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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9240

RIN 1545-BF15

Guidance Under Subpart F Relating to Partnerships

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains final and temporary regulations providing guidance under subpart F relating to partnerships. The temporary regulations add rules for determining whether a controlled foreign corporation's (CFC's) distributive share of partnership income is excluded from foreign personal holding company income under the exception contained in section 954(i). These temporary regulations will affect CFCs that are qualified insurance companies, as defined in section 953(e)(3), that have an interest in a partnership and U.S. shareholders of such CFCs. The text of these temporary regulations also serves as the text of the proposed regulations set forth in the Proposed Rules section in this issue of the **Federal Register**.

DATES: Effective Date: These regulations are effective January 17, 2006.

Applicability Date: For dates of applicability, see §1.954-2T(a)(5)(v).

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Kate Y. Hwa, (202) 622-3840 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR Part 1 relating to the rules under section 954(i) of the Internal Revenue Code (Code) for determining whether a controlled foreign corporation's (CFC's) distributive share of partnership income is excluded from foreign personal holding company income under the exception contained in section 954(i).

Need for Changes

On July 23, 2002, the IRS and the Treasury Department published in the **Federal Register** (TD 9008, 67 FR 48020) final regulations under section 702 and subpart F. Since the publication of TD 9008, the IRS and the Treasury Department have received several comments relating to the rule in the final regulations regarding the application of section 954(i) (special rule for income derived in the active conduct of an insurance business). These temporary regulations modify this rule in response to these comments.

Explanation of Revisions

Section 1.954-2(a)(5)(ii) sets forth special rules for determining the extent to which a CFC's distributive share of an item of income of a partnership is foreign personal holding company income. Section 1.954-2(a)(5)(ii)(C) addresses the exception contained in section 954(i) for income derived in the active conduct of an insurance business. Investment income that is excluded from insurance income as exempt insurance income under section 953(e) may nevertheless be treated as subpart F income if it falls within the definition of foreign personal holding company income under section 954(c) and the exception contained in section 954(i) is not satisfied.

Section 1.954-2(a)(5)(ii)(C) provides that a CFC's distributive share of partnership income is excluded from foreign personal holding company income under the exception contained in section 954(i) only if the CFC is a qualifying insurance company, generally as defined in section 953(e)(3), and the partnership, of which the CFC is a partner, generates qualified insurance income within the meaning of section 954(i)(2), taking into account only the income of the partnership. Qualified insurance income is defined under section 954(i)(2) as income of a qualifying insurance company that is derived from investment of certain of its reserves or surplus if certain other requirements are satisfied.

Commentators expressed concern that §1.954-2(a)(5)(ii)(C) would never permit a CFC's distributive share of partnership income to qualify for the exclusion under section 954(i). Section 7701(a)(3) and the regulations provide that any entity that is an insurance company is treated as a corporation for Federal tax purposes. See Rev. Rul. 83-132 (1983-2 C.B. 270). Thus, any entity engaged in an active insurance business generally would be treated as a corporation and therefore would not be subject to the rule in §1.954-2(a)(5)(ii)(C).

Commentators also distinguished section 954(i) from the other exceptions to foreign personal holding company income in section 954, arguing that those exceptions do not provide the appropriate model for section 954(i). The special rules in the regulations regarding the exception to foreign personal holding company income contained in section 954(c), or the exception for income derived from the active conduct of a banking or similar business contained in section 954(h), turn on whether the income was generated from certain active business activities. In contrast, income that is

excluded under section 954(i) may be generated from purely passive investments as long as the amount of the investments satisfies the requirements set forth in section 954(i). Commentators asked for clarification of the regulations to take into account the purposes of section 954(i).

In response to these comments, these temporary regulations provide that a CFC's distributive share of partnership income will qualify for the exception contained in section 954(i) if the CFC is a qualifying insurance company and the income of the partnership would have been qualified insurance income under section 954(i) if received by the CFC directly. Thus, whether the CFC partner's distributive share of partnership income is qualified insurance income is determined at the CFC partner level.

Special Analyses

It has been determined that this Treasury decision 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) 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, this temporary regulation will be 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 Kate Y. Hwa of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and the Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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 1.954-2 is amended by revising paragraphs (a)(5)(ii)(C) and (a)(5)(iii) Example 2, to read as follows:

§1.954-2 Foreign personal holding company income.

(a) * * *

(5) * * *

(C) [Reserved]. For further guidance, see §1.954-2T(a)(5)(ii)(C).

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(iii) * * *

Example 2. [Reserved]. For further guidance, see §1.954-2T(a)(5)(iii) Example 2.

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Par. 3. Section 1.954-2T is added as follows:

§1.954-2T Foreign personal holding company income (temporary).

(a)(1) through (5)(ii)(B) [Reserved]. For further guidance, see §1.954-2(a)(1) through (5)(ii)(B).

(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 is a qualifying insurance company, as defined in section 953(e)(3), and the income of the partnership would have been qualified insurance income, as defined in section 954(i)(2), if received by the controlled foreign corporation directly. See §1.952-1(g)(1).

(iii) Examples. [Reserved] For further guidance, see §1.954-2(a)(5)(iii).

Example 1. [Reserved] For further guidance, see §1.954-2(a)(5)(iii) Example 1.

Example 2. D Corp, a Country F corporation, is a controlled foreign corporation within the meaning of section 957(a). D Corp is a qualifying insurance company, within the meaning of section 953(e)(3), that is engaged in the business of issuing life insurance contracts. D Corp has reserves of \$100x, all of which are allocable to exempt contracts, and \$10x of surplus, which is equal to 10 percent of the reserves allocable to exempt contracts. D Corp contributed the \$100x of reserves and \$10x of surplus to DJ Partnership in exchange for a 40-percent partnership interest. DJ Partnership is an entity organized under the laws of Country G and is treated as a partnership under the laws of Country G and Country F. DJ Partnership earns \$30x of investment income during the taxable year that is received from persons who are not related persons with respect to D Corp, within the meaning of section 954(d)(3). D Corp's distributive share of this investment income is \$12x. This income is treated as earned by D Corp in Country F under the tax laws of Country F and meets the definition of exempt insurance income in section 953(e)(1). This \$12x of investment income would be qualified insurance income, under section 954(i)(2), if D Corp had received the income directly, because the \$110x invested by D Corp in DJ Partnership is equal to D Corp's reserves allocable to exempt contracts under section 954(i)(2)(A) and allowable surplus under section 954(i)(2)(B)(ii). Thus, D Corp's distributive share of DJ Partnership's income will be excluded from foreign personal holding company income under section 954(i).

(iv) [Reserved].

(v) Effective date. [Reserved]. See §1.954-2(a)(5)(v).

Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: December 13, 2005.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).