

LB&I International Practice Service Process Unit – Audit

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Part	2.5	General Subpart F Computational Issues	Level 2 UIL	9412.05
Chapter	2.5.1	Computing Subpart F Income	Level 3 UIL	N/A
Sub-Chapter	2.5.1.1	Computing Foreign Base Company Income		

Unit Name	Computing Foreign Base Company Income
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Process Overview

Computing Foreign Base Company Income

Process Description

When a controlled foreign corporation (“CFC”) generates certain kinds of income (for example, Foreign Base Company Income or “FBCI”), the US shareholder(s) of the CFC may have a current inclusion in income, even if the CFC does not distribute any of the income to the US shareholder(s). Computing the FBCI of a CFC involves aggregating the CFC’s Foreign Personal Holding Company Income (“FPHCI”) and Foreign Base Company (“FBC”) sales, services, and oil related income; adjusting the aggregate by applying the de minimis and full inclusion rules; reducing the adjusted income by the deductions properly allocable to such income; and removing any income that is subject to the high tax exception.

Note: after computing FBCI, the examiner can then compute the Subpart F inclusion to the US shareholder(s). Computing Subpart F is discussed in other units that cover concepts such as earnings and profits (“E&P”) limitations, previously taxed income (“PTI”), chain deficit rule, etc. The examiner should also consider the effect of any potentially offsetting foreign tax credit (“FTC”) resulting from the Subpart F inclusion. Computing FTC is also discussed in separate units.

Example Circumstances Under Which Process Applies

- While examining a tax return, the examiner identifies one or more items of income from FPHCI or FBC sales, services, or oil related income, and consequently the examiner will need to apply the steps described in this IPS Process Unit to compute FBCI.

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Determination of Process Applicability

Computing Foreign Base Company Income

As mentioned on the previous slide, computing the FBCI of a CFC involves aggregating its gross items of FBCI and applying the de minimis rule, full inclusion rule, properly allocable deductions, and high tax exception.

Criteria	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Whether the CFC has any items of FPHCI or FBC sales, services, or oil related income. These items may be reported on Form 5471, Schedule C, Lines 3-8 and/or Schedule I, Line 1. 	<ul style="list-style-type: none"> ▪ IRC 954 ▪ Bittker & Lokken Fundamentals of International Taxation 69.5 – 69.8 	

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Summary of Process Steps

Computing Foreign Base Company Income	
Step 1	Aggregate the CFC's FPHCI and FBC sales, services, and oil related income.
Step 2	Apply the de minimis and full inclusion rules.
Step 3	Reduce the income by the properly allocable deductions.
Step 4	Remove any income subject to the high tax exception.

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Step 1

Computing Foreign Base Company Income

Step 1: Aggregate the CFC's FPHCI and FBC sales, services, and oil related income.

The examiner will need to identify the CFC's items of FPHCI and FBC sales, services, and oil related income. These items of income are defined and discussed in various IPS Practice Transaction Units. In the aggregate, they are referred to as "Gross FBCI".

Considerations	Resources	6103 Protected Resources
The examiner should perform the necessary audit steps to confirm the accuracy and completeness of the amounts of FPHCI and FBC sales, services, and oil related income reported on the return in order to determine the correct amount of the CFC's Gross FBCI.	<ul style="list-style-type: none"> ▪ IRC 954(c), (d), (e), & (g) 	
The examiner should evaluate the applicability of any special rules and exceptions for FPHCI and FBC sales, services, and oil related income, such as the same country exception and the CFC manufacturing exception. These and many other special rules and exceptions are covered in detail in other IPS Practice Units.	<ul style="list-style-type: none"> ▪ IRC 954(c)(2), (3) & (6) ▪ IRC 954(h) & (i) ▪ Treas. Reg. 1.954-3(a)(4) ▪ Treas. Reg. 1.954-4(d) 	

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Step 2

Computing Foreign Base Company Income

Step 2: Apply the de minimis and full inclusion rules.

The examiner must apply the de minimis and full inclusion rules in order to compute the “Adjusted Gross FBCI”.

Considerations	Resources	6103 Protected Resources
Under the de minimis rule, if the sum of a CFC’s Gross FBCI and gross insurance income for the tax year is less than the <i>lesser</i> of 5% of gross income or \$1,000,000, then none of the CFC’s gross income for the tax year will be treated as FBCI or insurance income.	<ul style="list-style-type: none"> ▪ IRC 954(b)(3)(A) ▪ Treas. Reg. 1.954-1(b)(1)(i) 	
Under the full inclusion rule, if the sum of a CFC’s Gross FBCI and gross insurance income for the tax year is <i>more than</i> 70% of gross income, then all of the CFC’s gross income for the tax year will be treated as FBCI or insurance income.	<ul style="list-style-type: none"> ▪ IRC 954(b)(3)(B) ▪ Treas. Reg. 1.954-1(b)(1)(ii) 	
The examiner should determine whether the sum of the CFC’s Gross FBCI (computed in Step 1) and gross insurance income (covered in other IPS Practice Units) meets either the de minimis or full inclusion thresholds. If so, the Gross FBCI should be adjusted accordingly to arrive at Adjusted Gross FBCI.	<ul style="list-style-type: none"> ▪ IRC 954(b)(3)(A) & (B) ▪ Treas. Reg. 1.954-1(b)(1)(i) & (ii) 	


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Step 3

Computing Foreign Base Company Income

Step 3: Reduce the income by the properly allocable deductions.

The examiner should evaluate the deductions claimed by the taxpayer to offset FPHCI and FBC sales, services, and oil related income. Those deductions that are properly allocable to such income will reduce Adjusted Gross FBCI to arrive at "Net FBCI".

Considerations	Resources	6103 Protected Resources
The examiner should evaluate the deductions claimed against FBCI in much the same way as deductions claimed against any other type of income (e.g. accuracy, timing, amount, existence, and occurrence of the deduction; whether the deduction is ordinary and necessary; etc.).	<ul style="list-style-type: none"> IRC 162 	
The examiner should evaluate whether the deductions are <i>properly allocable</i> to FBCI, as only those amounts that are properly allocable may reduce Adjusted Gross FBCI to arrive at Net FBCI. For purposes of computing Net FBCI, the allocation of deductions is determined, for the most part, according to the rules used for Foreign Tax Credit (FTC) purposes.	<ul style="list-style-type: none"> IRC 954(b)(5) IRC 904(d) Treas. Reg. 1.954-1(c)(1)(i) 	
 CONSULTATION: The examiner may consult with the FTC Management (IBC) IPN for assistance with the proper allocation and apportionment of deductions.	<ul style="list-style-type: none"> International Issues, Phase II, Module D, FTC Allocation & Apportionment Rules 	

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Step 4

Computing Foreign Base Company Income

Step 4: Remove any income subject to the high tax exception.

The examiner should evaluate whether any items of FPHCI or FBC sales or services income are subject to an effective rate of foreign tax greater than 90% of the highest marginal US tax rate (note that oil related income does not fall under the high tax exception). If so, such income will not be treated as FBCI or insurance income [IRC 954(b)(4)].

Considerations	Resources	6103 Protected Resources
The high tax exception is not mandatory; the taxpayer may elect the exception on an item by item basis. However, if the taxpayer elects the exception for <i>any</i> of its passive FPHCI, the taxpayer must elect the exception for <i>all</i> of its passive FPHCI (i.e. the exception is “all or nothing” with respect to passive FPHCI).	<ul style="list-style-type: none"> ▪ IRC 954(b)(4) ▪ Treas. Reg. 1.954-1(d) 	
The high tax exception does not apply to portfolio interest (described in IRC 881(c)) or to oil related income.	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.954-1(d)(1) 	
When evaluating whether the high tax exception applies, note the examples in the regulation at right assume there are no earnings, deficits, or foreign income taxes in the post-1986 E&P and tax pools. The examiner must consider <i>accumulated</i> earnings and taxes (i.e. the pools) when evaluating the high tax exception (similar to the way IRC 960 computations are prepared).	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.954-1(d)(7)(i) 	

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Other Considerations / Impact to Audit

Computing Foreign Base Company Income		
Considerations	Resources	6103 Protected Resources
The examiner should determine early on in the audit process the total amount of unrepatriated offshore E&P, whether the CFC is engaged in transactions that generate the various categories of FBCI, and whether there are foreign tax credit offsets to any potential inclusion for FBCI. This will allow the examiner to determine the potential tax adjustment net of any offsetting foreign tax credit.	<ul style="list-style-type: none"> ▪ IRC 954(c), (d), (e), & (g) ▪ IRC 952(c) ▪ IRC 904 	
Since FBCI is a component of the potential Subpart F inclusion of the US shareholder, the examiner should review the E&P for each CFC, as a subpart F inclusion is limited to current year E&P. However, in the case of an E&P limitation, the income may be subject to recharacterization as Subpart F income in a future tax period. Computing the Subpart F inclusion (including the rules for E&P limitation and recharacterization) is covered in other units.	<ul style="list-style-type: none"> ▪ IRC 952(c) 	
The examiner should also consider the effect of any potential FTC offsets that may be allowed as a result of the FBCI. Computing FTC is covered in other units.	<ul style="list-style-type: none"> ▪ IRC 904 	

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Training and Additional Resources

Chapter 2.5.1 Computing Subpart F Income

Type of Resource	Description(s) and/or Instructions for Accessing	References
Prerequisite Reading	<ul style="list-style-type: none"> • Online reference 	<ul style="list-style-type: none"> ▪ Concept Practice Unit Subpart F Overview
Internal Revenue Code and Treasury Regulations	<ul style="list-style-type: none"> • Online or hard copy 	<ul style="list-style-type: none"> ▪ IRC 954 ▪ Treas. Reg. 1.954-1
Reference Materials - Treatises	<ul style="list-style-type: none"> ▪ Other reading materials 	<ul style="list-style-type: none"> ▪ Bittker & Lokken Fed. Tax'n Inc, Est and Gift Para 69.1-69.8 ▪ Bittker & Lokken Fed. Tax'n Inc, Est and Gift Para 69.9 ▪ Kuntz & Peroni – U.S. Int'l Tax Para B3.05 ▪ BNA Tax Management Int'l Portfolio 928-3rd Sec. III (CFCs - Foreign Base Company Income (Other than FPHCI))
White Papers / Guidance	<ul style="list-style-type: none"> • Online reference 	<ul style="list-style-type: none"> ▪ IRM 4.61.7

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Glossary of Terms and Acronyms

Acronym	Definition
CFC	Controlled Foreign Corporation
E&P	Earnings and Profits
FBC	Foreign Base Company
FBCI	Foreign Base Company Income
FBCSI	Foreign Base Company Sales Issues
FPHCI	Foreign Personal Holding Company Income
FTC	Foreign Tax Credit
IPG	Industry Practice Group
IPN	International Practice Network
IPS	International Practice Service
IRC	Internal Revenue Code
PTI	Previously Taxed Income

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Index of Related Issues

Issue	Associated UIL(s)	References
9412.05 Computing Subpart F Income	<ul style="list-style-type: none"> ▪ IPS Process Units: Computing Subpart F Income Part I (including E&P limitations, PTI, and basis adjustments); Computing Subpart F Income Part II (including chain deficit rule and special rules for illegal bribes, kickbacks and boycotts) 	
9413 Computing FTC	<ul style="list-style-type: none"> ▪ Consult FTC Management IPN website for units covering the computation of FTC. 	
Foreign Base Company Sales Issues (FBCSI)	9412.01	<ul style="list-style-type: none"> ▪ Various IPS Practice Transaction Units are (or will be) available illustrating the rules and exceptions for FBCSI.
FBC Services	9412.02	<ul style="list-style-type: none"> ▪ Various IPS Practice Transaction Units are (or will be) available illustrating the rules and exceptions for FBC Services.
FPHCI	9412.03	<ul style="list-style-type: none"> ▪ Various IPS Practice Transaction Units are (or will be) available illustrating the rules and exceptions for FPHCI.