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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9008]

RIN 1545-AY45

Guidance Under Subpart F Relating to Partnerships

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations providing guidance under subpart F relating to partnerships. The final regulations are necessary in order to clarify the treatment of a controlled foreign corporation's (CFC) distributive share of partnership income under subpart F. The final regulations will affect United States shareholders of CFCs that have an interest in a partnership.

DATES: Effective Dates: July 23, 2002.

Applicability Dates: For dates of applicability, see § 1.702-1(a)(8)(ii), 1.952-1(g)(3), 1.954-1(g)(4), 1.954-2(a)(5)(v), 1.954-3(a)(6)(iii), 1.954-4(b)(2)(iii), 1.956-2(a)(3).

FOR FURTHER INFORMATION CONTACT: Jonathan A. Sambur, (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

On September 20, 2000, the IRS and Treasury published in the **Federal Register** (65 FR 56836) proposed amendments to the regulations (REG-112502-00) under section 702 and subpart F

of the Internal Revenue Code (Code). Those proposed regulations substantially restated rules in former proposed regulations, REG-104537-97 (63 FR 14613), that were withdrawn in REG-113909-98 (64 FR 37727). Written comments were solicited and a public hearing was scheduled for December 5, 2000. Several comments were received and are discussed below. No public hearing was requested, therefore the hearing was cancelled. After consideration of all the comments, the proposed regulations under section 702 and subpart F are adopted as revised by this Treasury decision.

Summary of Public Comments and Explanation of Revisions

A. §1.702-1(a)(8)(ii) Characterization and Determination of Subpart F Income

Under the proposed regulations, gross income is characterized at the partnership level. If any part of the partnership's gross income is a type of income that would be subpart F income if received directly by partners that are CFCs, that part of the partnership's gross income must be separately taken into account by each partner under section 702. To the extent that the separately stated income results in subpart F income to the CFC partner, it will be taken into account in determining the CFC's total subpart F income for the taxable year.

The proposed regulations under section 702 clarify that an item must be separately taken into account when, if separately taken into account by any partner, the item would result in an income tax liability for that partner, or any other person, different from that which would result if the partner did not take the item into account separately.

One commentator noted that the proposed regulations are inconsistent with section 702(b), which requires that the character and source of an item of gross income be determined at the

partnership level, because the proposed regulations require the determination of subpart F income as if the income had been earned by the CFC. That commentator asserted further that the addition of the phrase “or for any other person” in the first sentence of §1.702-1(a)(8)(ii) goes beyond the regulatory authority provided in section 702(a)(7).

The IRS and Treasury believe there is ample statutory authority for these regulations. The regulations are based upon the authority of subchapter K and subpart F and the policies underlying those provisions. The legislative history of subchapter K provides that, for purposes of interpreting Internal Revenue Code provisions outside of subchapter K, a partnership may be treated as either an entity separate from its partners or an aggregate of its partners, depending on which characterization is more appropriate to carry out the purpose of the particular Internal Revenue Code or regulation section under consideration. H.R. Conf. Rep. No. 2543, 83rd Cong. 2d. Sess. 59 (1954).

To allow a CFC to avoid subpart F treatment for items of income through the simple expedient of receiving them as distributive shares of partnership income, rather than directly, is contrary to the intent of subpart F. Subpart F was intended to limit deferral of U.S. income tax on certain types of income received by CFCs. The IRS and Treasury believe that the approach set out in these regulations (which treats the partnership as an entity for certain purposes and as an aggregate for certain purposes) best achieves the purposes of subpart F and is consistent with the policies underlying subchapter K.

Another commentator stated that the requirement of a separate statement of subpart F income by the partnership would be difficult to administer because a foreign partnership generally is not required to prepare a Schedule K for its foreign partners.

The IRS and Treasury do not believe that applying the rules in the regulations will cause

significant problems. Because the rules of subpart F target certain specific types of income (e.g., passive income, certain income earned from transactions with related persons), the IRS and Treasury believe that, in most cases, either the partnership, the CFC partner, or both, will be able to determine without significant difficulty the income earned by the partnership that must be separately stated by the CFC partner.

B. §1.952-1(g) Treatment of Distributive Share of Partnership Income by a CFC Partner

The proposed regulations clarify that the definition of subpart F income includes a CFC's distributive share of any item of gross income of a partnership to the extent the income would have been subpart F income if received directly by the CFC partner. The proposed regulations apply to all partnership interests owned by CFC partners. In the preamble to the proposed regulations, comments were requested about whether these rules should apply for ownership interests that fall below a minimum threshold. This comment was requested because the IRS and Treasury were considering whether to provide that CFCs with a *de minimis* interest in a partnership should not be subject to the regulations (e.g., by analogy to the 10 percent ownership threshold that is used to determine a U.S. shareholder of a CFC).

One comment was received in response to this request. The commentator suggested that the proposed regulations should apply only to controlling partners, i.e. partners that hold more than a 50 percent interest. The commentator stated further that this result would be consistent with the subpart F ownership rules and would limit the rule to circumstances where the CFC partner could easily obtain the necessary information to determine whether its distributive share was subpart F income.

The commentator's suggestion of limiting the application of these rules to controlled

partnerships was not adopted. The IRS and Treasury do not believe that the objective of the regulations (which, as noted above, is to prevent CFCs from avoiding subpart F by receiving items of income as distributive shares of partnership income, rather than directly) can be achieved by limiting the application of these rules only to controlled partnerships. Further, upon additional consideration, the IRS and Treasury believe that requiring all partnership interests held by a CFC to be subject to the rules of these regulations best effectuates the legislative intent of subpart F and generally should not give rise to significant difficulties for the CFC partner.

C. §1.954-1(g) Test for Activity and Related Persons

Section 1.954-1(g) of the proposed regulations provides that, generally, in determining whether a distributive share of partnership income is subpart F income, whether an entity is a related person and whether an activity takes place in or outside the country under the laws of which the CFC is organized (e.g., for purposes of determining whether the income qualifies for a “same country” exception to subpart F), shall be determined with respect to the CFC partner and not the partnership.

One commentator objected to the rules in §1.954-1(g)(1). This commentator stated that the rule represented a “reverse” application of the aggregate theory of partnerships, and was inconsistent with the principles of subchapter K. The IRS and Treasury disagree with this comment. As noted above, subchapter K contemplates applying either an aggregate theory or an entity theory of partnerships, based on the approach that best serves the underlying purposes of the Code or regulations at issue. For purposes of applying the policies of subpart F, which focus in part on whether income is being shifted between a CFC and a related entity in a different country, the IRS and Treasury believe it is appropriate to make the determination of whether an entity is a related person with respect

to the CFC, and whether an activity takes place in or outside a CFC's country of incorporation, at the CFC partner level.

The IRS and Treasury also have become aware that some uncertainty exists under the proposed regulations with respect to the application of the related person test to certain purchase and sales transactions occurring between a partnership and its CFC partner. Specifically, where a purchase or sales transaction occurs between the partnership and its CFC partner, including sales or purchases on behalf of the CFC by the partnership, the general rule fails to provide guidance on whether the CFC partner's distributive share of the partnership income is derived from a transaction with a related person. As a result, the final regulations add a new rule for purposes of making that determination. In general, the final regulations provide that where the partnership enters into a purchase or sales transaction with the CFC partner, the transaction will be treated as a purchase or sales transaction with a related person where the CFC purchased the property that it sells to the partnership from a person related to the CFC or sells the property that it purchased from the partnership to such a related person. This rule also applies to purchases or sales by the CFC on behalf of a related person.

For example, if a partnership sells goods to its CFC partner that it bought from a person unrelated to the CFC, and the CFC partner then sells the goods to a person related to the CFC partner, the sale of goods by the partnership to the CFC will be treated as the sale of personal property to a related person for purposes of determining whether the CFC's distributive share of the partnership income relating to the sale of goods by the partnership is foreign base company sales income. An example has been included in the final regulations to illustrate this rule. In addition, the final regulations provide that when the CFC partner manufactures property that it sells to the partnership and the CFC

conducts sales or manufacturing activities through a branch, if the CFC's income from the sale of property to the partnership is foreign base company sales income under the branch rule of section 954(d)(2), the partnership's purchase of this property from the CFC will be treated as the purchase of personal property from a related person. The effect of these two rules is to treat the CFC partner's distributive share of the income earned by the partnership as income earned from a related person transaction if it would have been so treated if the CFC had purchased or sold the property directly, rather than through a partnership.

D. §1.954-2(a)(5)(ii) Exceptions Applicable to Foreign Personal Holding Company Income

Section 1.954-2(a)(5)(ii) of the proposed regulations provide that only the activities of, and property owned by, the partnership will be taken into account in determining whether the exceptions from foreign personal holding company income contained in section 954(c)(2), (h) and (i) apply.

One commentator argued that applying §1.954-2(a)(5)(ii) to a CFC with a qualified business unit (QBU) partnership that is seeking to qualify for the active financing exception under section 954(h) produces a result that is inconsistent with the intent of section 954(h). Specifically, section 954(h)(2)(B)(i) provides that a CFC that is engaged in a lending or finance business will be considered an "eligible controlled foreign corporation" for purposes of the active financing exception if the CFC derives more than 70 percent of its gross income directly from the active and regular conduct of a lending or finance business from transactions with unrelated customers. In addition, section 954(h)(3)(B) provides that, in the case of a CFC that conducts a lending or finance business (other than a banking or securities business), no income of the CFC (or QBU of the CFC) will qualify for the active financing exception unless more than 30 percent of the CFC's or QBU's gross income is derived

directly from the active conduct of a financing business from transactions with unrelated customers in the CFC or QBU's home country. The commentator stated that section 954(h) appears to provide that the 70 percent test must be applied at the CFC level based on the CFC's income (including branches and partnerships) and the 30 percent test must be applied at the partnership or QBU level.

The proposed regulations, however, require that the determination of whether the 70 percent test and the 30 percent test are met is based solely by reference to the activities of the partnership. The commentator concluded that the proposed regulations are inconsistent with the two-part test in section 954(h) and that applying the rule of the proposed regulations potentially could place a CFC that conducts a financial services business through a partnership in a significantly worse situation than a CFC that conducts a similar business through a branch or disregarded entity.

In response to this comment, the IRS and Treasury have included a new rule in the final regulations that applies the "eligible controlled foreign corporation" requirement under section 954(h)(2), including the 70 percent test of section 954(h)(2)(B)(i), at the CFC partner level (by including in the gross income of the CFC partner any gross income earned by partnerships or other QBUs of the CFC partner), and applies the qualified banking and financing income test (the 30 percent test) under section 954(h)(3) at the partnership level (by including only the gross income of the partnership). In addition, a new rule has been added under §1.954-2(a)(5)(ii) to clarify that for purposes of applying the special rule for income derived in the active conduct of an insurance business under section 954(i), the exception will apply only if the CFC partner is a qualifying insurance company, as defined in section 953(e)(3) (determined by examining premiums written by the CFC partner and any partnerships or other QBUs of the CFC partner), and the partnership generates qualified insurance

income, as defined in section 954(i)(2) (determined by examining only the income earned by the partnership). Two examples have been included in the final regulations that illustrate the operation of these rules.

Another comment was received suggesting that the proposed regulations inappropriately require the partnership, not the CFC partner, to satisfy the active trade or business tests to qualify for the exceptions to the foreign personal holding company rules. The commentator stated that such a rule allows a purely passive investor in a partnership to qualify for the exceptions, contrary to the purposes of subpart F. The commentator argued that, instead, the regulations should apply the active trade or business tests at the CFC partner level, but should provide a rule that limits the attribution of partnership activities to the CFC partners.

This suggestion was not adopted. In general, the IRS and Treasury believe that the policies underlying subpart F are best served by applying the relevant active trade or business tests at the level of the entity that actually earns the income (i.e., the partnership). As noted above, however, the IRS and Treasury believe that, for purposes of determining whether a CFC qualifies for the active financing exception, applying the 70 percent test of section 954(h)(2) (and determining a CFC's qualification as a qualifying insurance company under section 954(i)(2)) at the CFC partner level is consistent with the statutory language of these provisions and best effectuates the legislative intent behind these provisions.

E. §1.954-4(b)(2)(iii) Application of the Substantial Assistance Rule

The proposed regulations describe how the substantial assistance rules of §1.954-4(b)(1)(iv) apply when the CFC partner earns services income through the partnership. When the partnership is performing services for a person unrelated to the CFC partner, but the CFC partner, or a related

person, provides substantial assistance to the partnership, the CFC partner and the partnership are regarded as separate entities and the substantial assistance provided to the partnership by the CFC partner, or a related person, cause the CFC partner's distributive share of the services income to be treated as foreign base company services income.

Commentators argued that the proposed regulations should not treat the distributive share of the partnership's income as subpart F income if only the CFC partner provides substantial assistance to the partnership because, in that case, under an aggregate theory the CFC does not receive substantial assistance from a related person. This suggestion has not been adopted because the IRS and Treasury believe that excluding the CFC partner from the substantial assistance rule could potentially allow the CFC partner to circumvent the foreign base company service rules with respect to the services it is performing.

Special Analyses

It has been determined that this final regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) and (d) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Jonathan A. Sambur of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2 Section 1.702-1 is amended as follows:

1. Paragraph (a)(8)(ii) is revised.
2. Paragraph (c)(1)(iii) is amended by removing the word “and”.
3. Paragraph (c)(1)(iv) is amended by removing the period at the end and adding “; and” in its place.
4. Paragraph (c)(1)(v) is added.

The addition and revision read as follows:

§1.702-1 Income and credits of partner.

(a) * * *

(8) * * *

(ii) Each partner must also take into account separately the partner's distributive share of any

partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. Thus, if any partner is a controlled foreign corporation, as defined in section 957, items of income that would be gross subpart F income if separately taken into account by the controlled foreign corporation must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from gross income the part of the partner's distributive share which qualifies as earned income, as defined in section 911(b), the earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner. This paragraph (a)(8)(ii) applies to taxable years beginning on or after July 23, 2002.

* * * * *

(c) * * *

(1) * * *

(v) In determining whether the de minimis or full inclusion rules of section 954(b)(3) apply.

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Par. 3. In §1.952-1, paragraph (g) is added to read as follows:

§1.952-1 Subpart F income defined.

* * * * *

(g) Treatment of distributive share of partnership income--(1) In general. A controlled foreign

corporation's distributive share of any item of income of a partnership is income that falls within a category of subpart F income described in section 952(a) to the extent the item of income would have been income in such category if received by the controlled foreign corporation directly. For specific rules regarding the treatment of a distributive share of partnership income under certain provisions of subpart F, see §§1.954-1(g), 1.954-2(a)(5), 1.954-3(a)(6), and 1.954-4(b)(2)(iii).

(2) Example. The application of this paragraph (g) may be illustrated by the following example:

Example. CFC, a controlled foreign corporation, is an 80- percent partner in PRS, a foreign partnership. PRS earns \$100 of interest income that is not export financing interest as defined in section 954(c)(2)(B), or qualified banking or financing income as defined in section 954(h)(3)(A), from a person unrelated to CFC. This interest income would have been foreign personal holding company income to CFC, under section 954(c), if it had received this income directly. Accordingly, CFC's distributive share of this interest income, \$80, is foreign personal holding company income.

(3) Effective date. This paragraph (g) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

Par. 4. In §1.954-1, paragraph (g) is added to read as follows:

§1.954-1 Foreign base company income.

* * * * *

(g) Distributive share of partnership income--(1) Application of related person and country of organization tests. Unless otherwise provided, to determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been subpart F income if received by it directly, under §1.952-1(g), if a provision of subpart F requires a determination of whether an entity is a related person, within the meaning of section 954(d)(3), or whether an activity occurred within or outside the country under the laws of which the controlled foreign corporation is

created or organized, this determination shall be made by reference to such controlled foreign corporation and not by reference to the partnership. (2) Application of related person test for sales and purchase transactions between a partnership and its controlled foreign corporation partner. For purposes of determining whether a controlled foreign corporation's distributive share of any item of gross income of a partnership is foreign base company sales income under section 954(d)(1) when the item of income is derived from the sale by the partnership of personal property purchased by the partnership from (or sold by the partnership on behalf of) the controlled foreign corporation; or the sale by the partnership of personal property to (or the purchase of personal property by the partnership on behalf of) the controlled foreign corporation (CFC-partnership transaction), the CFC-partnership transaction will be treated as a transaction with an entity that is a related person, within the meaning of section 954(d)(3), under paragraph (g)(1) of this section, if--

(i) The controlled foreign corporation purchased such personal property from (or sold it to the partnership on behalf of), or sells such personal property to (or purchases it from the partnership on behalf of), a related person with respect to the controlled foreign corporation (other than the partnership), within the meaning of section 954(d)(3); or

(ii) The branch rule of section 954(d)(2) applies to treat as foreign base company sales income the income of the controlled foreign corporation from selling to the partnership (or a third party) personal property that the controlled foreign corporation has manufactured, in the case where the partnership purchases personal property from (or sells personal property on behalf of) the controlled foreign corporation.

(3) Examples. The application of this paragraph (g) is illustrated by the following examples:

Example 1. CFC, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country A. All of the stock of CFC is owned by USP, a U.S. corporation. Partnership earns commission income from purchasing Product O on behalf of USP, from unrelated manufacturers in Country B, for sale in the United States. To determine whether CFC's distributive share of Partnership's commission income is foreign base company sales income under section 954(d), CFC is treated as if it purchased Product O on behalf of USP. Under section 954(d)(3), USP is a related person with respect to CFC. Thus, with respect to CFC, the sales income is deemed to be derived from the purchase of personal property on behalf of a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC's country of organization, CFC's distributive share of the sales income is foreign base company sales income.

Example 2. (i) CFC1, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country B. CFC2, a controlled foreign corporation organized in Country B, owns the remaining 20 percent interest in Partnership. CFC1 and CFC2 are owned by a common U.S. parent, USP. CFC2 manufactures Product A in Country B. Partnership earns sales income from purchasing Product A from CFC2 and selling it to third parties located in Country B that are not related persons with respect to CFC1 or CFC2. To determine whether CFC1's distributive share of Partnership's sales income is foreign base company sales income under section 954(d), CFC1 is treated as if it purchased Product A from CFC2 and sold it to third parties in Country B. Under section 954(d)(3), CFC2 is a related person with respect to CFC1. Thus, with respect to CFC1, the sales income is deemed to be derived from the purchase of personal property from a related person. Because the property purchased is both manufactured and sold for use outside of Country A, CFC1's country of organization, CFC1's distributive share of the sales income is foreign base company sales income.

(ii) Because Product A is both manufactured and sold for use within CFC2's country of organization, CFC2's distributive share of Partnership's sales income is not foreign base company sales income.

Example 3. CFC, a controlled foreign corporation organized in Country A, is an 80 percent partner in MJK Partnership, a Country B partnership. CFC purchased goods from J Corp, a Country C corporation that is a related person with respect to CFC. CFC sold the goods to MJK Partnership. In turn, MJK Partnership sold the goods to P Corp, a Country D corporation that is unrelated to CFC. P Corp sold the goods to unrelated customers in Country D. The goods were manufactured in Country C by persons unrelated to J Corp. CFC's distributive share of the income of MJK Partnership from the sale of goods to P Corp will be treated as income from the sale of goods purchased from a related person for purposes of section 954(d)(1) because CFC purchased the goods from J Corp, a related person. Because the goods were both manufactured and sold for use outside of Country A, CFC's distributive share of the income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to MJK Partnership will

also be foreign base company sales income.

Example 4. The facts of are the same as Example 3, except that MJK Partnership purchased the goods from P Corp and sold those goods to CFC. CFC sold the goods to J Corp. J Corp sold the goods to unrelated customers in Country C. CFC's distributive share of the income of MJK Partnership from the sale of the goods by the partnership to itself will be treated as income from the sale of goods to a related person, for purposes of section 954(d)(1). Because the goods were both manufactured and sold for use outside of Country A, CFC's distributive share of income attributable to the sale of the goods is foreign base company sales income. Further, CFC's income from the sale of the goods to J Corp is also foreign base company sales income.

(4) Effective date. This paragraph (g) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

Par. 5. In §1.954-2, paragraph (a)(5) is added to read as follows:

§1.954-2 Foreign personal holding company income.

(a) * * *

(5) Special rules applicable to distributive share of partnership income -- (i) [Reserved].

(ii) Certain other exceptions applicable to foreign personal holding company income. To determine the extent to which a controlled foreign corporation's distributive share of an item of income of a partnership is foreign personal holding company income --

(A) The exceptions contained in section 954(c) that are based on whether the controlled foreign corporation is engaged in the active conduct of a trade or business, including section 954(c)(2) and paragraphs (b)(2) and (6), (e)(1)(ii) and (3)(ii), (iii) and (iv), (f)(1)(ii), (g)(2)(ii), and (h)(3)(ii) of this section, shall apply only if any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not

the separate activities or property of the controlled foreign corporation or any other person;

(B) A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(h) unless the controlled foreign corporation is an eligible controlled foreign corporation within the meaning of section 954(h)(2) (taking into account the income of the controlled foreign corporation and any partnerships or other qualified business units, within the meaning of section 989(a), of the controlled foreign corporation, including the controlled foreign corporation's distributive share of partnership income) and the partnership, of which the controlled foreign corporation is a partner, generates qualified banking or financing income within the meaning of section 954(h)(3) (taking into account only the income of the partnership);

(C) A controlled foreign corporation's distributive share of partnership income will not be excluded from foreign personal holding company income under the exception contained in section 954(i) unless the controlled foreign corporation partner is a qualifying insurance company, as defined in section 953(e)(3) (determined by examining premiums written by the controlled foreign corporation and any partnerships or other qualified business units, within the meaning of section 989(a), of the CFC partner), and the partnership, of which the controlled foreign corporation is a partner, generates qualified insurance income within the meaning of section 954(i)(2) (taking into account only the income of the partnership).

(iii) Examples. The application of paragraph (a)(5)(ii) is demonstrated by the following examples:

Example 1. B Corp, a Country C corporation, is a controlled foreign corporation within the

meaning of section 957(a). B Corp is an 80 percent partner of RKS Partnership, a Country D partnership whose principal office is located in Country D. RKS Partnership is a qualified business unit of B Corp, within the meaning of section 989(a). B Corp, including income earned through RKS Partnership, derives more than 70 percent of its gross income directly from the active and regular conduct of a lending or finance business, within the meaning of section 954(h)(4), from transactions in various countries with customers which are not related persons. Thus, B Corp is predominantly engaged in the active conduct of a banking, financing, or similar business within the meaning of section 954(h)(2)(A)(i). B Corp conducts substantial activity with respect to such business within the meaning of section 954(h)(2)(A)(ii). RKS Partnership derives more than 30 percent of its income from the active and regular conduct of a lending or finance business, within the meaning of section 954(h)(4), from transactions with customers which are not related persons and which are located solely within the home country of RKS Partnership, Country D. B Corp's distributive share of RKS Partnership's income from its lending or finance business will satisfy the special rule for income derived in the active conduct of banking, financing, or similar business of section 954(h). B Corp is an eligible controlled foreign corporation within the meaning of section 954(h)(2) and RKS Partnership generates qualified banking or financing income within the meaning of section 954(h)(3). B Corp does not have any foreign personal holding company income with respect to its distributive share of RKS Partnership income attributable to its lending or finance business income earned in Country D.

Example 2. D Corp, a Country F corporation, is a controlled foreign corporation within the meaning of section 957(a). D Corp satisfies the requirements of section 953(e)(3) and is a qualifying insurance company. D Corp is a 40 percent partner of DJ Partnership, a Country G partnership. DJ Partnership is a qualified business unit of D Corp, within the meaning of section 989(a), and is licensed by the applicable insurance regulatory body for Country G to sell insurance to persons other than related persons in its home country within the meaning of section 953(e)(4)(A). DJ Partnership receives income from persons who are not related persons, within the meaning of section 954(d)(3), from investments that satisfy the requirements of section 954(i)(2). D Corp's distributive share of DJ Partnership's income from investments that satisfy the requirements of section 954(i)(2) will not be treated as foreign personal holding company income because D Corp will satisfy the special rule of section 954(i) for income derived in the active conduct of insurance business. DJ Partnership is a qualifying insurance company branch within the meaning of section 953(e)(4) and its income is qualified insurance income within the meaning of section 954(i)(2). D Corp does not have any foreign personal holding company income as a result of its distributive share of DJ Partnership income that is attributable to the partnership's qualifying insurance income.

(iv) [Reserved].

(v) Effective date. This paragraph (a)(5) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

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Par. 6. In §1.954-3, paragraph (a)(6) is added to read as follows:

§1.954-3 Foreign base company sales income.

(a) * * *

(6) Special rule applicable to distributive share of partnership income--(i) In general. To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under §1.952-1(g), the property sold will be considered to be manufactured, produced or constructed by the controlled foreign corporation, within the meaning of paragraph (a)(4) of this section, only if the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person.

(ii) Example. The application of paragraph (a)(6)(i) of this section is illustrated by the following example:

Example. CFC, a controlled foreign corporation organized under the laws of Country A, is an 80 percent partner in Partnership X, a partnership organized under the laws of Country B. Partnership X performs activities in Country B that would constitute the manufacture of Product O, within the meaning of paragraph (a)(4) of this section, if performed directly by CFC. Partnership X, through its sales offices in Country B, then sells Product O to Corp D, a corporation that is a related person with respect to CFC, within the meaning of section 954(d)(3), for use within Country B. CFC's distributive share of Partnership X's sales income is not foreign base company sales income because the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if CFC had earned the income directly.

(iii) Effective date. This paragraph (a)(6) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

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Par. 7. In §1.954-4, paragraph (b)(2)(iii) is added to read as follows:

§1.954-4 Foreign base company services income.

* * * * *

(b) * * *

(2) * * *

(iii) Special rule applicable to distributive share of partnership income. A controlled foreign corporation's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person, within the meaning of section 954(e)(1)(A), if the partnership is a related person with respect to the controlled foreign corporation, under section 954(d)(3), and, in connection with the services performed by the partnership, the controlled foreign corporation, or a person that is a related person with respect to the controlled foreign corporation, provided assistance that would have constituted substantial assistance contributing to the performance of such services, under paragraph (b)(2)(ii) of this section, if furnished to the controlled foreign corporation by a related person. This paragraph (b)(2)(iii) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

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Par. 8. In §1.956-2, paragraph (a)(3) is added to read as follows:

§1.956-2 Definition of United States property.

(a) * * *

(3) Property owned through partnership. For purposes of section 956, if a controlled foreign corporation is a partner in a partnership that owns property that would be United States property, within the meaning of paragraph (a)(1) of this section, if owned directly by the controlled foreign corporation, the controlled foreign corporation will be treated as holding an interest in the property equal to its interest in the partnership and such interest will be treated as an interest in United States property. This paragraph (a)(3) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

David A. Mader,

Acting Deputy Commissioner of Internal Revenue.

Approved: July 16, 2002

Pamela F. Olson,

Acting Assistant Secretary of the Treasury.