

Part III - Administrative, Procedural, and Miscellaneous

Look-thru rule for related controlled foreign corporations

Notice 2007-9

SECTION 1. OVERVIEW

This notice provides guidance under section 954(c)(6) of the Internal Revenue Code (Code) enacted by the Tax Increase Prevention and Reconciliation Act of 2005 and amended by the Tax Relief and Health Care Act of 2006. In general, and subject to certain limitations, section 954(c)(6) provides that dividends, interest, rents, and royalties received or accrued by one controlled foreign corporation (CFC) from another CFC which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable to income of the related person which is neither subpart F income nor income treated as effectively connected with the conduct of a trade or business in the United States (ECI). The provisions of section 954(c)(6) apply to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of the foreign corporations end.

The Internal Revenue Service (IRS) and the Treasury Department intend to issue additional guidance concerning section 954(c)(6). The IRS and the Treasury Department expect to issue regulations that incorporate the guidance provided in this

notice and in any subsequent guidance.

SECTION 2. BACKGROUND

Section 951(a)(1) provides that if a foreign corporation is a CFC for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder of such corporation and who owns stock in such corporation on the last day, in such year, on which such corporation is a CFC shall include in its gross income, for its taxable year in which or with which such taxable year of the corporation ends, its pro rata share of the corporation's subpart F income for such year.

Section 957(a) defines a CFC as any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote, or more than 50 percent of the total value of the stock of such corporation, is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such corporation. Section 951(b) defines a United States shareholder as a United States person who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

Section 952(a)(2) provides that subpart F income includes foreign base company income (FBCI). Subject to certain exceptions, section 954(a)(1) provides that FBCI includes foreign personal holding company income (FPHCI) for the taxable year.

Section 954(c)(1)(A) provides that FPHCI includes dividends, interest, royalties, rents,

and annuities. Section 954(c) also provides special rules and exceptions to the definition of FPHCI (e.g., sections 954(c)(2) and (3)).

Section 103(b) of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA) (P.L. 109-222), enacted on May 17, 2006, added section 954(c)(6) to the Code.

Section 426(a) of Division A of the Tax Relief and Health Care Act of 2006 (P.L. 109-432), enacted on December 20, 2006, made technical corrections to section 954(c)(6).

Section 954(c)(6)(A) provides that for purposes of section 954(c), dividends, interest, rents, and royalties received or accrued from a CFC which is a related person shall not be treated as FPHCI to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is neither subpart F income nor ECI (section 954(c)(6) exception). For this purpose, interest includes factoring income which is treated as income equivalent to interest for purposes of section 954(c)(1)(E). Section 954(c)(6)(A) also provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provision, including regulations to prevent the abuse of the purposes of the provision.

Section 954(c)(6)(B) provides that subparagraph (A) applies to taxable years of foreign corporations beginning after December 31, 2005, and before January 1, 2009, and to taxable years of United States shareholders with or within which such taxable years of the foreign corporations end.

For purposes of section 954(c)(6), a related person has the meaning provided in section 954(d)(3) and Treas. Reg. § 1.954-1(f). The CFCs must be related persons only

at the time the particular dividend, interest, rent, or royalty in question is received or accrued. The section 954(c)(6) exception is not elective, and so applies to all covered transactions.

SECTION 3. DIVIDENDS

For purposes of section 954(c)(6), the term “dividend” has the meaning provided in section 316(a), including any amount treated as a section 301(c)(1) distribution as a result of a redemption described in either section 302 or section 304. That term also includes gains treated as dividends pursuant to sections 964(e) and 356(a)(2).

If a CFC is an exchanging shareholder and includes in income as a deemed dividend the all earnings and profits amount pursuant to Treas. Reg. § 1.367(b)-3(b)(3)(i), such inclusion is not eligible for the section 954(c)(6) exception.

With respect to the types of dividends above that are eligible for the section 954(c)(6) exception, the earnings and profits of the distributing CFC need not be accumulated during a period when it was a CFC, or during a period when the CFC receiving the dividend was a related person. The key requirement in this regard is that the relevant CFCs are related persons at the time the dividend is received.

Dividends are not eligible for the section 954(c)(6) exception to the extent they are distributed out of earnings and profits that are attributable to subpart F income or income that is (or is treated as) ECI. Because of the way the subpart F rules operate, distributions of earnings from a CFC to a related CFC typically will not be attributable to subpart F income for purposes of the section 954(c)(6) exception. Such a distribution will be attributable either to earnings and profits which are, or have been, included in a

United States shareholder's gross income under section 951(a) (i.e., previously taxed income) or, to the extent the distributions are attributable to earnings and profits that are not PTI, to income that is not subpart F income. Dividends that are attributable to income that is (or is treated as) ECI are not eligible for the section 954(c)(6) exception.

SECTION 4. PARTNERSHIPS

If interest is received or accrued from a partnership with one or more partners that are CFCs, such interest will be treated as received or accrued from a CFC for purposes of section 954(c)(6) to the extent that such CFC partner would be treated as the payor of the interest under Treas. Reg. § 1.954-2(b)(4)(i)(B). Similarly, if rents or royalties are received or accrued from a partnership with one or more partners that are CFCs, such rents or royalties will be treated as received or accrued from a CFC for purposes of section 954(c)(6) to the extent that such CFC partner would be treated as the payor of the rents or royalties under Treas. Reg. § 1.954-2(b)(5)(i)(B).

If dividends, interest, rents, or royalties are received by a partnership with one or more partners that are CFCs, such amounts will be treated as received or accrued by a CFC for purposes of section 954(c)(6) to the extent provided under Treas. Reg. §§ 1.702-1(a)(8)(ii), 1.952-1(g), and 1.954-1(g), as applicable.

SECTION 5. ALLOCATION AND ATTRIBUTION RULES FOR INTEREST

This section applies for purposes of determining the extent to which interest is attributable or properly allocable to income of the related person which is neither subpart F income nor ECI.

(a) Interest properly allocable or apportionable to non-subpart F income

Interest is not eligible for the section 954(c)(6) exception to the extent the deduction for the interest payment is allocated and apportioned under section 954(b)(5) and Treas. Reg. § 1.954-1(a)(4) and (c) to reduce the related CFC payor's adjusted gross FBCI (as defined in Treas. Reg. § 1.954-1(a)(3)), adjusted gross insurance income (as defined in Treas. Reg. § 1.954-1(a)(6)), or any other category of income included in subpart F income under section 952(a).

In general, interest that is allocated and apportioned to income that is not subpart F income is eligible for the section 954(c)(6) exception (subject to the rules below for ECI), even if interest deductions exceed the gross income of the related CFC payor in the year paid or accrued. However, interest is not eligible for the section 954(c)(6) exception to the extent interest deductions create (or increase) a deficit which under section 952(c) may reduce the subpart F income of the related CFC payor or another CFC.

(b) Interest properly allocable or apportionable to non-ECI

Interest is not eligible for the section 954(c)(6) exception to the extent the deduction for the interest payment is allocated and apportioned under section 882(c) and Treas. Reg. § 1.882-5, to gross income of the related CFC payor that is (or is treated as) ECI, or as expressly provided by or pursuant to a U.S. income tax treaty or accompanying documents (such as an exchange of notes), is allocated and apportioned to gross income of the related CFC payor that is attributable to a U.S. permanent establishment.

This paragraph applies if, in a single taxable year, the related CFC payor incurs both interest expense that, but for the application of section 5(b) of this notice, is eligible for the section 954(c)(6) exception (section 954(c)(6) interest expense), and other interest expense. In such a case, the amount of interest expense that is treated as allocated and apportioned to gross income of the related CFC payor that is (or is treated as) ECI, or under an applicable treaty, that is allocated and apportioned to gross income of the related CFC payor that is attributable to a U.S. permanent establishment, is the related CFC payor's interest expense for the taxable year multiplied by a fraction equal to the amount of section 954(c)(6) interest expense over the related CFC payor's total interest expense incurred during the taxable year.

Interest is not eligible for the section 954(c)(6) exception to the extent interest deductions create (or increase) a net operating loss carryover that is effectively connected with the conduct of a trade or business within the United States (or that is attributable to a permanent establishment, in the context of an applicable U.S. income tax treaty).

SECTION 6. ALLOCATION AND ATTRIBUTION RULES FOR RENTS AND ROYALTIES

This section applies for purposes of determining the extent to which rents and royalties are attributable or properly allocable to income of the related person which is neither subpart F income nor ECI.

(a) *Rents and royalties properly allocable or apportionable to non-subpart F income*

Rents and royalties are not eligible for the section 954(c)(6) exception to the

extent the deductions for the rent or royalty payments are allocated and apportioned under section 954(b)(5) and Treas. Reg. § 1.954-1(a)(4) and (c) to reduce the related CFC payor's adjusted gross FBCI (as defined in Treas. Reg. § 1.954-1(a)(3)), adjusted gross insurance income (as defined in Treas. Reg. § 1.954-1(a)(6)), or any other category of income included in subpart F income under section 952(a).

In general, rents and royalties that are allocated and apportioned to income that is not subpart F income are eligible for the section 954(c)(6) exception (subject to the rules below for ECI), even if deductions for such amounts exceed the gross income of the related CFC payor in the year paid or accrued. However, rents and royalties are not eligible for the section 954(c)(6) exception to the extent deductions for such amounts create (or increase) a deficit which under section 952(c) may reduce the subpart F income of the related CFC payor or another CFC.

(b) Rents and royalties properly allocable or apportionable to non-ECI

Rents and royalties are not eligible for the section 954(c)(6) exception to the extent the deductions for the rent or royalty payments are allocated and apportioned under section 882(c) and Treas. Reg. § 1.861-8, to gross income of the related CFC payor that is (or is treated as) ECI.

Rents and royalties are not eligible for the section 954(c)(6) exception to the extent deductions for such amounts create (or increase) a net operating loss carryover that is effectively connected with the conduct of a trade or business within the United States.

SECTION 7. ANTI-ABUSE RULES

(a) *Overview*

In addition to the general grant of regulatory authority, section 954(c)(6)(A) specifically grants the Secretary the authority to prescribe regulations to prevent the abuse of the purposes of section 954(c)(6). The transactions described below are abusive of the purposes of section 954(c)(6). However, the IRS and the Treasury Department do not intend this to be an exclusive list of abusive transactions and expect to provide further anti-abuse rules in subsequent guidance. For example, the IRS and the Treasury Department are considering a rule similar to the one described in section 7(d) of this notice for principal purpose domestic partnerships.

(b) *Amounts that reduce the U.S. income tax base, including factoring income*

Transactions abuse the purposes of section 954(c)(6) if they reduce income from the U.S. income tax base by having the net effect of creating a deduction of a payment, accrual, or loss of a person subject to U.S. tax without a corresponding inclusion in the subpart F income of the CFC recipient, where such inclusion would have resulted in the absence of section 954(c)(6).

For purposes of section 954(c)(6), interest includes factoring income which is treated as income equivalent to interest for purposes of section 954(c)(1)(E) and interest described in section 864(d) (collectively, factoring income). However, certain factoring income is not eligible for the section 954(c)(6) exception. Any factoring income derived from a transaction which has the net effect of creating a deduction of a payment, accrual, or loss of a person subject to U.S. tax without a corresponding inclusion in the subpart F income of the CFC recipient, where such inclusion would have

resulted in the absence of section 954(c)(6), is not eligible for the section 954(c)(6) exception. The following example illustrates the application of this paragraph:

Example. (i) Facts. USP, a domestic corporation, owns 100% of the stock of CFC1 and CFC2. USP sells inventory to CFC1 in exchange for receivables. USP sells the CFC1 receivables to CFC2 at a discount, and CFC2 generates income on the collection of the CFC1 receivables.

(ii) Analysis. The income earned by CFC2 on the collection of receivables is related person factoring income as defined in section 864(d) and, therefore, is treated as interest income received on a loan from CFC2 to CFC1. However, because CFC2 acquired the CFC1 receivables from USP at a discount, resulting in a current loss for USP, such interest income is not eligible for the section 954(c)(6) exception.

(c) Avoidance of section 956

If a dividend reduces or eliminates the applicable earnings of a CFC, within the meaning of section 956(b)(1), such that it reduces a U.S. shareholder's inclusion pursuant to section 951(a)(1)(B), the dividend is not eligible for the section 954(c)(6) exception. See also Treas. Reg. § 1.956-1T(b)(4). The following example illustrates the application of this paragraph:

Example. (i) Facts. USP, a domestic corporation, owns 100% of the stock of CFC1 which, in turn, owns 100% of the stock of CFC2. At the beginning of Year 1, at a time when the stock of CFC2 has a value of \$300 and CFC2 has zero applicable earnings (within the meaning of section 956(b)(1)), CFC2 loans \$100 to USP in exchange for a note. During Year 1, CFC2 generates \$100 of non-subpart F earnings and profits. Shortly before the end of Year 1, CFC2 distributes \$100 to CFC1 that results in a \$100 dividend to CFC1 and, as a result, CFC2 takes the position that its applicable earnings under section 956(b)(1) are reduced from \$100 to \$0.

(ii) Analysis. The USP note held by CFC2 is United States property (within the meaning of section 956(c)(1)(C)), and CFC2 generated \$100 of earnings and profits during Year 1. As a result, USP would have an income inclusion of \$100 pursuant to section 951(a)(1)(B), but for the applicable earnings limitation under section 956(b)(1). However, as a result of the Year 1 dividend CFC2 paid to CFC1, CFC2 does not have any applicable earnings and USP, therefore, would not have a section 951(a)(1)(B) inclusion. Thus, the dividend income of CFC1 is not eligible for the section 954(c)(6)

exception.

(d) Use of options or similar interests

When the use of options or similar interests causes a foreign corporation to become a CFC payor, and a principal purpose for the use of the options or similar interests is to qualify dividends, interest, rents, or royalties paid by the foreign corporation for the section 954(c)(6) exception, the dividends, interest, rents, or royalties received or accrued from such foreign corporation will not be treated as being received or accrued from a CFC payor and, therefore, will not be eligible for the section 954(c)(6) exception. For purposes of this paragraph, an interest that is similar to an option includes, but is not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock.

(e) Change of character of income through the use of a conduit entity

When a transaction changes the character of the underlying income, is effected through the use of a conduit entity, and a principal purpose for the use of the conduit entity is to qualify the underlying income for the section 954(c)(6) exception, the dividends, interest, rents, or royalties received or accrued will not be treated as being received or accrued from a related CFC and, therefore, will not be eligible for the section 954(c)(6) exception. The following example illustrates the application of this paragraph:

Example. (i) Facts. USP, a domestic corporation, owns 100% of the stock of CFC1, a country Y corporation, and CFC2, a country Z corporation. FC, a country Z corporation, is not a CFC, but is a related person under section 954(d)(3). In year 1, FC

leases property from CFC1 for \$100. USP causes the rental payment to be made through CFC2. Thus, CFC2 receives a payment from FC that is excluded from FPHCI under section 954(c)(3)(A)(i). CFC2 then makes a payment to CFC1, in satisfaction of the rent owed by FC, which is intended to qualify for the section 954(c)(6) exception. A principal purpose for the involvement of CFC2 in the transaction is to qualify the rental payment from FC to CFC1 as eligible for the section 954(c)(6) exception.

(ii) Analysis. If the rental payment had been made directly from FC to CFC1, it would have been included as FPHCI under section 954(c)(1)(A). By causing the payment to be made through CFC2, USP sought to convert the character of the income from FPHCI to income excluded from FPHCI. However, because a principal purpose of including CFC2 in the transaction as a conduit entity was to avoid inclusion of the rental payment from FC to CFC1 as FPHCI, the payment from CFC2 to CFC1 will be treated as being made from FC to CFC1. Therefore, the payment is not eligible for the section 954(c)(6) exception.

SECTION 8. EFFECTIVE DATE

Sections 3, 4, 5, 6, 7(b) and 7(c) of this notice are effective for taxable years of foreign corporations beginning after December 31, 2005. Sections 7(d) and 7(e) of this notice are effective for taxable years of foreign corporations beginning after December 31, 2006.

SECTION 9. DRAFTING INFORMATION

The principal author of this notice is Paul J. Carlino of the Office of Associate Chief Counsel (International). For further information regarding this notice contact Mr. Carlino at (202) 622-3840 (not a toll-free call).

Request for Comments

Comments may be submitted to CC:PA:LPD:PR (Notice 2007-9), Room 5203, Internal Revenue Service, PO Box 7604, Washington, DC 20044. Submissions may also be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to the Courier=s Desk at 1111 Constitution Avenue, NW., Washington, DC 20224, Attn:

CC:PA:LPD:PR (Notice 2007-9) Room 5203. Submissions may also be sent electronically via the internet to the following email address:

Notice.comments@irscounsel.treas.gov. Include the notice number (Notice 2007-9) in the subject line.