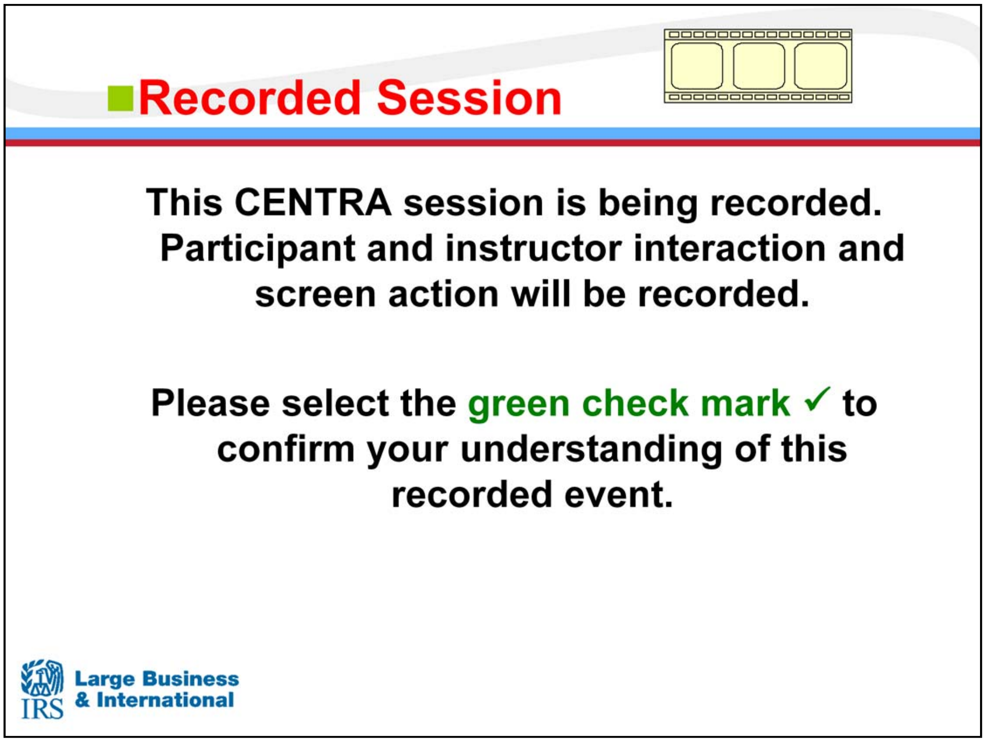

[Speaker]

This event is being recorded and will be available for playback.

Please select the green check mark to confirm you understand that this event is recorded.

[Once participants have acknowledged, press the record button]

Hello and welcome to the next lesson of RA Training 2014. The title for this lesson is Overview of Subpart F Income for US Individual Shareholders. The material for this presentation comes from the IPS unit by the same name located on the Foreign Entities IPN SharePoint site.

Presenters

(b) (6)

[redacted]

Jamie Song, Attorney, SBSE Counsel

Kristine Crabtree, Attorney, Associate Chief Counsel International (ACCI)

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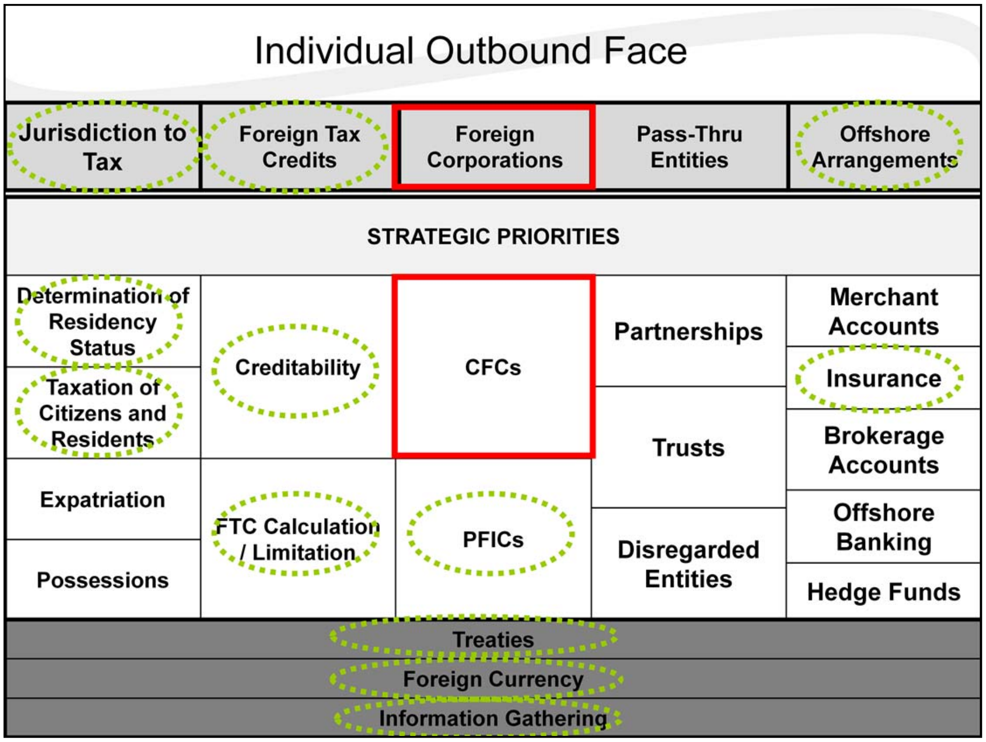
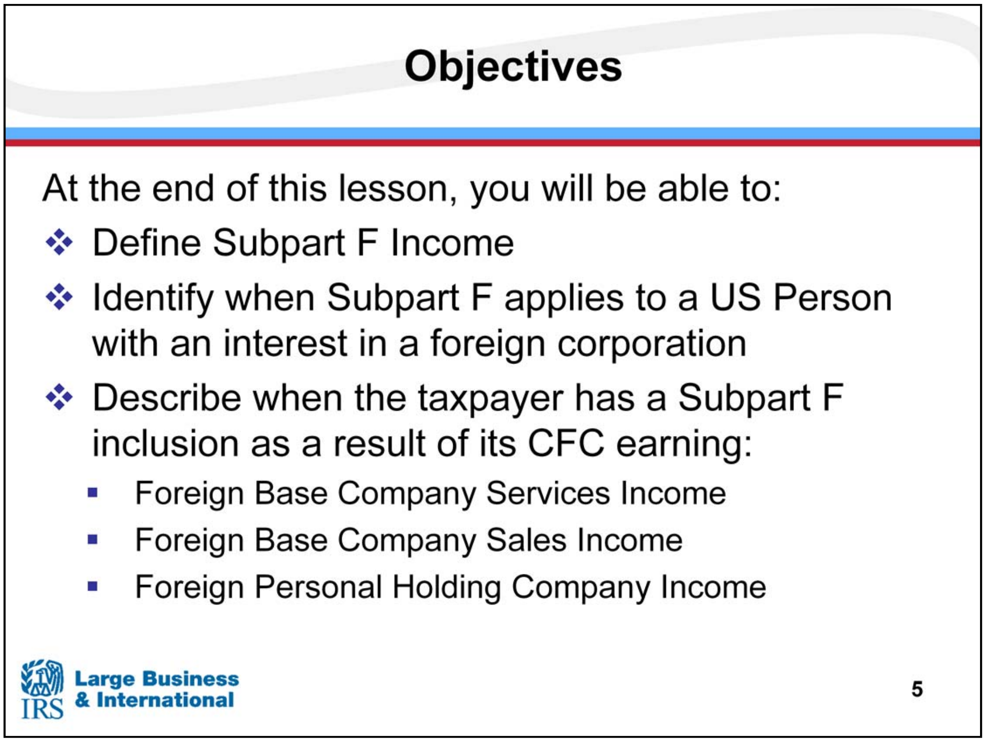
My name is [presenter's name]; I am a Technical Specialist with the Foreign Tax Credit-IPN. My co-presenters are listed on this slide; you may be hearing from them throughout the presentation. I would also like to thank Jamie Song from SBSE Counsel and Kristine Crabtree from ACCI for joining us today.



The red boxes shows where this lesson on the tax treatment of Subpart F Income falls on the Individual Outbound Face of the International Matrix. Controlled Foreign Corporations are a strategic priority under Foreign Corporations which is part of the Foreign Entities IPN.

In the lesson on **"Do We Have Jurisdiction to Tax"** you learned the definition of a **US Person**. You then learned how to identify a **US Shareholder** and a **Controlled Foreign Corporation** or CFC, in the lesson on **"Determination of US Shareholder and CFC Status".** The knowledge from these classes will be important to learning why, when and how Subpart F Income received by a CFC is taxed to US Individual Taxpayers.

Let's start by reviewing our Objectives. . .



Here are the objectives for this lesson on Subpart F Income for U.S. Individual Shareholders.

- ❖Define Subpart F Income
- ❖Identify when Subpart F applies to a US Person with an interest in a foreign corporation
- ❖Describe when the taxpayer has a Subpart F inclusion as a result of its CFC earning:

- Foreign Base Company Services Income
- Foreign Base Company Sales Income
- Foreign Personal Holding Company Income

Lets start with Defining Subpart F Income

What is Subpart F Income?

- "Moveable" income earned by a CFC
  - Income from the performance of services by or on behalf of a related person Foreign Base Company Services Income-(FBC Services Income)
  - Income from the purchase and sale of personal property involving a related person-Foreign Base Company Sales Income-(FBCSI)
  - Investment or passive income (such as dividends, interest, rents and royalties)-Foreign Personal Holding Company Income (FPHCI).
- Taxable to the U.S. Shareholders in the year earned even though it is not distributed.

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A foreign corporation is one type of entity through which foreign business operations may be conducted. A major tax advantage to a United States taxpayer of using a foreign corporation to conduct business 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.

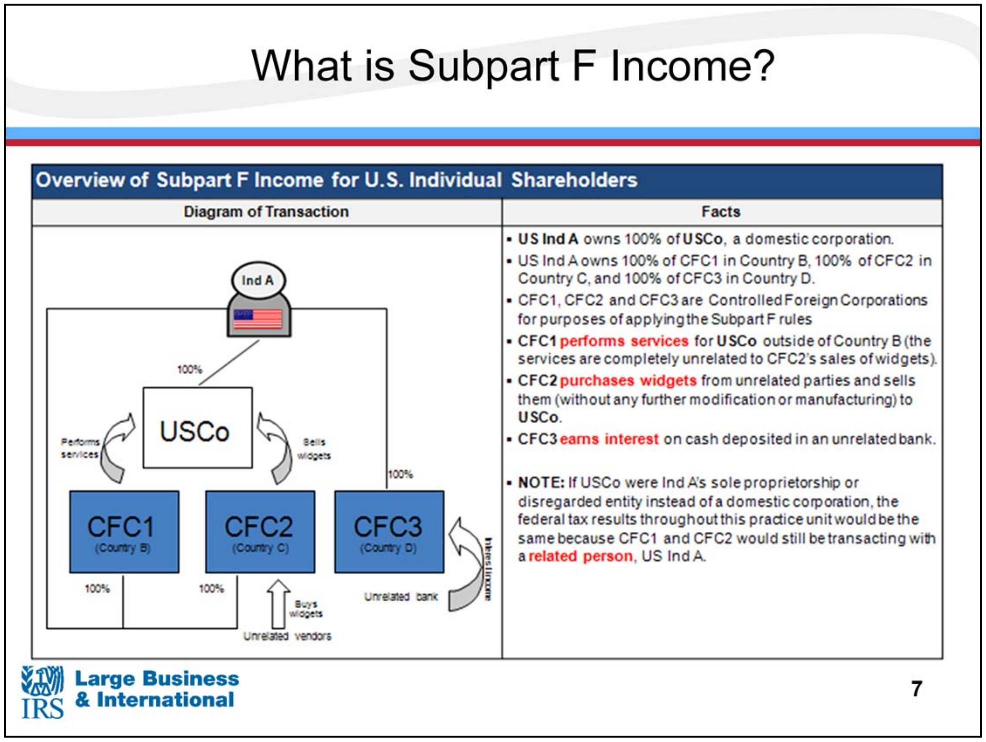
Prior to the enactment of Subpart F, many U.S. taxpayers achieved deferral of U.S. tax on certain kinds of movable income, such as dividends, interest, rents, and royalties, by earning such income through foreign corporations. By incorporating or locating these corporations in low- or no-tax jurisdictions, U.S. taxpayers were able to significantly reduce their overall tax liabilities. Congress disapproved of these arrangements, since they resulted in significant tax avoidance both in the United States and in foreign jurisdictions. The purpose of Subpart F is to deny a tax deferral for 'movable' income earned through a U.S.-controlled foreign corporation formed in a low- or no-tax country .

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 though the CFC does not distribute the income to its shareholders. Subpart F operates by treating the shareholders as if they had actually received the income from the CFC. The undistributed income of a CFC that is taxable to its U.S. shareholders under the Subpart F rules is referred to as "Subpart F income."

The Subpart F rules were first enacted in 1962 and have been amended many times generally to expand the coverage of Subpart F.

There are many categories of Subpart F income. In general, it consists of movable income. Subpart F income includes Foreign Base Company Services Income which is income received by a CFC from the **performance of services** for or on behalf of a **related person.** Another category of Subpart F income is Foreign Base Company Sales Income which derived in connection with the purchase and sale of personal property involving a **related person.** The last category of Subpart F income that we will cover in this lesson is Foreign Personal Holding Company Income which consists of generally investment type income such as dividends, **interest**, rents and royalties. We will be covering each of these categories of Subpart F income in a little more detail during this presentation.

The Subpart F rules also cover insurance income, investment of earnings in US property and foreign base company oil-related income; these topics are beyond the scope of this lesson.



This is the slide from the IPS Unit – Overview of Subpart F Income. The IPS Unit discusses transactions to better understand 3 of the major types of Subpart F Income that we are going to cover today – Foreign Base Company Services Income, Foreign Base Company Sales Income, and Foreign Personal Holding Company Income.

To better understand the concepts behind the implementation of Subpart F, lets look at the three transactions shown on this slide.

Go over the facts on the slide—use the Centra pointer to point to the items in the diagram as the facts are described above. We will cover these transactions one at a time in more detail later in the lesson to show the different provisions of Subpart F income and how to apply them to certain transactions.

I want to point out that in the examples we show you today for training we are using Individual A who owns a USCo which is a domestic corporation, but you don't have to have a domestic corporation in the equation in order to get the same results we are going to discuss in this lesson. If Individual A *(point with pointer)* had a sole proprietorship which did the same activity of USCo, you would end up with the same results. We put in a USCo to get you to think of possibilities and the fact that you have to audit the entire taxpayer, not just what shows on the tax return. If USCo files a Form 1120, and the taxpayer does not receive any salary or dividend from USCo, you may have no idea that USCo even existed. The only way that you are going to get there is asking questions, and the earlier such as during the initial interview the better.

So realize that this organization chart and the flow of services and products were completed through interviewing the taxpayer and maybe also looking at some documents or contracts. When we cover the various aspects of Subpart F income I suggest that you consider what type of questions that you would have to ask and what documents you would want to request in order to support the facts of these transactions. In fact in some parts during the presentation we will be asking for your input in exactly these areas.

Please keep this slide handy as the presenters will refer to this slide throughout this presentation. We will also pop this slide up from time to time during the presentation to review the particular transaction we are discussing at the time.

Subpart F Rules

- Three rules for applying the Subpart F rules to a US Shareholder with an interest in a foreign corporation are:
  - The U.S. Person must be a U.S. Shareholder
  - The foreign corporation must be a CFC and
  - The CFC must have Subpart F income.

The first two rules were covered in the previous lesson and they are in the IPS unit titled “Determination of US Shareholder and CFC Status”.

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Discuss the three rules for application of Subpart F and point out that this lesson will focus on the last rule regarding Subpart F income.

Subpart F Income from Services
(FBC **Services** Income)

- Income from services performed
  - Outside the CFC's country of incorporation

  and

  - For or on behalf of a related person.

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Now that we have given you a quick overview of what Subpart F income is, let's discuss in more detail our first category of Subpart F Income – Foreign Base Company Services income.

One area of potential 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.

FBC Services Income consists of income derived by a CFC in connection with the performance of services. The definition of services includes **technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or similar services.**

The other requirement for Foreign Base Company Services Income is that the services are provided FOR OR ON BEHALF of any RELATED PERSON and the services are performed OUTSIDE the CFC's country of incorporation. So let's look at the **two important requirements in more detail**:

FBC **Services** Income Requirements

Overview of Subpart F Income for U.S. Individual Shareholders		
Issue 1		
Whether A has a Subpart F inclusion as a result of the **services** performed by CFC1.		
Fact Element	**References / Resources**	**Restricted Resources[1]**
Related person requirement – the examiner should determine whether CFC1 performs services for or on behalf of a *related person.*	The examiner should have reviewed organizational charts and transaction agreements during initial factual development to establish whether a related party transaction took place. No additional factual development should be needed.	▪ International Information Returns (IIR) ▪ yK1
Place of performance requirement – the examiner should determine whether CFC1 performs its services within or outside of Country B.	The examiner should review documentation that substantiates where persons are physically located when they actually perform the services. Examples may include organizational structure, internal employee directories, travel records, cost center reports, etc.	

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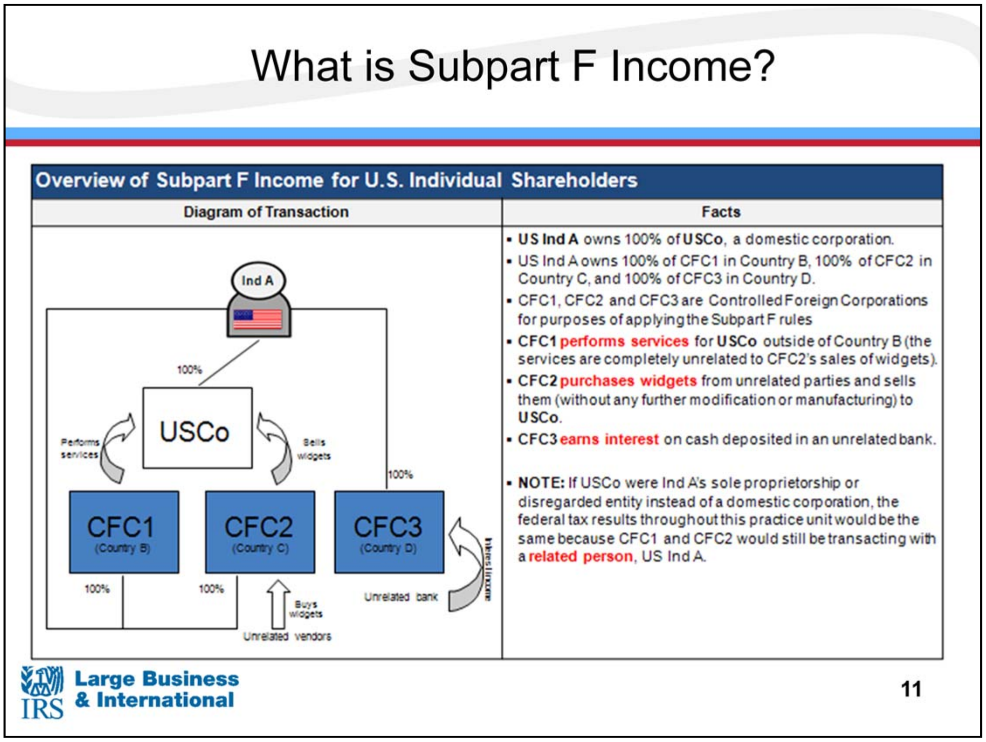
We defined what is considered "services" on the previous slide when we talked about **technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or like services.**

Now let's talk about outside the CFC's country of incorporation.

The "**<u>place of performance</u>**" requirement is pretty straightforward. Simply stated, if a CFC is incorporated in **Country B** and the specified types of services were provided in **Country A by the CFC's employees**, then the requirement would be met because the services were performed outside of Country B where the CFC was incorporated.

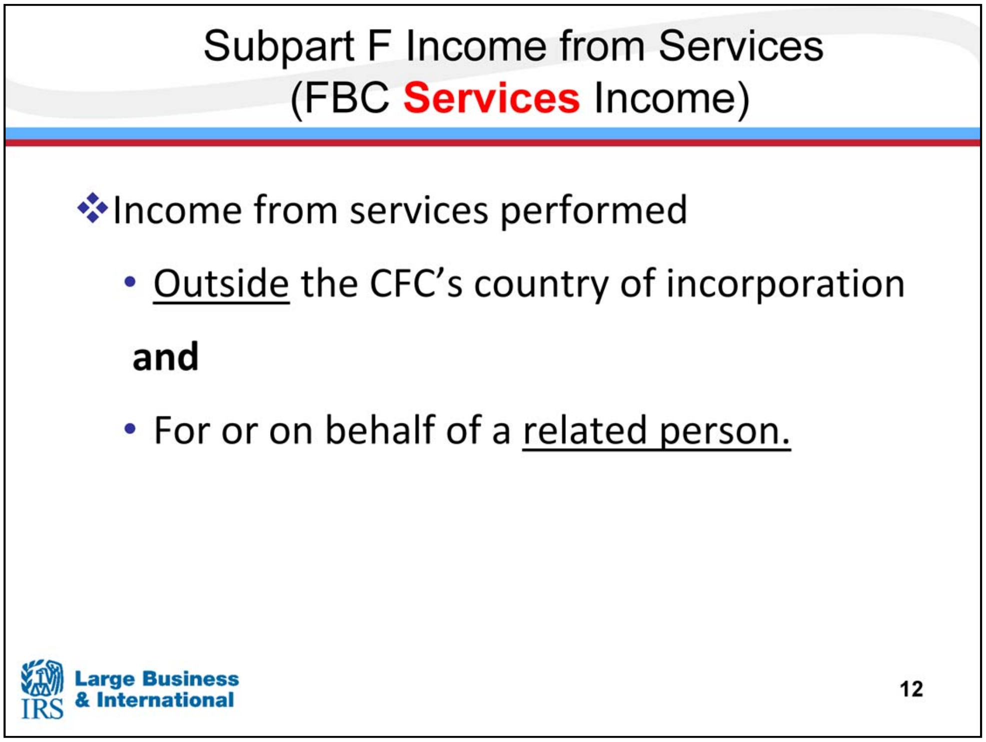


OK let's look at our Diagram now and discuss the transaction that involves services.

We have CFC1 which is incorporated in Country B. It states that CFC1 performs services outside of Country B, so it sounds like that requirement is met. Since the diagram doesn't specifically state what services were provided in this case we have to presume that it met the definition of services which again is for **technical, managerial, engineering, architectural, scientific, skilled, industrial, commercial or the like.**

So we are auditing Individual A, and you are just starting the audit and you ask what CFC1 does and Individual A responds that it provides services. So you know in order to have Subpart F – Foreign Base Company Services Income that the services have to be performed outside of Country B.

(Ask Audience) – "What are some of the questions you could ask Ind A to help in your determination on whether you might have the potential for Foreign Base Company Services Income based on where the services were provided"



Let's go back to our criteria again for Foreign Base Company Services income. We just discussed the first criteria and that we met that in our example, the services in our example were performed outside CFC's country of incorporation.

So **now** let's look at the second criteria which is that the services have to be provided for or on behalf of a related person. Let's first talk about for purposes of Foreign Base Company Services Income who is considered a related person.

FBC Services Income
Definition of Related Party

- **Person Controls or is Controlled by the CFC** (or is controlled by the same person that controls the CFC)
  - Person can be an Individual, Corporation, Partnership, Trust or Estate.
  - Control = direct or indirect ownership
    - Corporation –
      - > 50% Total Voting Power of all voting shares or
      - > 50% Total Value of Corporation
    - Partnership, Trust or Estate
      - > 50% (by value) of capital, profits or beneficial ownership of the entity.

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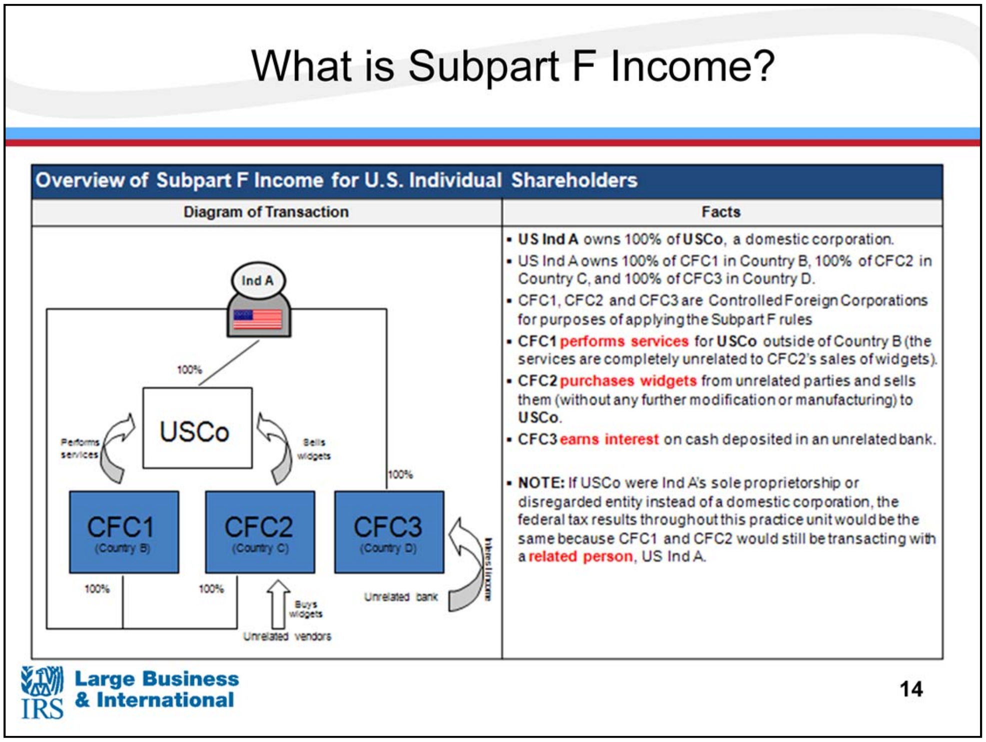
A person will be considered “related” if the person controls or is controlled by the CFC (or is controlled by the same persons that control the CFC). Bear in mind, that the term **person** could mean an **individual, corporation, partnership, trust or estate**. Control means <u>direct or indirect</u> 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; or (2) in the case of partnerships, trusts or estates, more than 50% (by value) of the capital, profits or beneficial interest in the entity.

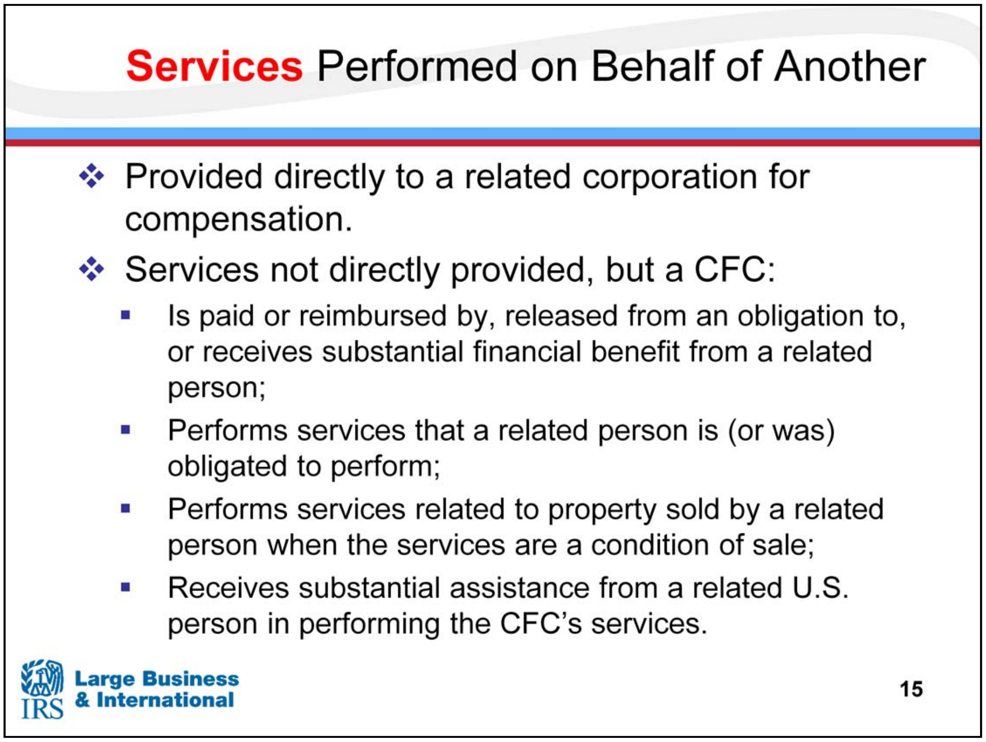
Let’s look back at our example to see if we have related persons in a transaction involving services.



Would USCo and CFC1 be considered related parties and if so why?

Answer: Yes – because Individual A owns 100% of US Co and Individual A also owns 100% of CFC#1

OK so now we have defined who is a related party – now let's look a little deeper into the definition of Services Performed on Behalf of Another.



The services could be provided directly to a related corporation for compensation. There are also situations in which a CFC will be considered to be performing services for, or on behalf of, a related person when the services are not directly provided to a related person:

<u>The first situation is when:</u>

- **The CFC is paid or reimbursed by, is released from an obligation to, or otherwise receives substantial financial benefit from, a related person for performing services.**

- For example, a **CFC could be paid by a related person to perform services for a customer of that related person;** Example: CFC A owned by a US person is paid by related 100 % owned CFC X for the installation and maintenance of machinery which CFC X manufactures and sells to unrelated customers in numerous countries. The installation and maintenance services provided by CFC A are performed for or on behalf of CFC X outside of CFC A's country of incorporation and therefore generate FBC services income.

<u>The second situation is when:</u>

CFC performs services that a related person is (or was) obligated to perform

Example: US person is obligated under a contract with a third party to construct a superhighway in a foreign country**.** At a later date the US person assigns the contract to its wholly owned CFC and the unrelated third party releases the US person from any obligation under the contract. The construction of the superhighway by the CFC is considered to be the performance of services for, or on behalf of, the US person.

The third situation is when:

- **The CFC performs services in relation to property sold by a related person and the performance of services constitutes a condition or material term of the sale;** Example: US person manufactures and sells industrial machines with a warranty for performance conditional upon their installation and maintenance by a factory-authorized service provider. A CFC, wholly owned by the US person, is the only authorized service provider. Any installation or maintenance services performed by the CFC outside the CFC's country of incorporation would generate FBC services income because the CFC is performing services on behalf of the US person.

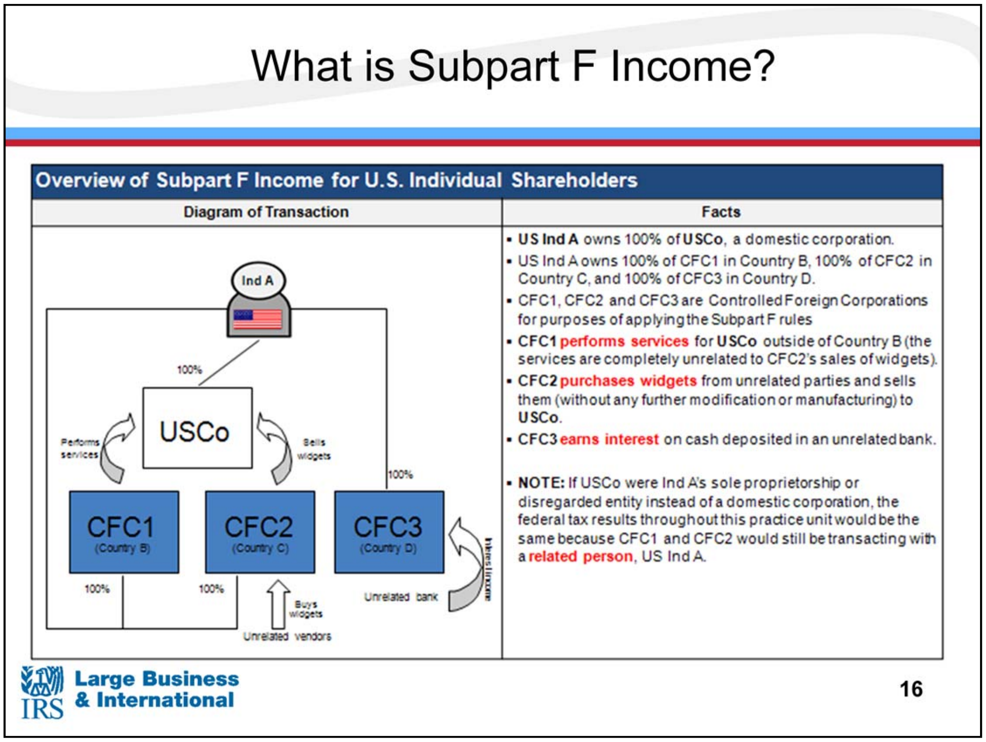
The fourth situation is when:

- **The CFC receives substantial assistance from a related U.S. person in the performance of CFC's services.**

We should mention that up to this point we have been tracking the foreign base company services income regulation found at Treas. Reg. 1.954-4. However, the substantial assistance rules in that regulation are outdated. They have been replaced with new rules that are found in Notice 2007-13. The new rules set a very high bar for what constitutes substantial assistance, so in many cases there will not be FBC services income where previously there might have been. Under the Notice, "substantial assistance" is defined as a related **US** person providing direction, supervision, services, know-how or other assistance to a CFC, if a cost test is satisfied. The cost test is satisfied if the cost to the CFC of the assistance furnished by the related US person is at least 80 percent of the total cost to the CFC of performing the services, after taking into account any 482 adjustments. Assistance provided by other CFCs doesn't count as substantial assistance – only assistance from a related US person constitutes substantial assistance that could result in FBC services income.

- Example: Ind A, a U.S. individual, wholly owns CFC1 and CFC2, each a foreign corporation, as well as USCo, a US corporation. CFC1 enters into a contract with FP, an unrelated foreign person, to design a bridge for FP in Country Y, a foreign country that is not CFC1's country of organization. CFC1 incurs a total of $100x of costs to design the bridge for FP. USCo's employees perform supervisory services in Country Y for CFC1 with respect to the contract for which CFC1 pays USCo a fee. CFC1 directly performs services related to the performance of that contract that cost CFC1 $15x. CFC2 performs centralized support services related to the performance of that contract in Country X, its country of organization, for which CFC1 pays CFC2 $10x. CFC1 is not treated as receiving substantial assistance in the performance of that contract because more than 20% of the cost of that contract is attributable to services furnished directly by CFC1 or a related CFC (CFC2).

As you can see, some of these situations are straight forward and some may require some fact finding to develop the issue.



One more time let's go back to our diagram and see if CFC1 has Foreign Base Company Services Income

What do you think?

We already said USCo was related to CFC1, and CFC1 was performing services for USCo. So in this example we meet the second criteria also which is "For or on behalf of a **related person."**

… So the answer is yes CFC1 would have Foreign Base Company Services Income.

OK – now time for another CPE Question

Identifying FBC **Services** Income

Requirement	Resources
Related Person Requirement	Review organization charts and transaction agreements.
Place of Performance Requirement	Review documentation that substantiates where persons are physically located when they performed the services such as organizational structure, internal employee directories, travel records, cost center reports, etc.

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Now that we have talked about the specifics in the law, let’s talk about how we audit the issue and what type of documents we might want to request or questions to ask.

For purposes of the related party requirement – one thing to do is ask the taxpayer for organizational charts of the taxpayer to see if you meet the related party requirement. In complicated transactions with multiple entities if the taxpayer has an organizational chart which includes the flow of goods and/or services that would be helpful, if not then it would be something that the examiner could create.

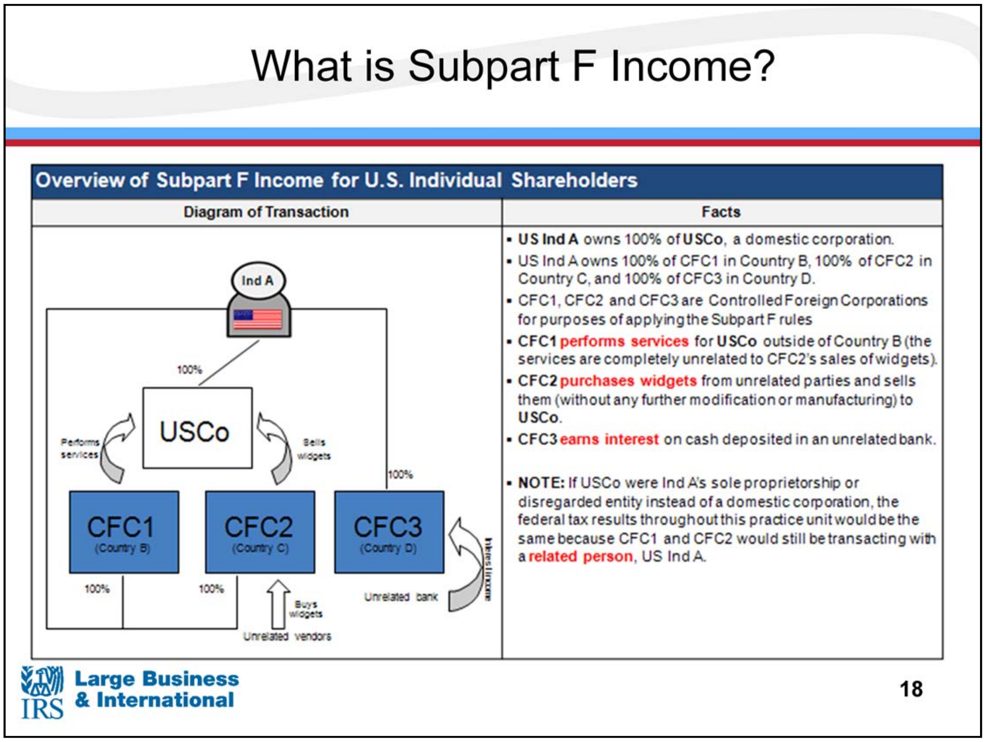
Again, for Foreign Base Company Services Income you must have 2 requirements:

1) The services were “performed for or on behalf of a Related Person” and

2) The Place of the Performance of services was outside the country of incorporation.

It is important to note that both requirements must be met to have Subpart F Income from Services. If only one requirement is met—there is no FBC services income!

Audience engagement: Has anyone had a case in which they had Foreign Base Company Services Income – and if so with being sensitive not to disclose any PII could you briefly explain the facts of your case.



For purposes of our next CPE question, let's remember the transaction we are talking about – we have individual A and CFC1.

5 Minute Stretch Break

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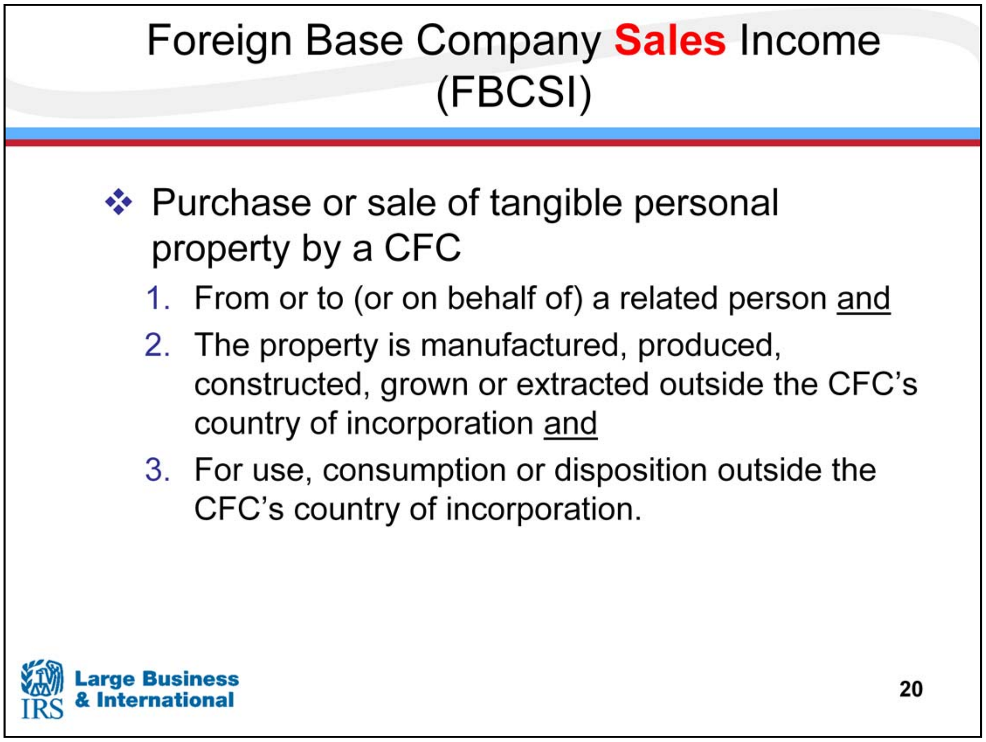
Time for a 5 minute stretch break (Note – may have to time the presentation and move this to a more appropriate mid-point)

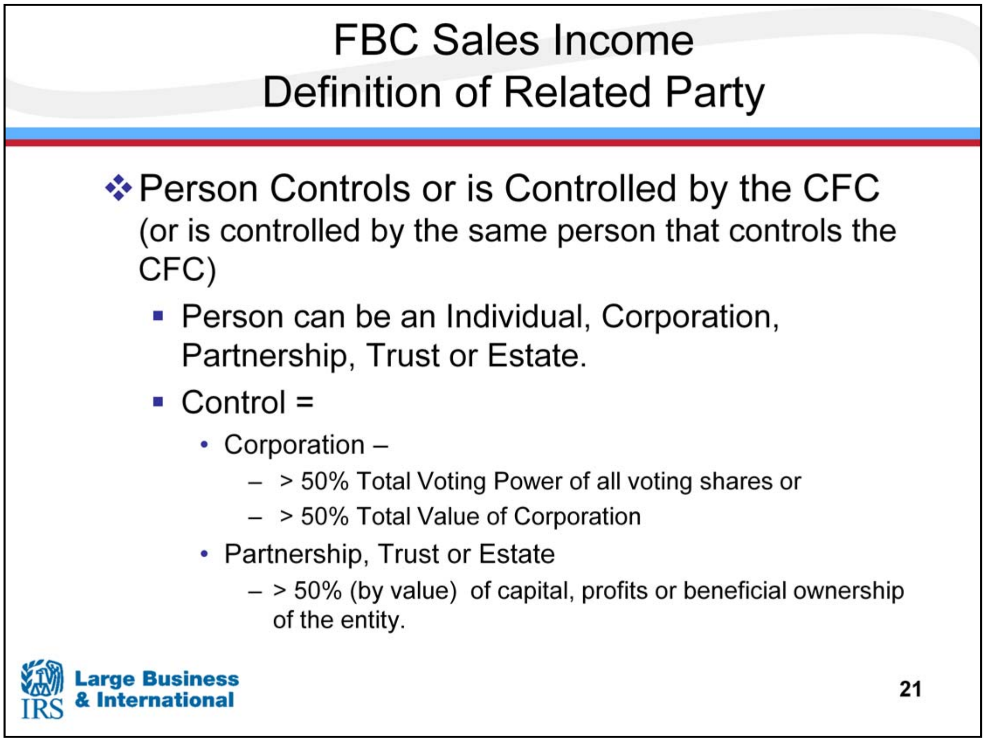


Now on to the Second Category of Subpart F income that we are going to discuss today – Foreign Base Company Sales Income.

Another example of potential abuse that Subpart F is intended to prevent is where U.S. shareholders use their CFCs to **shift sales income** from the U.S. to a foreign jurisdiction or from one foreign jurisdiction to another, to avoid U.S. and/or foreign tax. The foreign base company sales income (FBCSI) rules of Subpart F address this abuse.

When a CFC buys or sells tangible personal property (1) from or to (or on behalf of) a related person and (2) the property is manufactured, produced, constructed, grown, or extracted **outside** the CFC's country of incorporation and (3) the property is purchased/sold for use, consumption or disposition **outside** the CFC's country of incorporation, the income from the sale of the property by the CFC is FBCSI. If **all three of these requirements are met**, the CFC could have foreign base corporation sales income, resulting in the U.S. shareholder(s) of the CFC having a Subpart F inclusion.

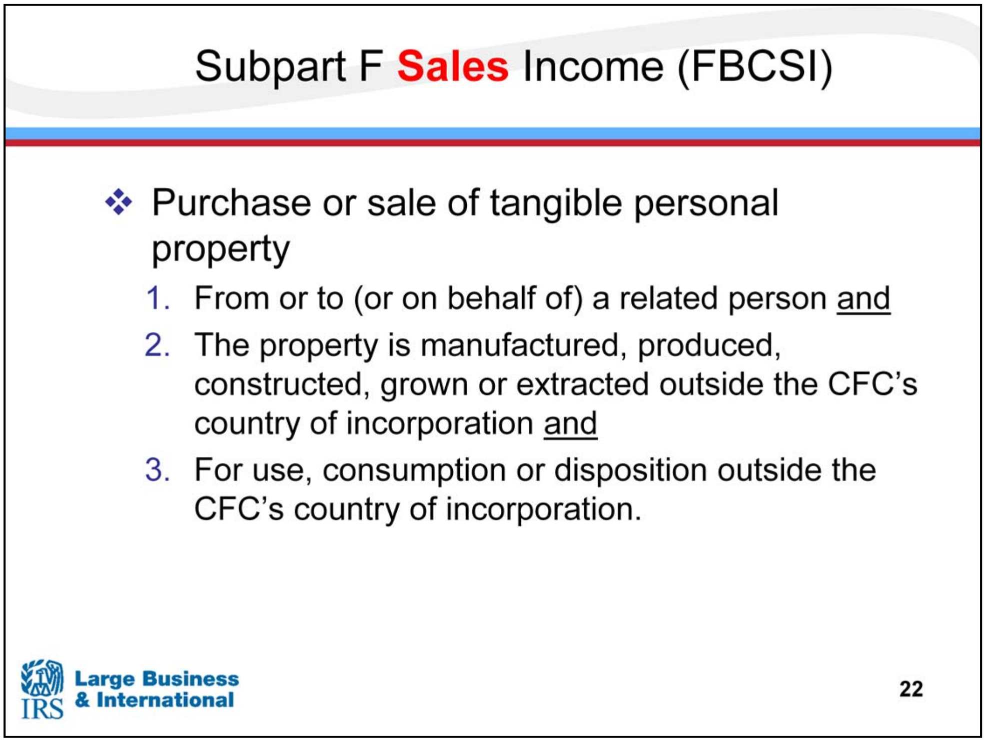
Let's break this down, in a little more detail and then we will look to our example and walk through that. So let's start with looking at criteria #1 – "From or to (or on behalf of) a related person" . Hopefully that should look familiar.



Like I stated this slide should look very familiar. The definition of related party is the same for Foreign Base Company Sales Income as we went over for Foreign Base Company Services Income.

The way that the Code works is that the definition of related party is under the section that covers FBC Sales Income and for FBC Services Income just refers to the IRC section under FBC Sales income that defines related party.

So that part was easy since we already covered it. Now let's look at the requirements again for FBC Sales Income.



We covered the first requirement. There are also **two "location-based" requirements** meaning that the property must be manufactured, produced, constructed, grown or extracted **outside** the CFCs country of incorporation **and** used consumed or disposed of **outside** the country of incorporation. **Hint:** Property that is sold to unrelated persons is generally deemed to be used, consumed or disposed of at the destination specified for delivery, unless the CFC knows or should know otherwise.

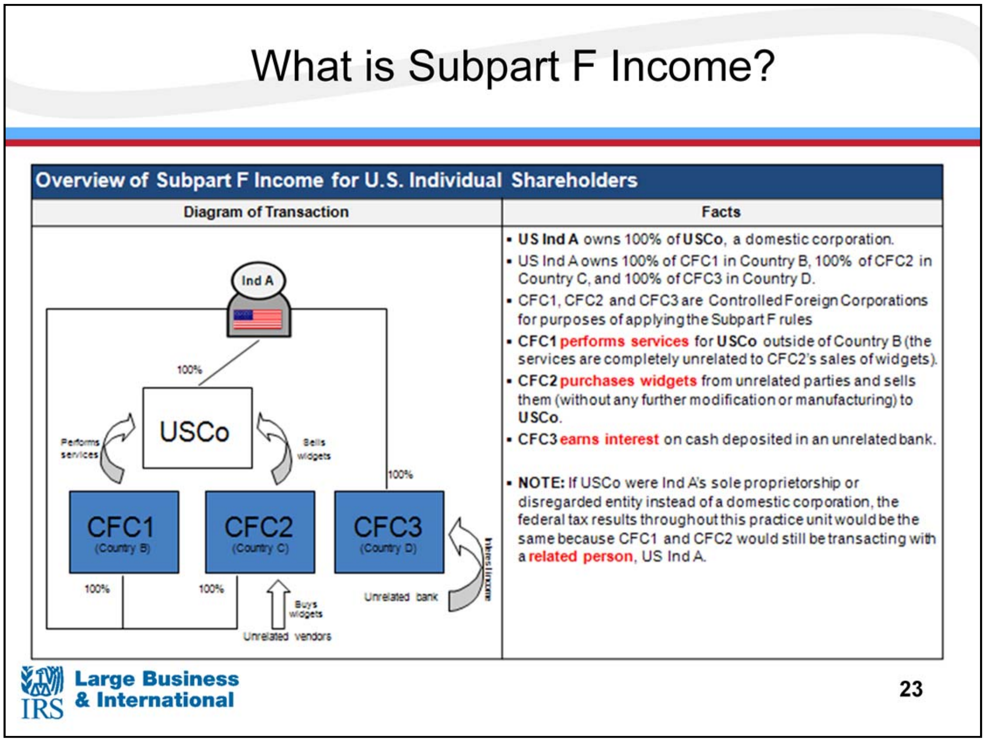
Let's consider the second requirement for income to be FBC Sales Income, which is that the property is manufactured, produced, constructed, grown or extracted outside the CFC's country of incorporation.

There are two manufacturing exceptions relating to FBC Sales Income. First there is a statutory "same-country" manufacturing exception. If the goods sold are manufactured by anyone in the country where the CFC is incorporated, then the sales income is not FBC Sales Income under IRC § 954(d)(1)(A). Second, there is the "CFC manufacturing exception". If the CFC's employees manufacture or construct the property sold (not only in the CFC's country, but anywhere), then the income is **not** FBC Sales Income under Treasury Regulation § 1.954-3(a)(4)(i).

Often determining whether manufacturing has occurred is not clear, but income of a CFC that merely assembles goods manufactured by its parent may not escape classification as FBC sales income. Whether a “**contract manufacturer**” is hired to manufacture a product on behalf of the CFC or US person can be a potential Subpart F issue and will require the examiner to thoroughly understand and review those types of arrangements.

The last requirement is that the tangible personal property must be used, consumed or disposed of outside of the CFC’s country of incorporation.

I want to make you aware that this IPS unit and this training session is just an overview unit of certain types of Subpart F income. It is meant for you to be able to recognize what is Subpart F income and that you might have a Subpart F issue. So let’s say you start your examination, you see the taxpayer has a Form 5471 **for a CFC** that sells goods to a related party, but you aren’t sure how to apply the requirement **of “is** the property manufactured outside the CFC’s country of incorporation?” If that is the case then I highly recommend **that you look** at the Deferral Planning IPN SharePoint site. They have IPS units that **delve more** into this issue of manufacturing requirement under FBC Sales income and that will be an excellent resource for you.



So **now** let's look at our example and the facts for CFC2.

US Ind A owns 100% of CFC2.

It states that CFC2 purchases widgets from an unrelated party and sells them (without any further modifications or manufacturing) to US Co.

Ask Audience "So do we have our first requirement – Purchase or sale of tangible personal property – From or to (or on behalf of) a related person?"

Answer – Yes, Ind A owns 100% of USCo and owns 100% of CFC2 so USCo and CFC2 meet the definition of a related party since they are both controlled by a common person. And CFC2 sells widgets to USCo so CFC2 is selling tangible personal property to a related party.

So there are 2 other requirements – let's look at the list again to remind us of the 2nd requirement before we come back to the facts.

Subpart F Income from Sales

- Purchase or sale of tangible personal property
  1. From or to (or on behalf of) a related person <u>and</u>
  2. The property is manufactured, produced, constructed, grown or extracted outside the CFC's country of incorporation <u>and</u>
  3. For use, consumption or disposition outside the CFC's country of incorporation.

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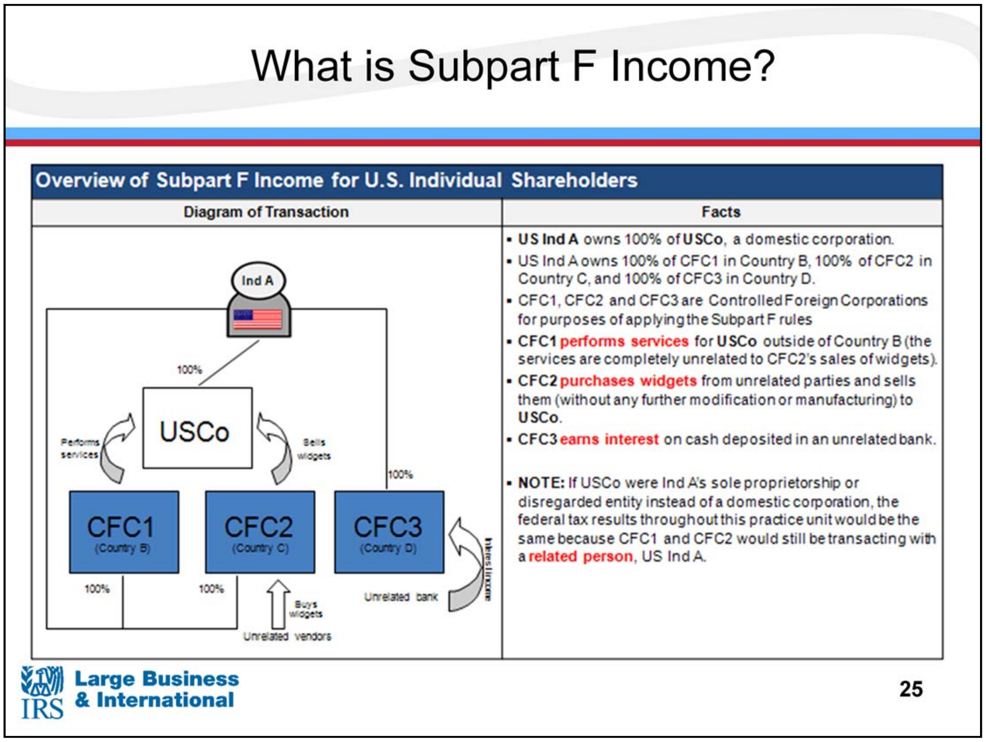
The second requirement is:

The property is manufactured, produced, constructed, grown or extracted outside the CFC's country or incorporation.



So in our example what do we know from the facts about the manufacturing.

We know that CFC**2** doesn't do any modification or manufacturing of the widgets before selling them to USCo.

Ask Audience – "So based on that fact can we conclude that the 2nd item of Foreign Base Company Sales Income is met? Please give us either a "green check mark" for yes or "red X" for no.

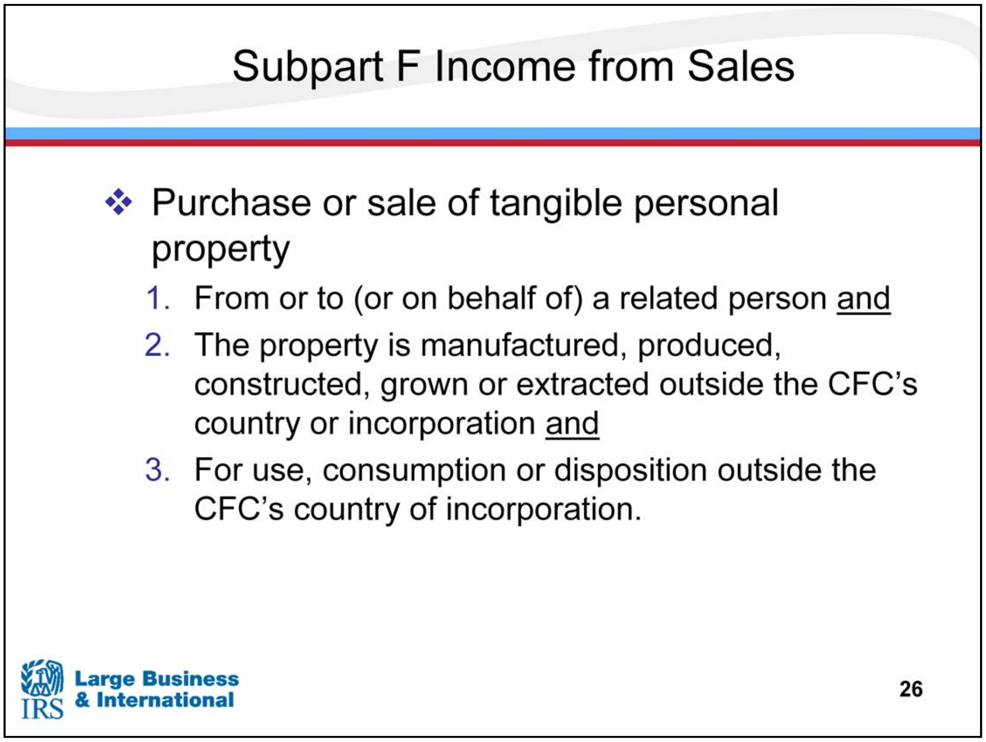
Answer – "No", **we do not know where the widgets were manufactured.** The widgets would have to be manufactured outside of CFC2's country of incorporation which is Country C.

Ask Audience - "So what steps can the agent take to help in making the determination of where the widgets are manufactured?" Can anybody give us an idea of what type of documents we could request?

Answer: Ask for vendor lists, CFC2 purchase documents, VAT returns also might indicate where the goods are manufactured.

Ask Audience – "So we know we have a little more work to do to tie down where the widgets were manufactured. Let's say they were manufactured outside of Country C – have we met all the requirements for Foreign Base Company Sales Income? ? Please give us either a "green check mark" for yes or "red X" for no.

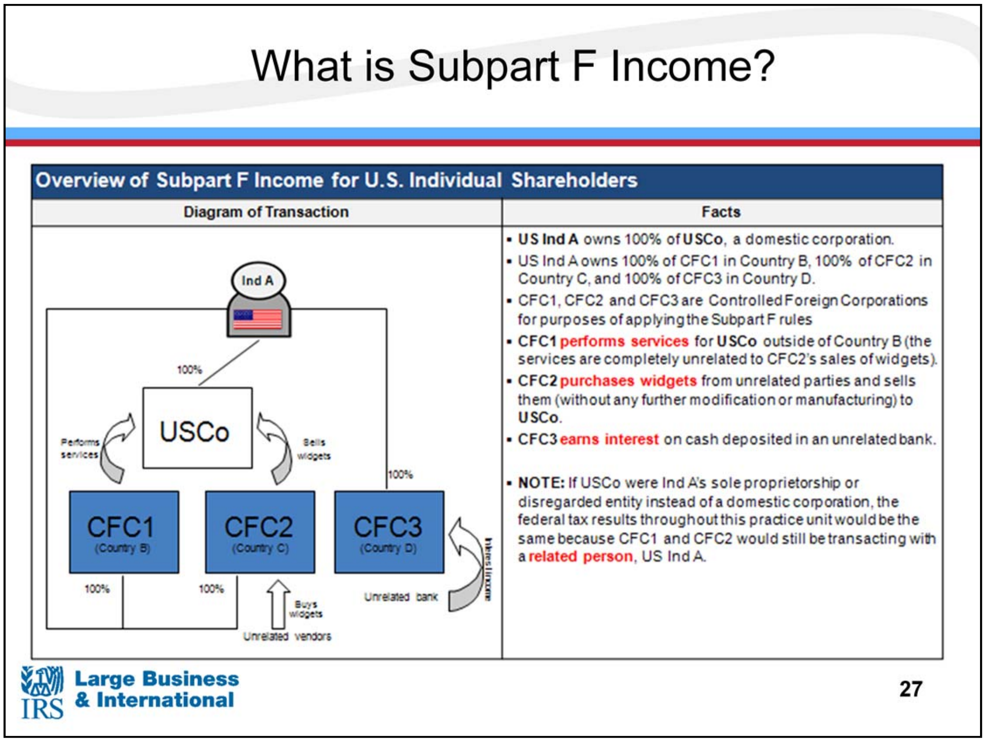
Answer – "No" - we need to meet the last requirement – let's go back to our list of the 3 requirements.



The third requirement is:

For use, consumption or disposition outside the CFC's country of incorporation.

Now let's go back to our example.



So in our example what do we know from the facts about the use or consumption of the widgets. We know that CFC2 sells the widgets to USCo.

Ask Audience – “So based on the facts listed can we conclude that the 3rd requirement for Foreign Base Company Sales Income is met – that the goods are for use, consumption or disposition outside the CFC’s country of incorporation ?”

Answer – “No”, **we do not know where the widgets are being used.**

Ask Audience – “So what steps can the agent take to help in making the determination of where the widgets are being “used, consumed or disposed”? How would you figure out where the widgets are being consumed?

Answer – “find out what USCo does with the widgets. Do they sell the widgets – if so, where are they sold? Are they used in further modification or manufacturing – if so, where is this further modification or manufacturing taking place? You want to ensure that after the widget is sold that it is the end of the line between the manufacturer and the customer.

So let’s look at a summary of our 3 requirements and some documents that we could request that would help us make that determination.

Identifying FBC **Sales** Income

Requirement	Resources
Related Person Requirement	Review organization charts and transaction agreements.
Place of Manufacture Requirement	Review vendor lists, purchase documents, and VAT returns to determine where product was acquired.
Place of Consumption or Use Requirement	Review transaction agreement to determine whether product was sold for use or consumption within country of incorporation.

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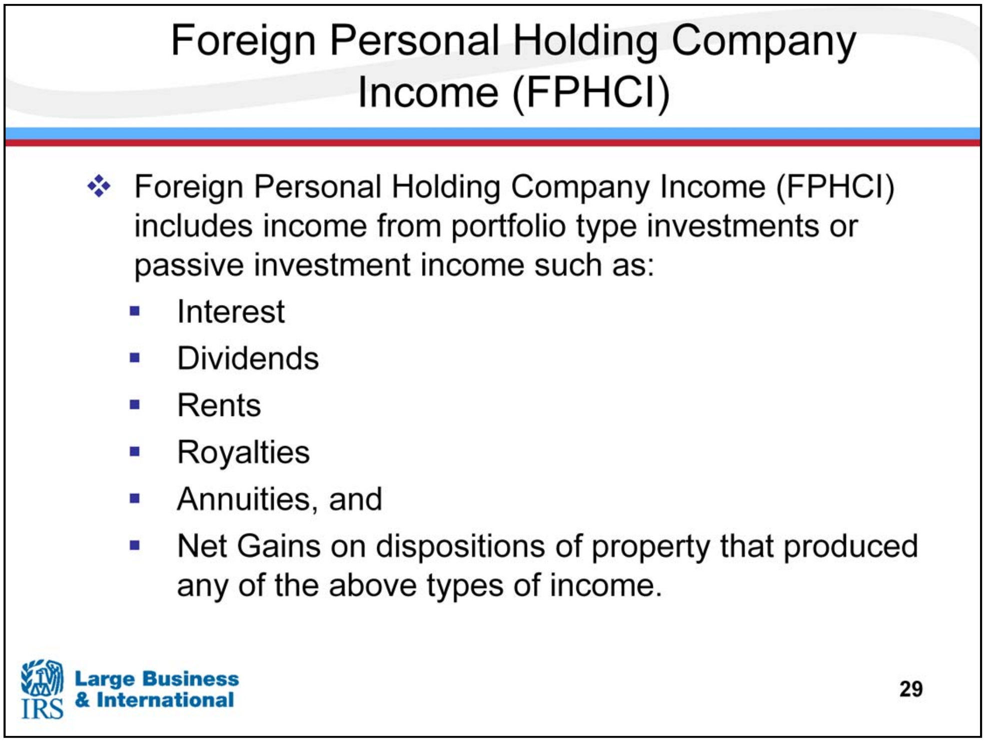
Here is a list of documents that we could request that would help us make that determination.

It is important to note that all three requirements must be met to have Subpart F Income from Sales. If only one requirement is met—there is no FBC sales income

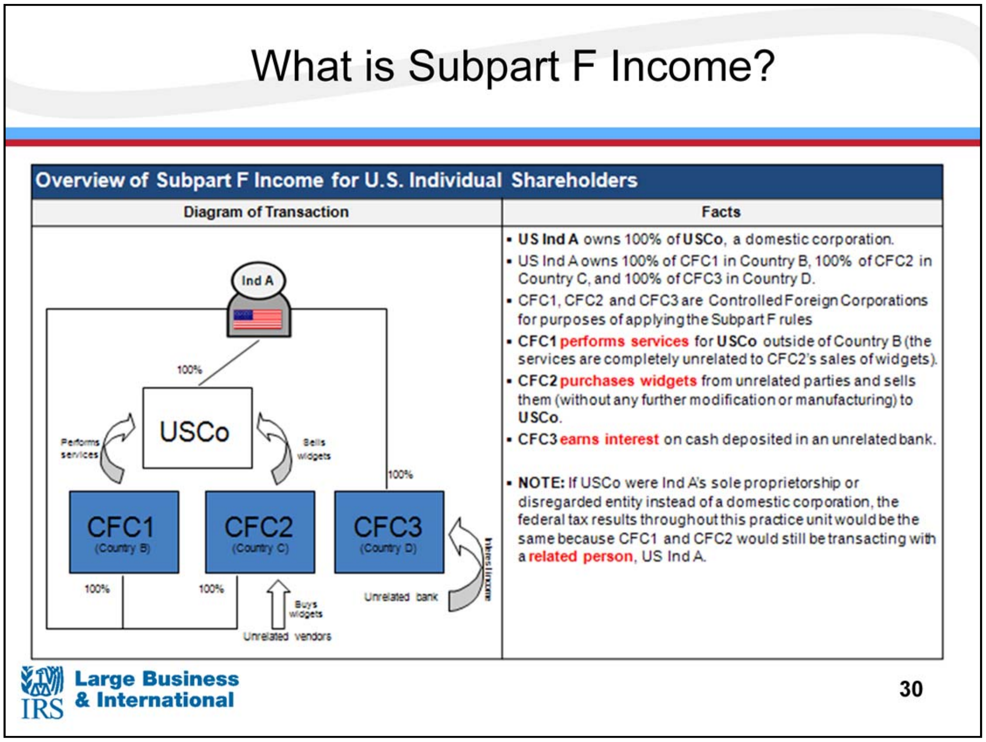
Now time for CPE Question #5



Let's move on to the last type of Subpart F income **that** we are going to talk about during this lesson today which is Foreign Personal Holding Company Income.

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 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. The provisions of Subpart F require a U.S. shareholder to include its **pro-rata share** of the CFC's foreign personal holding company income (FPHCI) in income currently.

FPHCI generally includes a CFC's income from interest, dividends, rents, royalties, annuities, and net gains on dispositions of property producing any of the foregoing types of income.



Let's go back to our beginning example and let's look at CFC3.

CFC3 is owned 100% by US Individual A.

CFC3 earns interest income.

So as simple as that – we have Foreign Personal Holding Company Income, since the CFC earned interest income.

Let's talk a little about, how we would identify foreign personal holding company income during an examination.

Ask the audience "Does anyone have any suggestions?"

After a few answers go to next slide

Identifying FPHCI - **Interest** Income

- Analyze the Form 5471, Schedule C (Income Statement), Line 5 for interest income.
- Request substantiation such as CFC's bank statements to confirm the amount of interest income.
- Request the computation of the Subpart F income and substantiation for any exception(s) claimed.

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How does an examiner that is assigned a Form 1040 with a related CFC determine whether the entity had interest income earned on cash deposited into a bank?

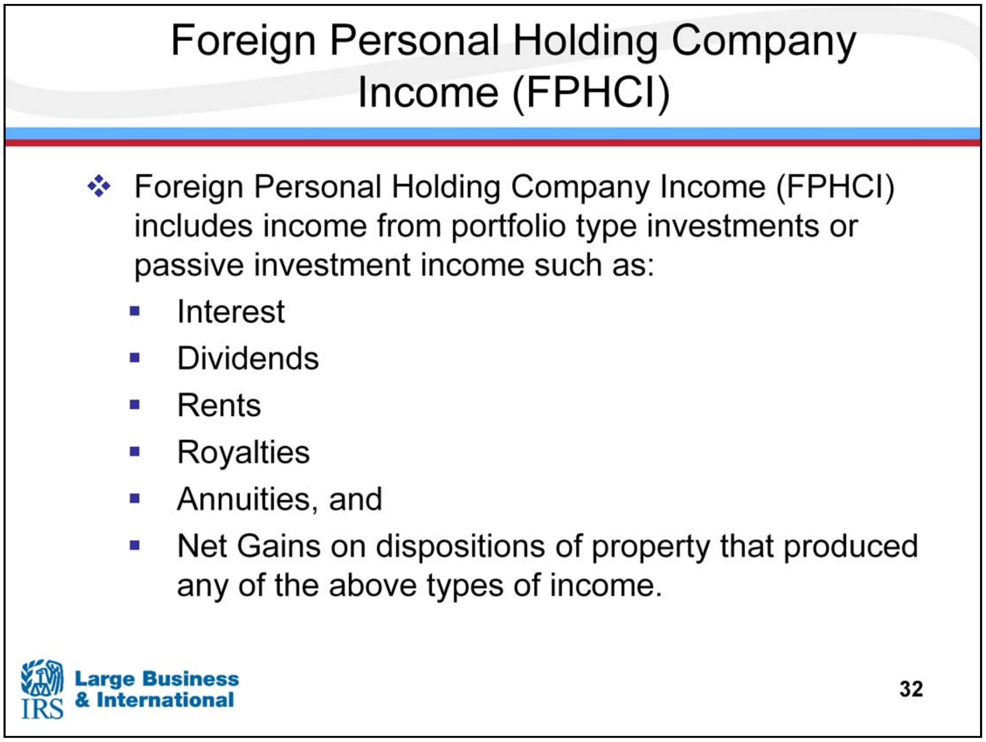
Later, in our Matrix Application Training, we will discuss who has to file a Form 5471.

However in this case, Individual A should have filed a Form 5471 for all three of the CFCs. For this issue, we would look at the **Form 5471 for CFC3.** We would look at Form 5471 **Schedule C,** which is the income statement for CFC3 to see if the taxpayer is reporting the interest income earned by CFC3.

The examiner may **reques**t substantiation such as **CFC3's bank statements** to confirm the amount of interest income. The examiner should **reques**t the **computation of the Subpart F income for CFC3**, as well as substantiation of any exception(s) claimed.

If you have an individual that is a US shareholder of a CFC, then any Subpart F inclusion should be reported on Form 1040 line 21 as "Other Income". Sometimes, preparers put it in other places, so if the taxpayer has stated they had Subpart F income (or, more accurately, that their CFC had subpart F income) and you can't find it on Line 21, you should review Form 1040, Schedule B under interest or dividends as you could find it there.

You should ask the taxpayer or representative where the income is reported if you can't find it.



In this IPS unit we don't delve heavily into Foreign Personal Holding Company Income. In the future, we will be developing an IPS unit that covers this topic in much more detail.

In each of these areas of Foreign Personal Holding Company Income there are exceptions to the general rule that this type of income meets the definition of foreign personal holding company income. That is why in the previous screen we recommended that if the taxpayer is claiming any exception to why the type of income is not Foreign Personal Holding Company income then you should ask the taxpayer for their support. At that time you will need to delve deeper into the topic to see if the taxpayer meets the exceptions. A very common exception that could cause the CFC's income to NOT be FPHCI is the look-thru rule in section 954(c)(6). Westlaw has lots of reference materials on international taxation that you can find and if you research foreign personal holding company income you should be able to find lots of information on point.

[There is also a Centra presentation on FPHCI entitled ""Receipt of Certain Payments by a CFC" that discusses the exceptions to FPHCI posted to the Deferral Planning IPN site that should give you a great start to understanding the exceptions that the taxpayer may be claiming. If you still have questions please consult a Technical Specialist.]

Now, it is time for **CPE** Question #7

Volume	Part	Chapter	Subchapter
Foreign Corporations	Individuals with Investments in a CFC	Taxability of income from the CFC	Subpart F Income

All Issues, Step 1: Initial Factual Development

Overview of Subpart F Income for U.S. Individual Shareholders

Taxpayer may be conducting activities through (or merely booking income to) a CFC to shift profits out of the U.S. into a country with a lower tax rate.

Fact Element	Issue Identification Resources	Issue Identification Resources (Restricted)[1]
US Ind A owns 100% of CFC1, CFC2, and CFC3. The examiner should review the transactions engaged in by the CFCs to determine whether they generate FBCSI, FBC Services Income, or FPHCI (please see next slide for additional information).	▪ Worldwide Tax and Legal Organizational Charts ▪ Contracts containing the critical facts of the transactions ▪ Product Flows and Transaction Flowcharts ▪ Form 5471, Schedule M ▪ Form 1120, Schedule M-3	
? **DECISION POINT: The examiner should review the unrepatriated offshore E&P for each CFC. An inclusion under IRC 951(a) is limited to current E&P.**		

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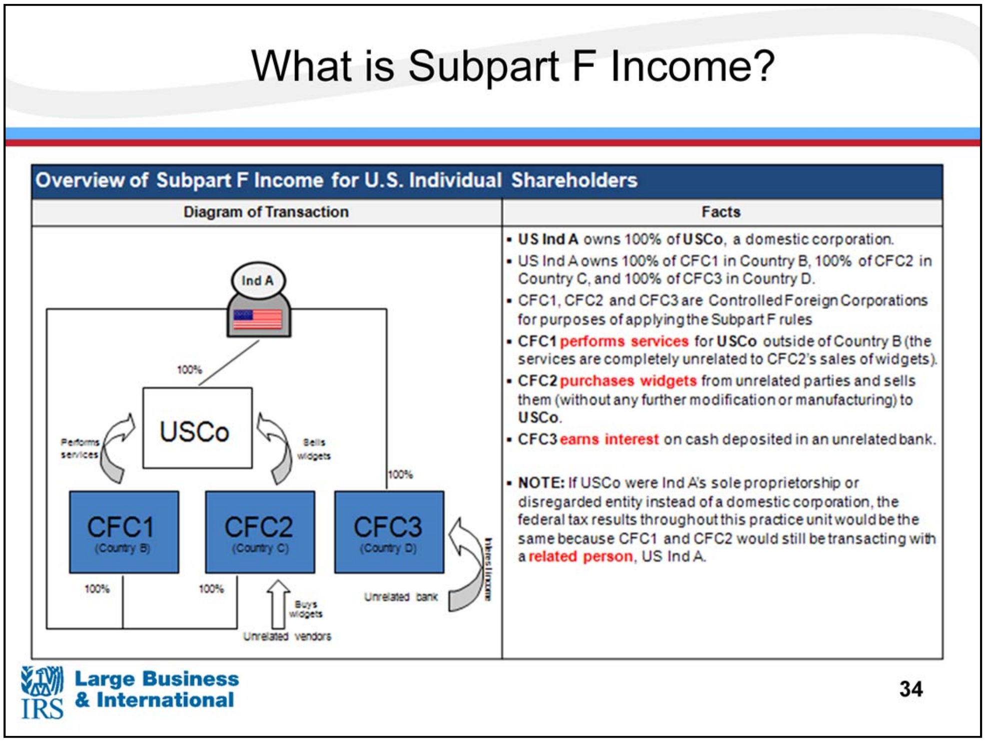
IRS [1]Access to restricted resources is limited to IRS employees on a need to know basis.

In this presentation as we pointed out earlier, we are just doing an Overview of Subpart F Income. We are not covering every aspect of Subpart F income.

One item that we would like to stress at this point is that Subpart F income is limited to the current E&P of the CFC.

For example, let's say you are examining CFC3 in our previous example and it has $100 of interest that would be considered Foreign Personal Holding Company Income, however it has other activities also that creates negative Earnings and Profits for the current year. Since there are no current earnings and profits, CFC3 would not have any Subpart F income for the current year.



Another example of the Current E&P limitation is let's say we are looking at CFC1. As we stated when we went through CFC1 we had determined that CFC#1 had Subpart F income. But let's say that because of all the expenses CFC1 incurred for the year that they actually had a net loss from operations and it resulted in negative current earnings and profits.

Since we have no current earnings and profits then we can't have Subpart F income.

So part of your risk analysis when looking at the Form 5471s to see if you should delve further into the potential Subpart F income issue is looking to see if there is any current E&P.

There are other types of limitations and exclusions that come into play when talking about Subpart F income and what is included in income, but those are beyond the scope of our presentation today and we will covered in a future IPS unit which will be called – **Subpart F Income – Computational Issues**.

Volume	Part	Chapter	Subchapter
Foreign Corporations	Individuals with Investments in a CFC	Taxability of income from the CFC	Subpart F Income

Issue 1, Step 4: Develop Arguments

Overview of Subpart F Income for U.S. Individual Shareholders

Issue 1

Whether A has a Subpart F inclusion as a result of the services performed by CFC1.

Explanation of Approach	References / Resources	Restricted Resources[1]
With respect to the income from services performed for USCo, CFC1 will have FBC Services Income assuming the services are performed outside Country B. Calculate the amount of CFC1's FBC Services Income and A's Subpart F inclusion. A may also make an election under IRC 962 to claim an indirect Foreign Tax Credit (FTC) for foreign income taxes paid by CFC1. *Note: recall that **both** requirements for FBC Services Income must be met. If **either** one of the requirements is missing, the income will **not** be FBC Services Income.*	▪ IRC 954(e) ▪ Treas. Reg. 1.954-4 ▪ BNA 928-3rd-TMFEDPORT No 928 s III - CFCs - Foreign Base Company Income (Other than FPHCI) ▪ "General Subpart F Computational Issues" IPS Unit ▪ "Section 962 – Election by individuals to be taxed at Corporate Rates" IPS Unit	

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IRS [1]Access to restricted resources is limited to IRS employees on a need to know basis.

Step 4 Issue # 1 of this IPS Unit – discusses the transaction of CFC#1 providing services to USCo which we determined generated Foreign Base Company Services Income.

Quick test - does anyone remember why? Please raise your hand and we will pass you the microphone.

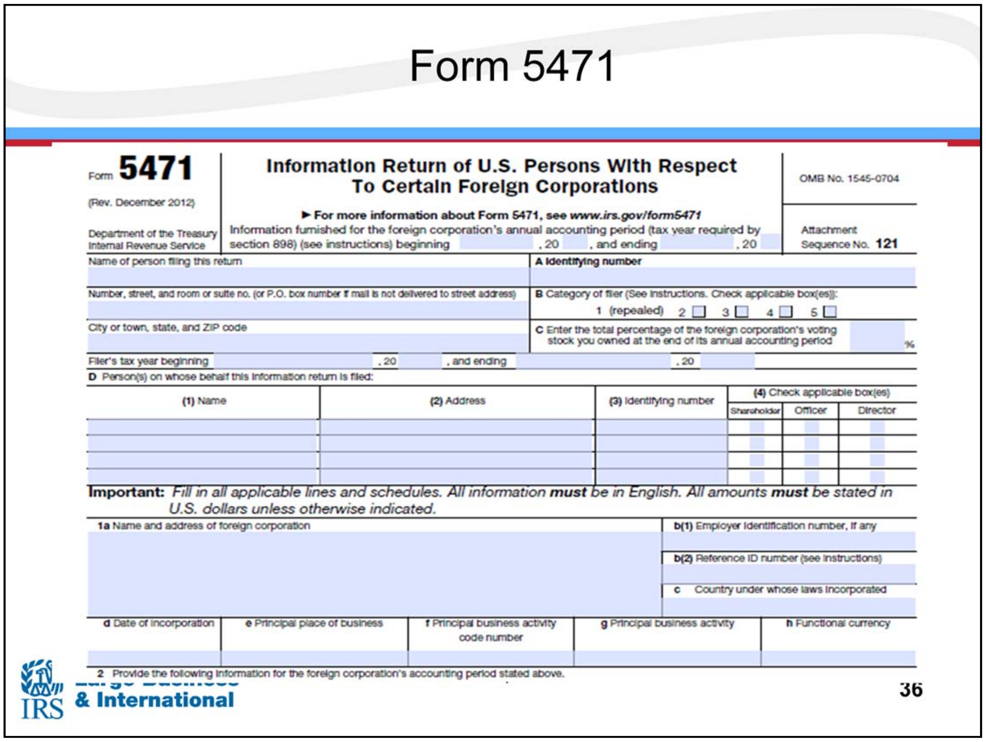
Answer – Services were provided to a related party outside CFC1's country of incorporation.

So the next step, after you determine that you have Subpart F income, is to actually compute the amount of the CFC's Subpart F income and the amount of the US shareholder's Subpart F inclusion. Again, the Subpart F income calculation is beyond the scope of this presentation. As we have previously stated, we plan to develop an IPS unit on some of the computational issues involved in Subpart F Income…. so stay tuned.

Please note, if an individual shareholder would have a Subpart F inclusion, an **election** can be made under **IRC Section 962** to be taxed at corporate rates on his/her Subpart F inclusion which also entitles them to claim indirect foreign tax credits under **IRC Section 960** as if they were a domestic corporation. Again, this topic is also beyond the scope of this lesson but just wanted to make you aware that you might see this.

In fact, you might see this issue in OVDI cases. In the future, we plan to develop an IPS unit that covers this issue.

With the limited time left for this lesson, we would like to cover a couple of items that should help you with identifying potential Subpart F issues on Form 5471. Please refer to the handouts provided to you for this part of the lesson.



This is a snapshot of the top half of the first page of the Form 5471. This page can be useful in that it provides some useful information that if completed correctly by the taxpayer, you may find helpful in trying to identify potential Subpart F Income.

(Use Asterisk to point out certain line items that you are discussing)

Line 1e – it provides **principal place of business**.

Compare that to

Line 1c – which shows **place of incorporation**

If these are two different places then remember one of the key elements of Foreign Base Company Sales Income and Foreign Base Company Services Income is that things are done **outside** the Country of Incorporation, so this could be a sign.

Line 1g will give you the **principal business activity** so you want to look for things like services which could indicate Foreign Base Company **Services** Income, if **sales** are listed – you should consider the possibility of foreign base company sales income, if **investments is listed** it could indicate the possibility of foreign personal holding company income.

Form 5471
Schedule C

Schedule C **Income Statement** (see instructions)

Important: *Report all information in functional currency in accordance with U.S. GAAP. Also, report each amount in U.S. dollars translated from functional currency (using GAAP translation rules). However, if the functional currency is the U.S. dollar, complete only the U.S. Dollars column. See instructions for special rules for DASTM corporations.*

				Functional Currency	U.S. Dollars
Income	1a	Gross receipts or sales	1a		
	b	Returns and allowances	1b		
	c	Subtract line 1b from line 1a	1c		
	2	Cost of goods sold	2		
	3	Gross profit (subtract line 2 from line 1c)	3		
	4	Dividends	4		
	5	Interest	5		
	6a	Gross rents	6a		
	b	Gross royalties and license fees	6b		
	7	Net gain or (loss) on sale of capital assets	7		
	8	Other income (attach statement)	8		
	9	Total income (add lines 3 through 8)	9		
Deductions	10	Compensation not deducted elsewhere	10		
	11a	Rents	11a		
	b	Royalties and license fees	11b		
	12	Interest	12		
	13	Depreciation not deducted elsewhere	13		
	14	Depletion	14		
	15	Taxes (exclude provision for income, war profits, and excess profits taxes)	15		
	16	Other deductions (attach statement—exclude provision for income, war profits, and excess profits taxes)	16		
	17	Total deductions (add lines 10 through 16)	17		
Net Income	18	Net income or (loss) before extraordinary items, prior period adjustments, and the provision for income, war profits, and excess profits taxes (subtract line 17 from line 9)	18		
	19	Extraordinary items and prior period adjustments (see instructions)	19		
	20	Provision for income, war profits, and excess profits taxes (see instructions)	20		
	21	Current year net income or (loss) per books (combine lines 18 through 20)	21		

Form 5471, Schedule C is the income statement. Here you can look on certain line items that might indicate the possibility of Foreign Personal Holding Company Income. Also maybe if you have **cost of goods sold** it could indicate sales or purchases and you might want to follow up. If there are **large labor costs** and **no cost of goods sold** it could indicate the CFC provides **services**. Again all these items are just indications and should be used in your initial risk analysis to determine if further audit steps should be taken.

Form 5471
Schedule H – Current Earnings and Profits

Schedule H **Current Earnings and Profits** (see instructions)
Important: *Enter the amounts on lines 1 through 5c in **functional** currency.*

		Net Additions	Net Subtractions		
1	Current year net income or (loss) per foreign books of account			1	
2	Net adjustments made to line 1 to determine current earnings and profits according to U.S. financial and tax accounting standards (see instructions):				
a	Capital gains or losses				
b	Depreciation and amortization				
c	Depletion				
d	Investment or incentive allowance				
e	Charges to statutory reserves				
f	Inventory adjustments				
g	Taxes				
h	Other (attach statement)				
3	Total net additions				
4	Total net subtractions				
5a	Current earnings and profits (line 1 plus line 3 minus line 4)			5a	
b	DASTM gain or (loss) for foreign corporations that use DASTM (see instructions)			5b	
c	Combine lines 5a and 5b			5c	
d	Current earnings and profits in U.S. dollars (line 5c translated at the appropriate exchange rate as defined in section 989(b) and the related regulations (see instructions))			5d	
	Enter exchange rate used for line 5d ▶				

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Remember a few minutes ago we discussed that in order to have Subpart F income the CFC has to have Current Earnings and Profits. One of the schedules that you want to consider in your risk analysis when determining whether to raise a Subpart F Income issue is Schedule H – which is a schedule of the CFC's current earnings and profits.

Remember though that these forms are just indications, you really need to evaluate the risk potential involved. You might see a large negative Current Earnings and profits but when you look at the schedule you see that Line 1 of this form was positive and that they made an unidentified adjustment to arrive at the negative E&P. So the large adjustment might be incorrect, so you may have current earnings and profits, so you can't always rely solely on the Schedule H to make that evaluation. You need to look at the **Schedule C** along with the **Schedule H** and see what type of risk is involved in the taxpayer's E&P calculation – maybe upon audit you would come to determine what looked like negative E&P at first, is actually a situation of having Current E&P.

Form 5471
Schedule I

Schedule I **Summary of Shareholder's Income From Foreign Corporation** (see instructions)

If item D on page 1 is completed, a separate Schedule I must be filed for each Category 4 or 5 filer for whom reporting is furnished on this Form 5471. This schedule I is being completed for:

Name of U.S. shareholder ▶ Identifying number ▶

1	Subpart F income (line 38b, Worksheet A in the instructions)	1	
2	Earnings invested in U.S. property (line 17, Worksheet B in the instructions)	2	
3	Previously excluded subpart F income withdrawn from qualified investments (line 6b, Worksheet C in the instructions)	3	
4	Previously excluded export trade income withdrawn from investment in export trade assets (line 7b, Worksheet D in the instructions)	4	
5	Factoring income	5	
6	Total of lines 1 through 5. Enter here and on your income tax return. See instructions	6	
7	Dividends received (translated at spot rate on payment date under section 989(b)(1))	7	
8	Exchange gain or (loss) on a distribution of previously taxed income	8	

	Yes	No
• Was any income of the foreign corporation blocked?	☐	☐
• Did any such income become unblocked during the tax year (see section 964(b))?	☐	☐

If the answer to either question is "Yes," attach an explanation.

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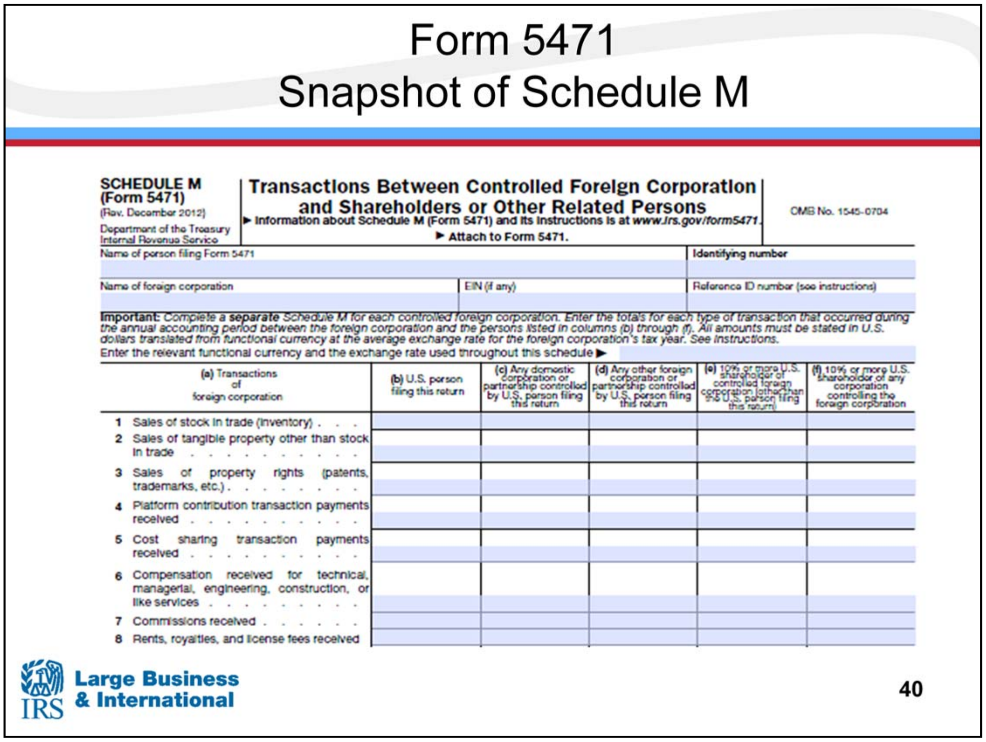
This is the next schedule on the Form 5471 – Schedule I. This is a summary of the shareholder's income from the foreign corporation.

On Form 5471 Schedule I **Line 1** - Here is where the taxpayer self reports their Subpart F Income. As part of your examination, if you cannot determine how the taxpayer arrived at the number on this line, you may want ask the taxpayer to provide you with their original workpapers, to reconcile the amount on this line so you know how the taxpayer arrived at their Subpart F income.



Form 5471
Snapshot of Schedule M

SCHEDULE M (Form 5471)
(Rev. December 2012)
Department of the Treasury
Internal Revenue Service

Transactions Between Controlled Foreign Corporation and Shareholders or Other Related Persons
► Information about Schedule M (Form 5471) and its instructions is at *www.irs.gov/form5471*.
► Attach to Form 5471.

OMB No. 1545-0704

Name of person filing Form 5471		Identifying number
Name of foreign corporation	EIN (if any)	Reference ID number (see instructions)

Important: *Complete a* **separate** *Schedule M for each controlled foreign corporation. Enter the totals for each type of transaction that occurred during the annual accounting period between the foreign corporation and the persons listed in columns (b) through (f). All amounts must be stated in U.S. dollars translated from functional currency at the average exchange rate for the foreign corporation's tax year. See instructions.*

Enter the relevant functional currency and the exchange rate used throughout this schedule ►

(a) Transactions of foreign corporation	(b) U.S. person filing this return	(c) Any domestic corporation or partnership controlled by U.S. person filing this return	(d) Any other foreign corporation or partnership controlled by U.S. person filing this return	(e) 10% or more U.S. shareholder of controlled foreign corporation (other than the U.S. person filing this return)	(f) 10% or more U.S. shareholder of any corporation controlling the foreign corporation
1 Sales of stock in trade (inventory)					
2 Sales of tangible property other than stock in trade					
3 Sales of property rights (patents, trademarks, etc.)					
4 Platform contribution transaction payments received					
5 Cost sharing transaction payments received					
6 Compensation received for technical, managerial, engineering, construction, or like services					
7 Commissions received					
8 Rents, royalties, and license fees received					

Here is a small snap shot of the Form 5471 – **Schedule M**. You can look at your ***handouts*** if you want to look at the entire form. This form is called "transactions between controlled foreign corporation and shareholders or other related persons". So if the taxpayer completes this page correctly, this may lead you to indications of the potential for Subpart F income. It shows transactions between the CFC and other related entities and the transactions include the **sale or purchase of tangible personal property from/to a related party, services provided from/to a related party**. This form would give you indications that you might want to follow up with interview questions, document requests to see if you can develop whether you might have **Foreign Base Company Sales Income or Foreign Base Company Services income**.

Again, I wouldn't necessarily rely on the fact that if this form isn't completed or has all zeros that there aren't any related party transactions, but it should definitely consider it when you are doing a risk analysis.

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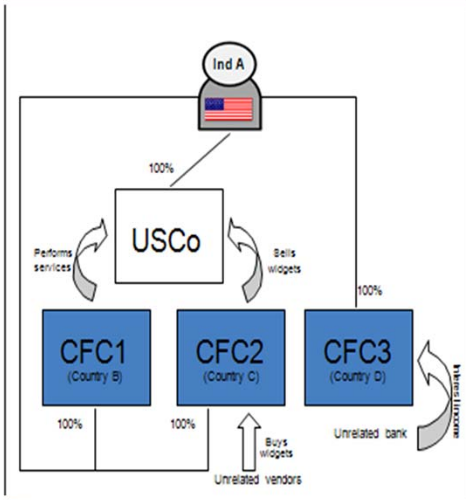
How to Identify potential Subpart F Income



Issue Identification Resources

- Worldwide Tax and Legal Organizational Charts
- Contracts containing the critical facts of the transactions
- Product Flows and Transaction Flowcharts
- Form 5471, Schedule M
- Form 1120, Schedule M-3

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And we already went over this, but here is a list of documents that could help you in your examination.

Now, it is time for our last CPE **Question.**

Training and Additional Resources

Chapter 13.X.X Determination of CFC Status		
Type of Resource	**Descriptions and/or Instructions for Accessing**	**References**
CENTRA sessions	▪ FY2010 IBC CPE Subpart F. The slide decks are located in the Deferral Planning IPN, IPN Resources and there is also a link to the live recording of the Subpart F Centra.	▪ International Current Topics in Subpart F
White Papers / Guidance	▪ Refer to IRM(s) listed at right.	▪ IRM 4.61.7 Controlled Foreign Corporations
Podcasts / Videos	▪ FY2011 CPE with accompanying PowerPoint slides	▪ Training - FY2011 CPE Live Recordings ▪ Training Deferral Planning CPE July 2011

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We are going to go through a couple of the last pages of the IPS unit which covers resources that are available. Please note that there are other resources such as Determination of CFC Status out on the Foreign Entities IPN SharePoint site.

Training and Additional Resources (Cont'd)

Chapter 13.X.X Determination of CFC Status		
Type of Resource	**Descriptions and/or Instructions for Accessing**	**References**
Other Training Materials	▪ IE Phase Training materials and accompanying pre-reads	▪ 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 ▪ Kuntz & Peroni US International Taxation B3.05 ▪ Bittker & Lokken Fundamentals of International Taxation (see references throughout this unit) ▪ BNA Portfolios (see TMFEDPORT references throughout this unit)

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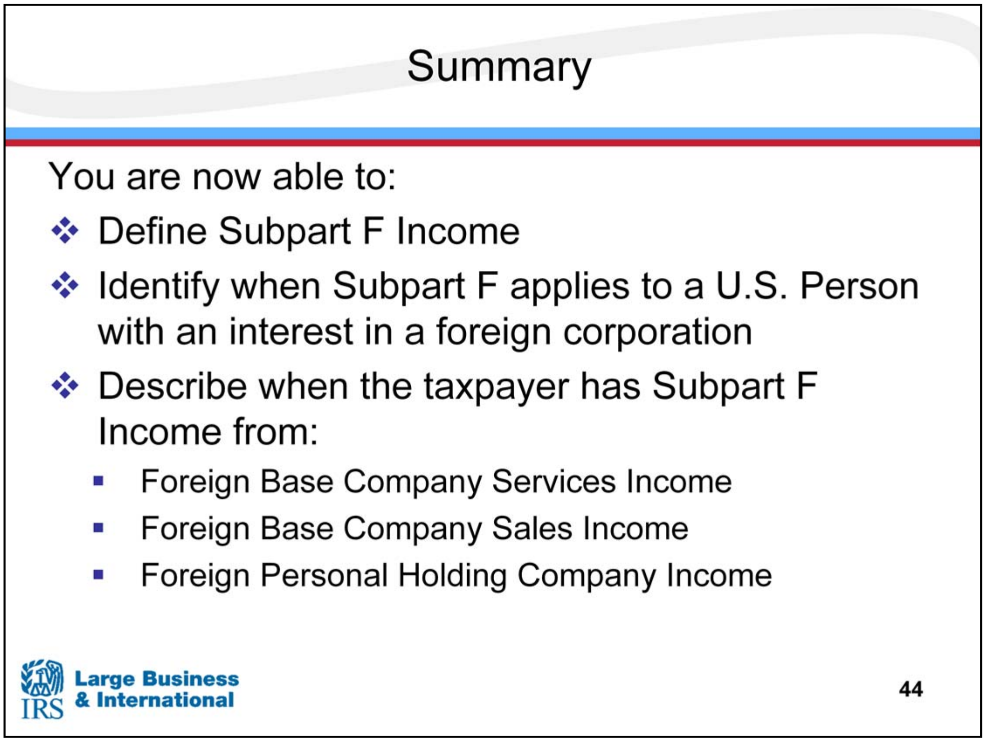
Likewise, there are additional resources available on the FE IPN SharePoint site.



You are now able to:

- ❖Define Subpart F Income
- ❖Identify when Subpart F applies to a US Person with an interest in a foreign corporation
- ❖Describe when the taxpayer has a Subpart F inclusion as a result of its CFC earning:

- Foreign Base Company Services Income
- Foreign Base Company Sales Income
- Foreign Personal Holding Company Income

Any questions?

CPE Question #1 Answer

B. The principal purpose of the Subpart F provisions is to eliminate the deferral of U.S. tax on certain 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.

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The Correct answer is B.

Now let's go to our second CPE Question.

CPE Question #2 Answer

False

The provisions of Subpart F do not tax the CFC. The provisions of Subpart F require a **U.S. shareholder** to include its pro-rata share of the CFC's Subpart F Income in income currently<u>. This amount (the U.S. shareholder's pro-rata share of the CFC's Subpart F income for the taxable year) is referred to as the U.S. shareholder's Subpart F inclusion.</u>

CPE Question #3 Answer

Yes

F is a CFC since owned 51% by D. F performs services outside the country of incorporation (incorporated in Country X and performs construction services in Country Y).

D and F are related since D owns more than 50% of F. F performs services for D, a related party.

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The answer is Yes.

CPE Question #4 Answer

D--All the above

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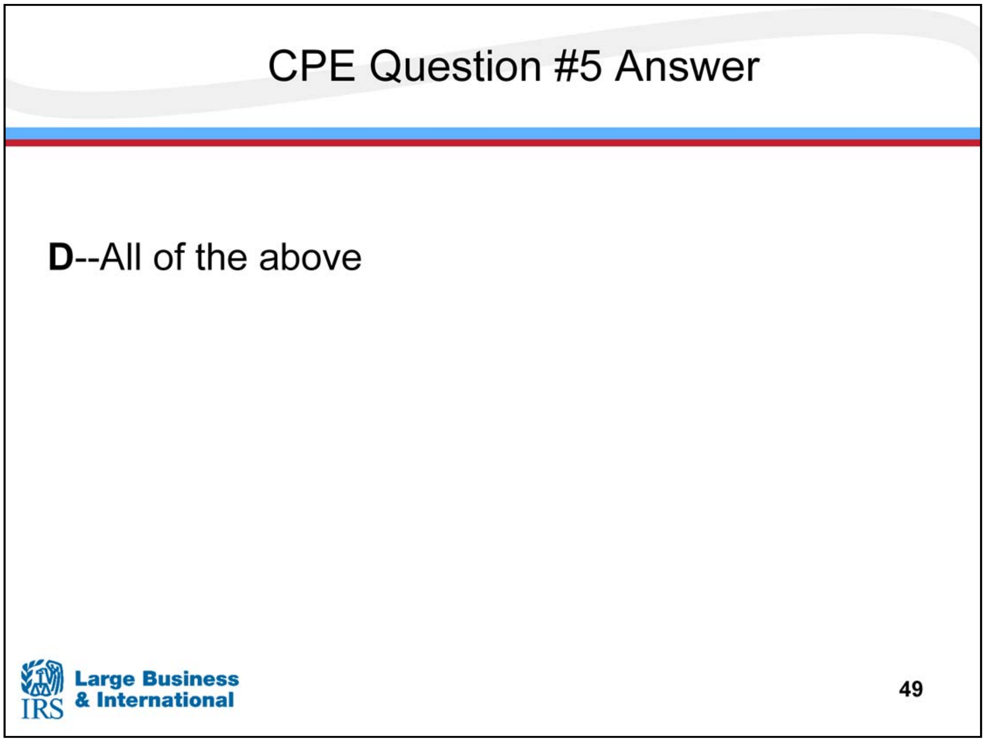
Correct answer is D – all of the above.

The organization chart would help make the determination that USCo and CFC1 are related.

The contractual agreements may in itself help in determine where the services are being performed. If not then the Internal Employee Directories may help in the determination of where the services were performed. Let's say that the services provided were engineering services, the internal employee directory of the CFC could tell you who were the engineers, you could interview the engineers to determine where they performed their work.

Or you could ask for copies of their travel vouchers to determine if the engineers spent time outside the CFC's country of incorporation working on the project.



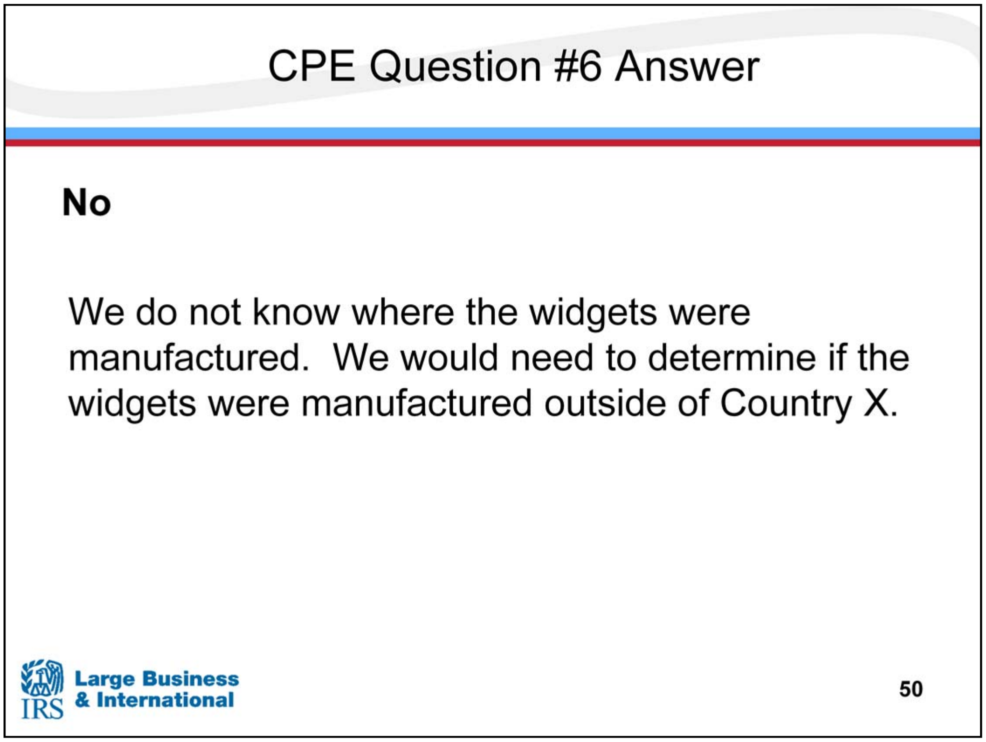
Answer is D – All of the above

The Vendor Lists

The Value Added Tax (VAT) returns to determine where product was acquired

Transaction agreements to determine whether product was sold for use or consumption within the country of incorporation

Will all be helpful in making the determination on whether we have Foreign Base Company Sales Income.



Read Answer.
We do meet the 1st criteria since the widgets were sold to a related party by CFC1 and the 3rd criteria since the widgets were sold for use outside of country X

CPE Question #7 Answer

Yes

The U.S. shareholder is required to include in income currently their pro rata share of the CFC's Foreign Personal Holding Company Income ("FPHCI") or investment income such as dividends, interest, rents, and royalties.

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Read answer and explanation.

CPE Question #8 Answer

False

Subpart F income is limited to Current earnings and profits of the CFC under IRC Section 952(c) (1)(A).

The U.S. Shareholder's Subpart F inclusion under IRC Section 951(a) is his pro rata share of the CFC's Subpart F income for the taxable year.

Read Answer and explanation.