).

Detailed Explanation of the Concept (cont'd)

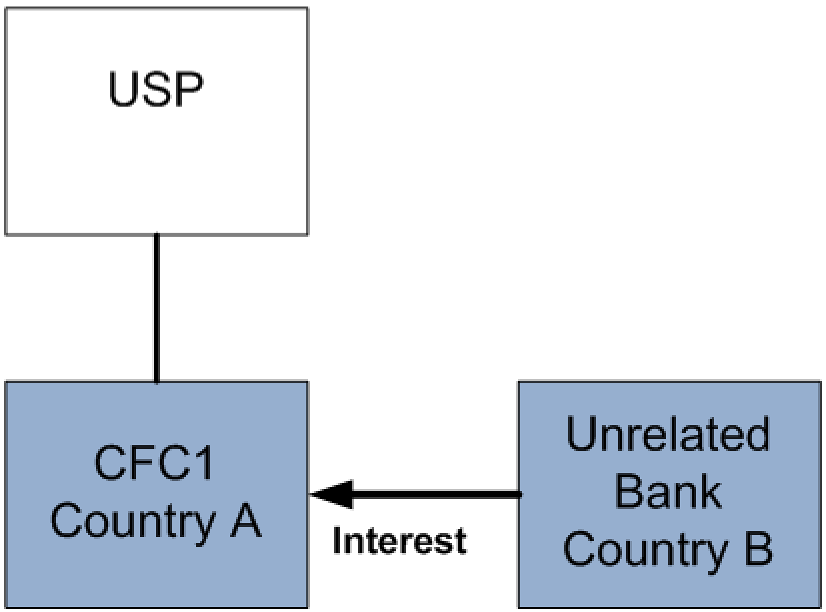
Concepts of FPHCI
The FPHCI rules provide for several exceptions, many of which are contingent upon whether or not the payor of the income is a related person with respect to the recipient of such income.

Analysis	Resources
2. The relationship, if any, between the recipient of the income and the *payor* of the income. It is important to determine the relationship, if any, between the CFC deriving the income and the party that is paying the income as there are certain exceptions from FPHCI for items of income that a CFC receives from a related payor and other exceptions for items of income a CFC receives from unrelated payors. A related person is an individual who controls the CFC or a corporation, partnership, trust or estate that controls or is controlled by the CFC (or the same person(s) that control the CFC). Control means direct or indirect ownership of: (1) in the case of corporations, stock having more than 50% of the total voting power of all classes of stock entitled to vote or of the total value of stock of the corporation; and (2) in the case of a partnership, trust, or estate, more than 50% (by value) of the capital or profits in the partnership or more than 50% (by value) of the beneficial interest in the trust or estate. For example, a CFC and its USP are related parties.	▪ IRC 954(d)(3) ▪ Treas. Reg. 1.954-1(f).

Examples of the Concept

Concepts of FPHCI

Examples



CFC 1, incorporated under the laws of foreign Country A, is a wholly-owned subsidiary of domestic corporation USP.

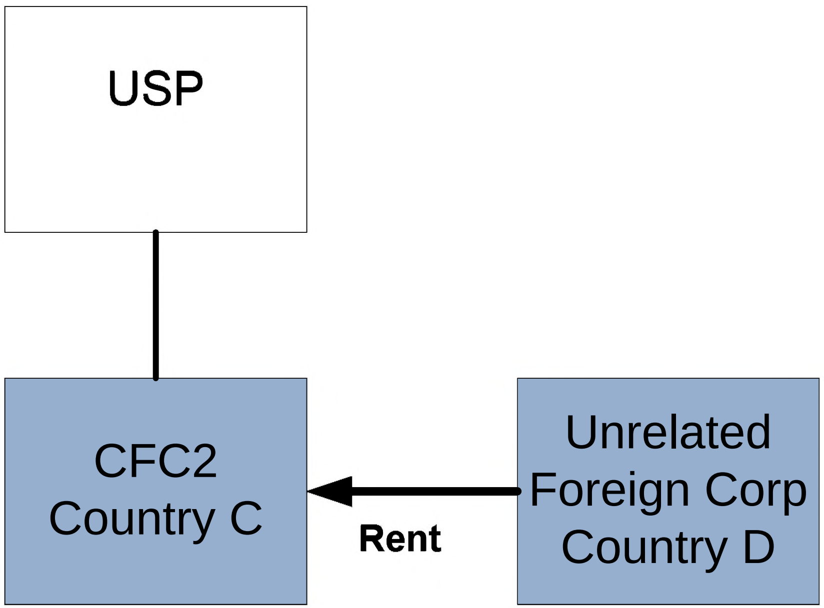
CFC1 manufactures widgets which it sells to unrelated parties. It is not a bank or financing business, and it deposits its excess cash into an unrelated bank in Country B. It receives interest in excess of $1 million on its deposits. The interest income makes up 40% of CFC1's income for the taxable year.

The interest income received from the bank is FPHCI. CFC1 is not eligible for the active financing exception as it is not actively engaged in the conduct of a banking, financing, or similar business. IRC 954(c)(1)(A).

Examples of the Concept

Concepts of FPHCI

Examples



CFC 2, incorporated under the laws of foreign Country C, is a wholly-owned subsidiary of domestic corporation USP.

CFC2 purchases a building that it holds for investment. It receives rental income from an unrelated Country D foreign corporation.

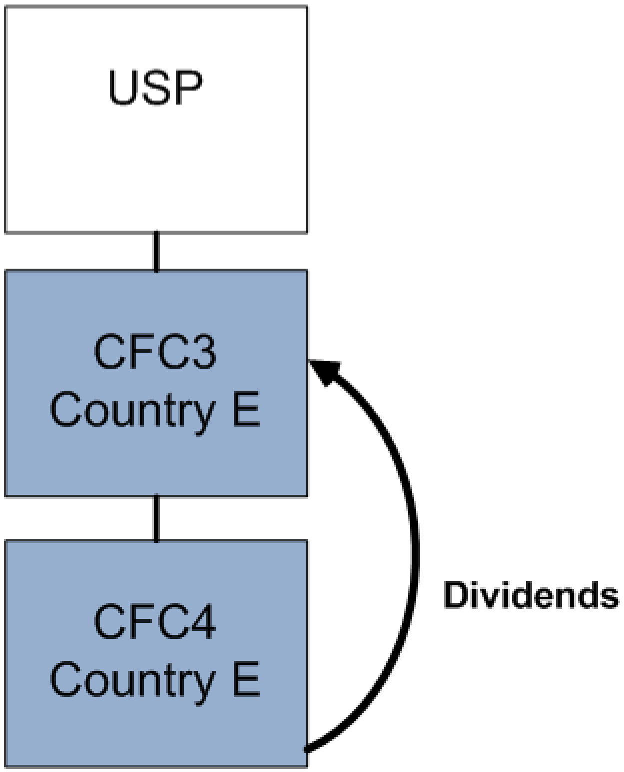
The rental income earned by CFC2 is FPHCI because the income does not qualify for the active leasing exception when CFC2 holds the building for investment purposes.

Treas. Reg. 1.954-2(b)(6).

Examples of the Concept

Concepts of FPHCI

Examples



CFC3 is incorporated under the laws of foreign Country E. CFC4 is also incorporated under the laws of foreign Country E, where it uses a substantial part of its assets in a trade or business. CFC3 owns (and has always owned) 100% of CFC4's stock, so the CFCs are related persons. IRC 954(d)(3).

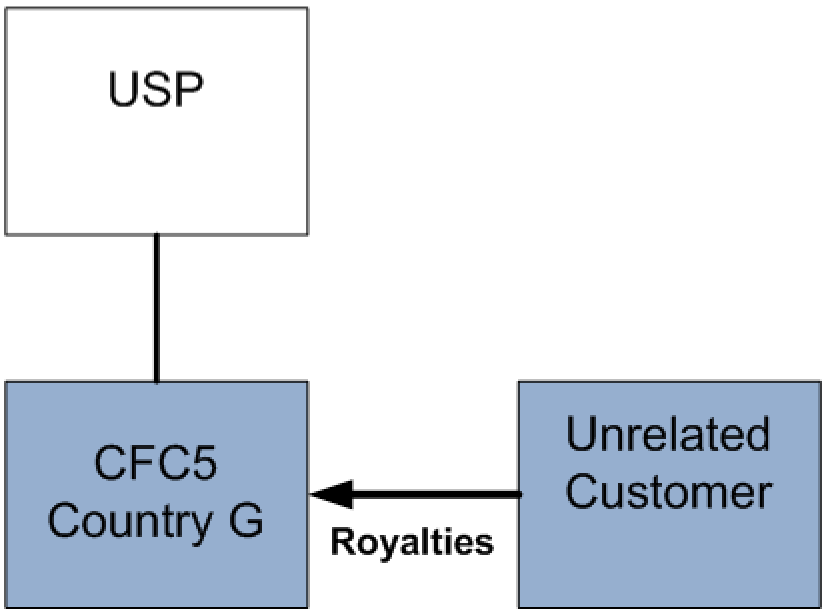
CFC4 paid a dividend to CFC3. The dividend did not reduce any potential subpart F income or Effectively Connected Income (ECI) of CFC4.

The same country exception (IRC 954(c)(3)) applies to the dividend (and the look-thru rule under IRC 954(c)(6), if in effect, would also apply), so CFC3's dividend income is not FPHCI.

Examples of the Concept

Concepts of FPHCI

Examples



CFC5, through its own staff of employees, owns and operates a research facility in Country G. CFC5's employees are regularly engaged in Country G in technical activities that result in the issuance of patents which CFC5 licenses.

CFC5 received royalties from an unrelated customer for the privilege of using patented rights that CFC5 developed as a result of its employees' research activity.

Since the royalties were derived in the active conduct of a trade or business under IRC 954(c)(2)(A), CFC5's royalty income qualifies for the active licensing exception and is not FPHCI.

Treas. Reg. 1.954-2(d)(3) *Ex. 1*.

Training and Additional Resources

Concepts of FPHCI

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	▪ Training - FY 2011 CPE "Live" Recordings ▪ CLE Centra – Subpart F 20130930 ▪ 2010 Centra – Subpart F update ▪ IRC Section 954(c)(6) Look-Thru Rules February 2014 (LRQ368149)	▪ Discussion of FPHCI is included in the resources at left.
White Papers / Guidance	▪ Westlaw subscription	▪ Bittker & Lokken 69.4 ▪ TMFEDPORT No. 6220-1st, CFCs - Foreign Personal Holding Company Income ▪ FAA20132702F

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
ECI	Effectively Connected Income
FBCSI	Foreign Base Company Sales Income
FBCSvcI	Foreign Base Company Services Income
FPHCI	Foreign Personal Holding Company Income
IPG	Issue Practice Group
IPN	International Practice Network
QBU	Qualified Business Unit
QBFI	Qualified Banking or Financing Income
USP	United States Parent

Index of Related Issues

Issue	Associated UIL(s)	References
▪ Sales or leases of tangible property/goods	▪ 9411.05, 9422.07	▪ Various units available
▪ Subpart F Overview	▪ 9412, 9433.01	▪ Subpart F Overview, DPL/CU/V_2_01(2013); Overview of Subpart F Income for U.S. Individual Shareholders, FEN/9433.01_09(2013)
▪ Active financing exception to FPHCI	▪ 9412.03	▪ Interest Income Derived by CFC or QBU Engaged in Banking, Financing, or Similar Business, DPL/9412.03_02(2013)
▪ Look-thru rule and same country exception to FPHCI	▪ 9412.03	▪ Receipt of Dividends or Interest from a Related CFC, DPL/9412.03_04(2015)
▪ Foreign Base Company Income	▪ 9412.05	▪ Computing Foreign Base Company Income, DPL/9412.05_05(2013)
▪ Functional Analysis	▪ 9412.06	▪ Conducting Functional Analysis for Foreign Base Company Income (FBCI), DPL/9412.06_12(2015)