EXHIBIT 3 Continued

ANNUALIZED DIVIDEND YIELDS FOR THE INDICATED QUARTER FOR UTILITIES RETAINED IN THE SAMPLE

YEAR=88 QUARTER=2

TICKER SYMBOL	PRICE, 1ST MONTH OF QRTR-HIGH	PRICE, 1ST MONTH OF QRTR-LOW	PRICE, 2ND MONTH OF QRTR-HIGH	PRICE, 2ND MONTH OF QRTR-LOW	PRICE, 3RD MONTH OF QRTR-HIGH	PRICE, 3RD MONTH OF QRTR-LOW	AVERAGE PRICE	DIVIDENDS: ANNUAL RATE	ANNUALIZED DIVIDEND YIELD
NU	20.250	18.875	19.875	18.500	20.375	18.875	19.458	1.760	9.045
NVP	22.000	20.000	21.125	19.750	21.500	20.125	20.750	1.480	7.133
OEC	19.250	17.250	18.875	17.625	19.000	17.875	18.313	1.960	10.703
OGE	31.125	29.125	32.000	30.125	32.750	31.750	31.146	2.280	7.320
ORU	30.125	28.000	29.375	28.125	31.250	28.750	29.271	2.220	7.584
PCG	16.000	14.250	15.875	14.000	16.125	15.125	15.229	1.920	12.607
PE	19.125	16.875	18.375	16.875	19.000	17.500	17.958	2.200	12.251
PEG	24.000	22.000	23.875	22.000	25.000	23.500	23.396	2.000	8.549
PGN	22.625	21.250	23.500	22.125	24.125	22.250	22.646	1.960	8.655
PNW	28.000	25.000	25.125	22.750	24.875	23.000	24.792	2.800	11.294
POM	22.375	20.875	22.500	20.125	23.125	21.375	21.729	1.380	6.351
PPL	35.375	33.625	36.875	34.500	37.500	35.375	35.542	2.760	7.766
PPW	35.250	33.250	35.375	33.500	37.000	35.000	34.896	2.640	7.565
PSD	19.750	18.250	19.250	18.125	19.750	18.625	18.958	1.760	9.284
PSR	21.750	20.500	22.000	21.250	23.125	21.625	21.708	2.000	9.213
SAJ	24.500	21.750	22.000	20.125	22.750	20.250	21.896	1.400	6.394
SCE	32.000	30.000	33.625	30.500	37.250	32.500	32.646	2.380	7.290
SCG	31.625	30.000	32.875	30.625	33.750	31.625	31.750	2.400	7.559
SDO	32.500	30.625	33.625	30.625	33.875	31.875	32.188	2.600	8.078
SIG	27.250	26.000	28.750	26.250	29.250	27.000	27.417	1.700	6.201
SO	23.375	21.750	23.375	21.750	23.750	22.750	22.792	2.140	9.389
SRP	22.875	21.500	22.125	21.000	23.500	21.875	22.146	1.760	7.947
TE	23.250	21.375	22.500	21.250	24.000	22.625	22.500	1.420	6.311
TEP	58.250	54.750	57.250	54.875	58.625	55.500	56.542	3.900	6.898
TNP	19.000	18.125	19.250	18.500	19.875	19.125	18.979	1.470	7.745
TXU	26.250	24.750	25.875	25.000	27.125	25.125	25.688	2.880	11.212
UCU	19.363	17.770	20.098	18.000	19.375	18.000	18.768	1.040	5.541
UEP	23.875	21.875	23.750	21.750	24.375	22.625	23.042	1.920	8.333
UIL	20.500	19.750	21.750	19.125	23.000	19.500	20.604	2.320	11.260
UTL	30.125	29.250	29.875	28.750	29.250	27.875	29.188	2.040	6.989
UTP	30.750	29.375	31.000	29.875	30.875	27.500	29.896	2.320	7.760
WEC	25.375	23.750	26.250	24.625	27.375	26.000	25.563	1.540	6.024
WPH	45.500	42.625	44.625	43.000	47.125	44.625	44.583	3.240	7.267
WPS	21.875	21.000	22.000	20.625	22.750	21.875	21.688	1.540	7.101
WWP	26.375	24.375	26.875	25.500	28.250	26.375	26.292	2.480	9.433

N= 86

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[T.D. 8216]

Income Taxes; Definition of a Controlled Foreign Corporation and Foreign Personal Holding Company Income of a Controlled Foreign Corporation After December 31, 1986

AGENCY: Internal Revenue Service, Treasury.

ACTION: Temporary and final regulations.

SUMMARY: This document contains temporary Income Tax Regulations relating to the definition of a controlled foreign corporation and the definitions of foreign base company income and foreign personal holding company income of a controlled foreign corporation for taxable years of the foreign corporation beginning after December 31, 1986. These regulations are necessary because of the changes made to the prior law by the Tax Reform Act of 1986. The regulations will provide the public with the guidance needed to comply with that act and would affect United States shareholders of controlled foreign corporations. The temporary regulations set forth in this document also serve as the text of the proposed regulations cross-referenced in the notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register.**

DATES: Effective January 1, 1987.

The temporary regulations apply to the definition of a controlled foreign corporation and the definitions of foreign base company income and foreign personal holding company income of a controlled foreign corporation for taxable years of the foreign corporation beginning after December 31, 1986.

FOR FURTHER INFORMATION CONTACT: Riea M. Lainoff of the Office of Associate Chief Counsel (International), within the Office of the Chief Counsel, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC 20224 (Attention CC:LR:T (INTL-953-86). Telephone (202) 566-6645 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

This regulation is being issued without prior notice and public procedure pursuant to the Administrative Procedure Act (5 U.S.C. 553). For this reason, the collection of information contained in this regulation has been reviewed and, pending receipt and evaluation of public comments, approved by the Office of Management and Budget (OMB) under control number 1545-1068. The estimated average burden associated with the collection of information in this regulation is one hour per respondent.

For further information concerning this collection of information, and where to submit comments on this collection of information and the accuracy of the estimated burden, and suggestions for reducing this burden, please refer to the preamble to the cross-reference notice of proposed rulemaking published elsewhere in this issue of the **Federal Register.**

Background

This document contains temporary regulations amending the Income Tax Regulations (26 CFR Part 1) under sections 954(b), 954(c) and 957(a) of the Internal Revenue Code. Sections 954 and 957 were amended by sections 1201, 1221, 1222 and 1223 of the Tax Reform Act of 1986 (Pub. L. 99-514). These regulations are issued under authority contained in section 7805 of the Internal Revenue Code of 1986.

Discussion

Statutory Provisions

A U.S. shareholder of a controlled foreign corporation is subject to current U.S. taxation on the subpart F income of the foreign corporation. Subpart F income is defined under section 952 and consists of several categories of income. One of the principal categories of subpart F income is foreign base company income, as defined under section 954. Foreign base company income, in turn, consists of several categories of income, also defined under section 954. These categories include foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, and foreign base company oil related income. In general, foreign personal holding company income consists of several types of passive, financial, or otherwise moveable types of income. These include, for example, interest, dividends, rents, royalties, annuities, and gains from various property transactions. The foreign base company sales and services income categories generally include income from activities that are routed through a controlled foreign corporation organized outside the country in which the economic activities occur.

The gross amounts of foreign base company income are subject to several special rules and exceptions under section 954. These include an exception for de minimis amounts of foreign base company income, a full inclusion rule for large amounts of foreign base company income, and an exception for income subject to high foreign taxes. The definition of foreign personal holding company income also includes several exceptions and special rules. These include certain exceptions applicable to transactions engaged in by dealers and commodity merchants, an exception for certain transactions related to the business needs of a controlled foreign corporation, and an exception from certain export financing transactions. Additional exceptions apply to certain active rents and royalties and certain income received from related persons created or organized in the same foreign country as the foreign corporation.

Section 957 defines the term controlled foreign corporation. In general, a foreign corporation is a controlled foreign corporation if more than fifty percent of the total combined voting power or value of its outstanding shares is held by ten percent or greater U.S. shareholders.

1986 Act Changes

Although the provisions of subpart F were first enacted in 1962, the Tax Reform Act of 1986 made significant changes to those provisions. In general, the Act narrowed the exceptions to subpart F income, and added to it certain other types of income that Congress judged to be particularly susceptible to manipulation. New Types of income added to foreign personal holding company income include net gains on sales of property that do not generate active income, net commodities gains, and net foreign currency exchange gains. The prior law exception for certain payments between related persons has been limited by a look-through rule intended to prevent avoidance of subpart F when the related payor itself earned subpart F income. The Act repealed the prior law's exceptions from foreign personal holding company income for interest, dividends, and securities gains of banks and insurance companies.

Due in part to these expansions of Subpart F income, the Act placed increased reliance on the exception that excludes income that is subject to high foreign taxes from subpart F income. This rule is intended to distinguish cases in which a foreign corporation (instead of a U.S. corporation) is utilized for business reasons from those cases in which one is utilized for tax avoidance purposes. The Act therefore replaced the subjective "significant purpose" test that applied under prior law with an objective test to detemine whether income that has been earned through a foreign corporation has in fact been subject to less tax than if it had been earned through a U.S. corporation.

Finally, the definition of a controlled foreign corporation under section 957 was modified by adding to the prior law's voting control test the additional stock-value test. This modification was based on Congress' concern that taxpayers could manipulate the prior test to avoid the provisions of subpart F by sharing voting stock evenly with non-U.S. shareholders while retaining the majority of the value of the foreign corporation in the form of preferred stock or other securities. Congress also considered but did not adopt a reduction of the "more than 50 percent" definition of control to "50 percent or more." Congress' retention of prior law in this regard is said to have been based in part on its understanding that under the provisions of § 1.957–1(b) a foreign corporation effectively controlled by U.S. shareholders will be treated as a controlled foreign corporation.

Summary of Regulation

Because of the substantial modification of the provisions of Subpart F by the Tax Reform Act of 1986, the regulations under section 954 relating to the general definition of foreign base company income and to the definition of foreign personal holding company income have been redrafted in their entirety, and are hereby adopted as temporary regulations §§ 1.954–1T and 1.954–2T, applicable with respect to taxable years of controlled foreign corporations beginning after December 31, 1986. The existing final regulations under section 954 are retained (although redesignated as §§ 1.954A–1 and 1.954A–2) because they remain applicable with respect to taxable years of controlled foreign corporations beginning before January 1, 1987. Similarly, several modifications in the form of temporary regulations are made to the final regulations under section 957.

Section 1.954–1T provides rules concerning the definition and computation of foreign base company income. The regulations first specify the order in which various special rules and exceptions must be applied by providing rules for computing gross, adjusted gross, net, and adjusted net foreign base company income, which is the amount ultimately includible under subpart F. (Certain of these provisions also apply for purposes of computing insurance income under section 953, another category of subpart F income.) In connection with these computational rules, § 1.954–1T(b) provides specific guidance on the application of the de minimis and full inclusion rules of section 954(b)(3) in computing adjusted gross foreign base company income, including an anti-base rule to prevent manipulation of the rules through the use of multiple controlled foreign corporations.

Section 1.954–1T(c) provides rules for allocating and apportioning expenses among various types of adjusted gross foreign base company income and non-foreign base company income in order to compute net foreign base company income. In general, that paragraph references rules in regulations under section 904(d) relating to separate limitations and the foreign tax credit. Section 1.954–1T(c) provides, however, that each category of foreign base company income is not reduced below zero in allocating and apportioning expenses, so that the positive categories of foreign base company income are not effectively reduced by losses in negative categories of foreign base company income. No inference should be drawn from this provision regarding either the application of section 952(c), which limits a controlled foreign corporation's subpart F income by its current earnings and profits, or the apportionment of deductions between Subpart F and other income of a controlled foreign corporation.

Section 1.954–1T(d) provides specific guidance on the application of the high tax exception of section 954(b)(4) in computing adjusted net foreign base company income. To minimize the additional administrative burdens imposed by these rules, they rely to the greatest extent possible on calculations already required for purposes of the foreign tax credit limitation under section 904. Finally, § 1.954–1T(e) provides rules for characterizing income of a controlled foreign corporation, since the categories of income received by a foreign corporation will significantly affect the calculation of its subpart F income, and also provides coordination rules among the various categories of foreign base company income.

Section 1.954–2T provides detailed rules on the calculation of foreign personal holding company income under section 954(c). Rules of general application are set forth in § 1.954–2T(a), including coordination rules among the various categories of foreign personal holding company income, and relevant definitions. Section 1.954–2T(b) provides for the inclusion in foreign personal holding company income of dividends, interest, rents, royalties, and annuities, and provides guidance on the export financing and same country related person exceptions applicable to certain types of such income. Several of these rules are based upon the old regulations, but they have been modified in several ways. In addition, a special rule preserves the character of tax exempt interest received by a controlled foreign corporation, ensuring that such income is exempt from income tax in the hands of a U.S. shareholder (but potentially subject to the alternative minimum tax). Rents received in the active conduct of a trade or business may be excluded from foreign personal holding company income pursuant to the rules set forth in § 1.954–2T(c). Similarly, § 1.954–2T(d) permits the exclusion of royalties received in the active conduct of a trade or business. In both cases the rules provided are based upon the old regulations under section 954, but have been modified in significant ways.

Section 1.954–2T(e) provides guidance concerning the new category of foreign personal holding company income arising from dispositions of property that either produces passive income or does not produce income. Since the amount included in foreign personal holding company income is specifically limited under the Code to the excess of gains over losses, any excess of losses over gains (i.e. a net loss in the category) is definitionally excluded from the computation of foreign personal holding company income and may not reduce any such income in another category. Special rules address the treatment of property that gives rise to more than one type of income, and specify the classification of gain or loss from dispositions of debt instruments and options.

Commodities transactions, another new category of foreign personal holding company income, are addressed by § 1.954–2T(f). The section provides definitions of relevant terms and detailed guidance on the exceptions applicable to certain active business sales and hedging transactions. In general, these exceptions are only available to an active producer, processor, merchant or handler of the commodity in question. Again, because the statutory provisions reaches only the excess of gains over losses, a net loss in this category is not taken into account in computing foreign personal holding company income.

Section 1.954–2T(g) provides rules concerning the new category of gains from foreign currency transactions. Rules are provided concerning the exception for transactions related to the business needs of the controlled foreign corporation. In addition, the regulations provide a simplified alternative to the business needs rule, which permits an election to include in foreign personal holding company income a foreign corporation's net foreign currency gain or loss. This procedure is intended to reduce the administrative burden imposed on corporations that tend to hedge their foreign currency exposures resulting in negligible net gain or loss. Although the definitional limitation generally prevents the inclusion of a net currency loss, pursuant to the regulatory net inclusion election a net currency loss may be taken into account for purposes of computing foreign personal holding company income. Finally, a special rule is provided for qualified business units using the dollar approximate separate transactions method under § 1.985–3T.

Section 1.954–2T(h) provides guidance on the new category of income equivalent to interest. General guidance on the definition of such income is provided, together with specific rules concerning income from factoring receivables, and several examples are set forth. In addition, the regulation specifically excludes income from sales of property from its definition of income equivalent to interest. Finally, rules similar to those of sections 483 and 1274 apply to income from the performance of services where payment is delayed beyond 120 days. Although the legislative history of this provision provides relatively little guidance, the regulation seeks to define the term in a common-sense manner by comparing the income from the transactions in issue with income earned by lending money. Thus, for example, if a foreign corporation buys a note receivable from one person for $95 and 60 days later collects $100 from the obligor, its income would appear to be economically equivalent to the interest income it could have earned by advancing $95 to another person in the form of a loan, to be repaid in 60 days with $5 of interest. In both such cases the foreign corporation has advanced funds to another party, and received in return income attributable to the time value of money and the assumption of the risk of non-payment (and possibly the performance of a collection function). Such transactions are therefore included in income equivalent to interest, together with all transactions that yield a similar flow of income.

Section 1.957–1T modifies paragraph (a) of final regulations § 1.957–1 to conform its provisions to the changes made by the Tax Reform Act of 1986, and specifically to take into account the new stock-value definition of control. The provisions of final regulations § 1.957–1(b) remain unchanged, but two additional examples are added by these temporary regulations to final regulations § 1.957–1(c).

Special Analyses

It has been determined that this temporary rule is not a major rule as defined in Executive Order 12291 and that a Regulatory Impact Analysis is therefore not required. A general notice of proposed rulemaking is not required by 5 U.S.C. 553(b) for temporary regulations. Accordingly, these temporary regulations do not constitute regulations subject to the Regulatory Flexibility Act (5 U.S.C. chapter 6). There is a need for immediate guidance with respect to the provisions contained in this Treasury decision because the provisions of the Internal Revenue Code concerning the definition of a controlled foreign corporation and foreign personal holding company income (sections 954(b), 954(c), and 957(a)) are applicable with respect to United States shareholders of controlled foreign corporations, foreign base company income and foreign personal holding company income of controlled foreign corporations for taxable years of the controlled foreign corporation beginning after December 31, 1986. For this reason, it is found impracticable to issue the regulations with notice and public procedure under subsection (b) of the section 553 of Title 5 of the United States Code or subject to the effective date limitation of subsection (d) of that section.

Drafting Information

The principal author of this regulation is David L. Paul, formerly of the Office of the Associate Chief Counsel (International), Internal Revenue Service. However, personnel from other offices of the Internal Revenue Service and Treasury Department participated in developing the regulations on matters of substance and style.

List of Subjects in 26 CFR Parts 1.861–1 Through 1.997–1

Income taxes, Aliens, Exports, DISC, Foreign investments in U.S., Foreign tax credit, FSC, Sources of income, United States investments abroad.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR Part 1 is amended to read as follows:

Income Tax Regulations

PART 1—[AMENDED]

Paragraph 1. The authority for Part 1 is amended by adding the following citations:

Authority: 26 U.S.C. 7805. * * * Sections 1.954–0T, 1.954–1T, 1.954–2T, and 1.957–1T also issued respectively under 26 U.S.C. 954(b), 954(c), and 957(a). * * *

Par. 2. The following new section is added immediately after § 1.953–6.

§ 1.954–0T Introduction (temporary).

(a) *Effective date.* (1) The provisions of §§ 1.954–1T and 1.954–2T apply to taxable years of a controlled foreign corporation beginning after December 31, 1986. Consequently, any gain or loss (including foreign currency gain or loss as defined in section 988(b)) recognized during such taxable years of a controlled foreign corporation is subject to these provisions.

(2) The provisions of §§ 1.954A–1 and 1.954A–2 apply to taxable years of a controlled foreign corporation beginning before January 1, 1987. All references therein to sections of the Code are to the Internal Revenue Code of 1954 prior to the amendments made by the Tax Reform Act of 1986.

(b) *Outline of regulation provisions for sections 954(b)(3), 954(b)(4), 954(b)(5) and 954(c) for taxable years of a controlled foreign corporation beginning after December 31, 1986.*

(I) *§ 1.954–0T Introduction.*
(a) Effective dates.
(b) Outline.
(II) *§ 1.954–1T Foreign base company income.*
(a) In general.
(1) Purpose and scope.
(2) Definition of gross foreign base company income.
(3) Definition of adjusted gross foreign base company income.
(4) Definition of net foreign base company income.
(5) Definition of adjusted net foreign base company income.
(6) Insurance income definitions.
(7) Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).
(8) Illustration.
(b) Computation of adjusted gross foreign base company income and adjusted gross insurance income.
(1) De minimus rule and full inclusion rule.
(i) In general.
(ii) Five percent de minimus test.
(iii) Seventy percent full inclusion test.
(2) Character of items of adjusted gross foreign base company income.
(3) Coordination with section 952(c).
(4) Anti-abuse rule.
(i) In general.

§ 1.954–1 [Redesignated as § 1.954A–1]

Par. 3. Section 1.954–1 is redesignated as § 1.954A–1.

Par. 4. The following new section is added:

§ 1.954–1T Foreign base company income; taxable years beginning after December 31, 1986 (temporary).

(a) *In general*—(1) *Purpose and scope.* Section 954 (b) through (g) and §§ 1.954–1T and 1.954–2T provide rules for computing the foreign base company income of a controlled foreign corporation. Foreign base company income is included in the subpart F income of a controlled foreign corporation under the rules of section 952 and the regulations thereunder. Subpart F income is included in the gross income of a United States shareholder of a controlled foreign corporation under the rules of section 951 and the regulations thereunder, and thus is subject to current taxation under section 1 or 11 of the Code. The determination of whether a foreign corporation is a controlled foreign corporation, the subpart F income of which is included currently in the gross income of its United States shareholders, is made under the rules of section 957 and the regulations thereunder.

(2) *Gross foreign base company income.* For taxable years of a controlled foreign corporation beginning after December 31, 1986, the gross foreign base company income of a controlled foreign corporation consists of the following categories of gross income:

(i) Its foreign personal holding company income, as defined in section 954(c) and § 1.954–2T,

(ii) Its foreign base company sales income, as defined in section 954(d) and the regulations thereunder,

(iii) Its foreign base company services income, as defined in section 954(e) and the regulations thereunder,

(iv) Its foreign base company shipping income, as defined in section 954(f) and the regulations thereunder, and

(v) Its foreign base company oil related income, as defined in section 954(g) and the regulations thereunder.

(3) *Adjusted gross foreign base company income.* The term "adjusted gross foreign base company income" means the gross foreign base company income of a controlled foreign corporation as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section.

(4) *Net foreign base company income.* The term "net foreign base company income" means the adjusted gross foreign base company income of a controlled foreign corporation reduced so as to take account of deductions properly allocable to such income under the rules of section 954(b)(5) and paragraph (c) of this section. In computing net foreign base company income, foreign personal holding company income is reduced (but not below zero) by related person interest expense before allocating and apportioning other expenses in accordance with the rules of paragraph (c) of this section and § 1.904(d)–5(c)(2).

(5) *Adjusted net foreign base company income.* The term "adjusted net foreign base company income" means the net foreign base company income of a controlled foreign corporation reduced by any items of net foreign base company income for which the high tax exception of paragraph (d) of this section is elected. The term "foreign base company income" as used in the Code and elsewhere in the regulations generally means adjusted net foreign base company income.

(6) *Insurance income definitions.* The term "gross insurance income" includes any item of gross income taken into account in determining insurance income under section 953 and the regulations thereunder. The term "adjusted gross insurance income" means gross insurance income as adjusted by the de minimis and full inclusion rules of paragraph (b) of this section. The term "net insurance income" means adjusted gross insurance income reduced under section 953 and the regulations thereunder so as to take into account deductions properly allocable or apportionable to such income. The term "adjusted net insurance income" means net insurance income reduced by any items of net insurance income for which the high tax exception of paragraph (d) of this section is elected.

(7) *Additional items of adjusted net foreign base company income or adjusted net insurance income by reason of section 952(c).* Earnings and profits of the controlled foreign corporation that are recharacterized as foreign base company income or insurance income under section 952(c) are items of adjusted net foreign base company income or adjusted net insurance income. Thus, they are not included in the gross foreign base company income or gross insurance income of the controlled foreign corporation in computing adjusted gross foreign base company income or adjusted gross insurance income (for purposes of applying the de minimis and full inclusion tests of paragraph (b) of this section).

(8) *Illustration.* The order of computation is illustrated by the following example. Computations in this paragraph (a)(8) and in paragraph (b)(5) of this section involving the operation of section 952(c) are included for purposes of illustration only and do not provide substantive rules concerning the operation of that section.

Example. (i) *Gross income. CFC,* a controlled foreign corporation, has gross income of $1000 for the current taxable year. Of that $1000 of income, $100 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954–2T(b)(1)(ii), is not income from a trade or service receivable described in section 864(d)(1) or (6), and is not excluded from foreign personal holding company income under any provision of section 954(c) and § 1.954–2T. Another $50 is foreign base company sales income under section 954(d) and the regulations thereunder. The remaining $850 of gross income is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g), or 953 and the regulations thereunder, and is foreign source general limitation income described in section 904(d)(1)(I) and the regulations thereunder.

(ii) *Expenses. CFC* has expenses for the current taxable year of $500. Of that $500, $8 is from interest paid to a related person and is allocable to foreign personal holding company income along with $2 of other expense. Another $20 of expense is allocable to foreign base company sales. The remaining $470 of expense is allocable to income other than foreign base company income or insurance income.

(iii) *Earnings and deficits. CFC* has earnings and profits for the current taxable year of $500. In the prior taxable year, *CFC* had losses with respect to income other than gross foreign base company income or gross insurance income. By reason of the limitation provided under section 952(c)(1)(A) and the regulations thereunder, those losses reduced the Subpart F income (consisting entirely of foreign source general limitation income) of *CFC* by $600 for the prior taxable year.

(iv) *Taxes.* Foreign tax of $30 is considered imposed on the interest income under the rules of section 954(b)(4) and paragraph (d) of this section. Foreign tax of $14 is considered imposed on the foreign base company sales income under the rules of section 954(b)(4) and paragraph (d) of this section. Foreign tax of $177 is considered imposed on the remaining foreign source general limitation income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have $500 of subpart F income as defined in section 952(a) (consisting entirely of foreign source general limitation income) determined as follows. The following steps do not illustrate the computation of the subpart F income of a controlled foreign corporation that has income from a trade or service receivable treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

Step 1—Determine gross income:

(1) Gross income	$1000

Step 2—Determine gross foreign base company income and gross insurance income:

(2) Interest income included in foreign personal holding company income under section 954 (c)	100
(3) Foreign base company sales income under section 954(d)	50
(4) Total gross foreign base company income gross insurance income as defined in sections 954(c), (d), (e), (f) and (g) and 953 and the regulations thereunder (line (3) plus line (4))	150

Step 3—Determine adjusted gross foreign base company income and adjusted gross insurance income:

(5) Five percent of gross income (.05 × line (1))	50
(6) Seventy percent of gross income (.70 × line (1))	700
(7) Adjusted gross foreign base company income and adjusted	

gross insurance income after the application of the de minimis test of paragraph (b) (line (4), or zero if line (4) is less than the lesser of line (5) or $1,000,000) 150

(8) Adjusted gross foreign base company income and adjusted gross insurance income after the application of the full inclusion test of paragraph (b) (line (4), or line (1) if line (4) is greater than line (6)) 150

Step 4—Compute net foreign base company income:

(9) Related person interest expense and other expense allocable and apportionable to foreign personal holding company income 10

(10) Deductions allocable and apportionable to foreign base company sales income 20

(11) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (2) or line (7), reduced (but not below zero) by line (9)) 90

(12) Foreign base company sales income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (the lesser of line (3) or line (7), reduced (but not below zero) by line (10)) 30

(13) Total net foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (11) plus line (12)) 120

Step 5—Compute net insurance income:

(14) Net insurance income under section 953 and the regulations thereunder 0

Step 6—Compute adjusted net foreign base company income:

(15) Foreign tax imposed on foreign personal holding company income (as determined under paragraph (d)) 30

(16) Foreign tax imposed on foreign base company sales income (as determined under paragraph (d)) 14

(17) Ninety percent of the maximum U.S. corporate tax rate 30.6

(18) Effective rate of foreign tax imposed on foreign personal holding company income (interest) under section 954(b)(4) and paragraph (d) (line (15) divided by line (11)) 33

(19) Effective rate of foreign tax imposed on $40 of foreign base company sales income under section 954(b)(4) and paragraph (d) (line (16) divided by line (12)) 47

(20) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (11) if line (18) is greater than line (17)) 90

(21) Foreign base company sales income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (12) if line (19) is greater than line (17)) 30

(22) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (13), reduced by the sum of line (20) and line (21)) 0

Step 7—Compute adjusted net insurance income:

(23) Adjusted net insurance income 0

Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):

(24) Earnings and profits for the current year 500

(25) The excess in earnings and profits over subpart F income subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (24) over the sum of lines (22) and (23); if there is a deficit, then the limitation of section 952(c)(1) may apply for the current year) 500

(26) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder 600

(27) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (22), line (23), and the lesser of line (25) or line (26)) 500

(b) *Computation of adjusted gross foreign base company income and adjusted gross insurance income*—(1) *De minimis rule, etc.*—(i) *In general.* If the de minimis rule of paragraph (b)(1)(ii) of this section applies, then adjusted gross foreign base company income and adjusted gross insurance income are each equal to zero. If the full inclusion rule of paragraph (b)(1)(iii) of this section applies, then adjusted gross foreign base company income consists of all items of gross income of the controlled foreign corporation other than gross insurance income, and adjusted gross insurance income consists of all items of gross insurance income. Otherwise, the adjusted gross foreign base company income of a controlled foreign corporation consists of the gross foreign base company income of the controlled foreign corporation, and the adjusted gross insurance income of a controlled foreign corporation consists of the gross insurance income of the controlled foreign corporation.

(ii) *Five percent de minimis test*—(A) *In general.* The de minimis rule of this paragraph (b)(1)(ii) applies if the sum of the gross foreign base company income and the gross insurance income of a controlled foreign corporation is less than the lesser of—

(*1*) 5 percent of gross income, or

(*2*) $1,000,000.

Controlled foreign corporations having a functional currency other than the U.S. dollar shall translate the $1,000,000 threshold using the exchange rate provided under section 989(b)(3) and the regulations thereunder for amounts included in income under section 951(a).

(B) *Coordination with section 864(d).* Gross foreign base company income or gross insurance income of a controlled foreign corporation always includes items of income from trade or service receivables described in section 864(d)(1) or (6), even if the de minimis rule of this paragraph (b)(1)(ii) is otherwise applicable. In that case, adjusted gross foreign base company income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross foreign base company income, and adjusted gross insurance income consists only of the items of income from trade or service receivables described in section 864(d)(1) or (6) that are included in gross insurance income.

(iii) *Seventy percent full inclusion test.* The full inclusion rule of this paragraph (b)(1)(iii) applies if the sum of the foreign base company income and the gross insurance income for the taxable year exceeds 70 percent of gross income.

(2) *Character of items of gross income included in adjusted gross foreign base company income.* The items of gross income included in the adjusted gross foreign base company income of a controlled foreign corporation retain their character as foreign personal holding company income, foreign base company sales income, foreign base company services income, foreign base company shipping income, or foreign base company oil related income. Items of gross income included in adjusted gross income because the full inclusion test of paragraph (b)(1)(iii) of this section is met are termed "full inclusion foreign base company income," and constitute a separate category of adjusted gross foreign base company income for purposes of allocating and apportioning deductions under paragraph (c) of this section.

(3) *Coordination with section 952(c).* Items of gross foreign base company income or gross insurance income that are excluded from adjusted foreign base company income or adjusted gross insurance income because the de minimis test of paragraph (b)(1)(ii) of this section is met are potentially subject to recharacterization as adjusted net foreign base company income or adjusted net insurance income (or other categories of income included in the computation of Subpart F income under section 952 and the regulations thereunder) for the taxable year under the rules of section 952(c). Items of full

inclusion foreign base company income that are included in adjusted gross foreign base company income because the full inclusion test of paragraph (b)(1)(iii) of this section is met, and are included in Subpart F income under section 952 and the regulations thereunder, do not reduce amounts that, under section 952(c), are subject to recharacterization in later years on account of deficits in prior years.

(4) *Anti-abuse rule*—(i) *In general.* For purposes of applying the de minimis and full inclusion tests of paragraph (b)(1) of this section, the income of two or more controlled foreign corporations shall be aggregated and treated as the income of a single corporation if one principal purpose for separately organizing, acquiring, or maintaining such multiple corporations is to avoid the application of the de minimis or full inclusion requirements of paragraph (b)(1) of this section. For purposes of this paragraph (b), a principal purpose need not be the purpose of first importance.

(ii) *Presumption.* Two or more controlled foreign corporations are presumed to have been organized, acquired or maintained to avoid the effect of the de minimis and full inclusion requirements of paragraph (b)(1) of this section if the corporations are related persons as defined in subdivision (iii) of this paragraph (b)(4) and the corporations are described in subdivision (A), (B), or (C). This presumption may be rebutted by proof to the contrary.

(A) The activities now carried on by the controlled foreign corporations, or the assets used in those activities, are substantially the same activities that were carried on, or assets that were previously held by a single controlled foreign corporation, and the United States shareholders of the controlled foreign corporations or related persons (as determined under subdivision (iii) of this paragraph (b)(4)) are substantially the same as the United States shareholders of the one controlled foreign corporation in that prior taxable year. A presumption made in connection with the requirements of this subdivision (A) of paragraph (b)(4)(ii) may be rebutted by proof that the activities carried on by each controlled foreign corporation would constitute a separate branch under the principles of § 1.367(a)–6T(g) if carried on directly by a United States person.

(B) The controlled foreign corporations carry on a business, financial operation, or venture as partners directly or indirectly in a partnership (as defined in section 7701(a)(2) and § 301.7701–3) that is a related person (as defined in subdivision (iii) of this paragraph (b)(4)) with respect to each such controlled foreign corporation.

(C) The activities carried on by the controlled foreign corporations would constitute a single branch operation under § 1.367(a)–6T(g)(2) if carried on directly by the United States person.

(iii) *Related persons.* For purposes of this paragraph (b), two or more persons are related persons if they are in a relationship described in section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c). In determining for purposes of this paragraph (b) whether a corporation is related to a partnership under section 267(b)(10), a person is considered to own the partnership interest owned directly by such person and the partnership interest owned with the application of section 267(e)(3).

(iv) *Illustration.* The following example illustrates the application of this paragraph (b)(4).

Example. USP is the sole United States shareholder of three controlled foreign corporations: *CFC1, CFC2* and *CFC3.* The three controlled foreign corporations all have the same taxable year. The three controlled foreign corporations are partners in *FP,* a foreign entity classified as a partnership under section 7701(a)(2) and § 301.7701–3 of the regulations. For their current taxable years, each of the controlled foreign corporations derives all of its income other than foreign base company income from activities conducted through *FP,* and its foreign base company income from activities conducted both jointly through *FP* and separately without *FP.* Based on the facts in the table below, for their current taxable years, the foreign base company income derived by each controlled foreign corporation, including income derived from *FP,* is less than five percent of the gross income of each controlled foreign corporation and is less than $1,000,000:

	CFC1	CFC2	CFC3
Gross income	$4,000,000	$8,000,000	$12,000,000
Five percent of gross income	200,000	400,000	600,000
Foreign base company income	199,000	398,000	597,000

Thus, without the application of the anti-abuse rule of this subparagraph (5), each controlled foreign corporation would be treated as having no foreign base company income after the application of the de minimis rule of section 954(b)(3)(A) and § 1.954–1T(b)(1).

However, under these facts the requirements of subdivision (i) of this paragraph (b)(4) are presumed to be met. The sum of the foreign base company income of the controlled foreign corporations is $1,194,000. Thus, the amount of adjusted gross foreign base company income will not be less than the amount of gross foreign base company income by reason of the de minimis rule of section 954(b)(3)(A) and this paragraph (b).

(5) *Illustration.* The following example illustrates computations required by sections 952 and 954 and this § 1.954–1T if the full inclusion test of paragraph (b)(1)(iii) is met (see paragraph (a)(8) for an example illustrating computations required if the de minimis test of paragraph (b)(1)(ii) is met):

Example. (i) *Gross Income. CFC,* a controlled foreign corporation, has gross income of $1,000 for the current taxable year. Of that $1,000 of income, $720 is interest income that is included in the definition of foreign personal holding company income under section 954(c)(1)(A) and § 1.954–2T(b)(ii), is not income from trade or service receivables described in section 864(d) (1) or (6), and is not excluded from foreign personal holding company income under any provisions of section 954(c) and § 1.954–2T. The remaining $280 is services income that is not included in the definition of foreign base company income or insurance income under sections 954(c), (d), (e), (f), (g) or 953 and the regulations thereunder, and is foreign source general limitation income for purposes of section 904(d)(1)(I).

(ii) *Expenses. CFC* has expenses for the current taxable year of $650. Of that $650, $350 is from interest paid to related persons that is allocable to foreign personal holding company income along with $50 of other expense. The remaining $250 of expense is allocable to services income other than foreign base company income or insurance income.

(iii) *Earnings and deficits. CFC* has earnings and profits for the current taxable year of $350. In the prior taxable year, *CFC* had losses with respect to income other than foreign base company income or insurance income. By reason of the limitation provided under section 952(c)(1)(A) and the regulations thereunder, those losses reduced the subpart F income of *CFC* (consisting entirely of foreign source general limitation income) by $600 for the prior taxable year.

(iv) *Taxes.* A foreign tax of $120 is considered imposed on the $720 of interest income under the rules of section 954(b)(4) and paragraph (d) of this section, and a foreign tax of $2 is considered imposed on the services income under the rules of section 954(b)(4) and paragraph (d) of this section. For the taxable year of the foreign corporation, the maximum U.S. rate of taxation under section 11 is 34 percent.

(v) *Conclusion.* Based on these facts, if *CFC* elects to exclude all items of income subject to a high foreign tax under section 954(b)(4) and paragraph (d), it will have $350 of subpart F income as defined in section 952(a) determined as follows:

Step 1—Determine gross income:

(1) Gross income.......$1000

Step 2—Compute gross foreign base company income and gross insurance income:

(2) Gross foreign base company income and insurance income as defined in sections 954(c), (d), (e), (f), (g) and 953 and the regulations thereunder (interest income).......720

Step 3—Compute adjusted gross foreign base company income:

(3) Seventy percent of gross income (.70 × line (1)).......700

(4) Adjusted gross foreign base company income or insurance income after the application of the full inclusion rule of this paragraph (b)(1) (line (2), or line (1) if line (2) is greater than line (3)).......1000

(5) Full inclusion foreign base company income under paragraph (a)(2)(vi) (line (4) minus line (2)).......280

Step 4—Compute net foreign base company income:

(6) Related person interest expense and other deductions allocable and apportionable to foreign personal holding company income under section 954(b)(5) and paragraph (c).......400

(7) Deductions allocable and apportionable to full inclusion foreign base company income under section 954(b)(5) and paragraph (c).......250

(8) Foreign personal holding company income after allocating deductions under section 954(b)(5) and paragraph (c) of this section (line (2) reduced (but not below zero) by line (6)).......320

(9) Full inclusion foreign base company income after allocating deductions under section 954(b)(5) paragraph (c) of this section (line (5) reduced (but not below zero) by line (7)).......30

(10) Total gross foreign base company income after allocating deductions under section 954(b)(5) and paragraph (c) (line (8) plus line (9)).......350

Step 5—Compute net insurance income:

(11) Net insurance income under section 953 and the regulations thereunder.......0

Step 6—Compute adjusted net foreign base company income:

(12) Foreign tax imposed on foreign personal holding company income (interest).......120

(13) Foreign tax imposed on full inclusion foreign base company income.......2

(14) Ninety percent of the maximum U.S. corporate tax rate.......30.6

(15) Effective rate of foreign tax imposed on $320 of foreign personal holding company income under section 954(b)(4) and paragraph (d) (line (12) divided by line (8)).......38

(16) Effective rate of foreign tax imposed of $30 of full inclusion foreign base company income under section 954(b)(4) and paragraph (d) (line (13) divided by line (9)).......7

(17) Foreign personal holding company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (8) if line (15) is greater than line (14)).......320

(18) Full inclusion foreign base company income subject to a high foreign tax under section 954(b)(4) and paragraph (d) (zero, or line (9) if line (16) is greater than line (14)).......0

(19) Adjusted net foreign base company income after applying section 954(b)(4) and paragraph (d) (line (10), reduced by the sum of line (17) and line (18)).......30

Step 7—Compute adjusted net insurance income:

(20) Adjusted net insurance income.......0

Step 8—Additions to or reduction of adjusted net foreign base company income by reason of section 952(c):

(21) Earnings and profits for the current year.......350

(22) The excess in earnings and profits over subpart F income, which is subject to being recharacterized as adjusted net foreign base company income under section 952(c)(2) (excess of line (21) over the sum of line (19) and line (20)); if there is a deficit, then the limitation of 952(c)(1) may apply for the current year.......320

(23) Amount of reduction in subpart F income for prior taxable years by reason of the limitation of section 952(c)(1) and the regulations thereunder.......600

(24) Subpart F income as defined in section 952(a), assuming section 952(a) (3), (4), or (5) does not apply (the sum of line (19) and line (20) plus the lesser of line (22) or line (23)).......350

(25) Amount of prior years' deficit remaining to be recharacterized as subpart F income in later years under section 952(c) (excess of line (23) over line (22)).......280

(c) *Computation of net foreign base company income*—The net foreign base company income of a controlled foreign corporation is computed by reducing (but not below zero) the amount of gross income in each of the categories of adjusted gross foreign base company income described in paragraph (b)(2) of this section, so as to take into account deductions allocable and apportionable to such income. For purposes of section 954 and this section, expenses must be allocated and apportioned consistent with the allocation and apportionment of expenses for purposes of section 904(d). For purposes of this § 1.954–1T, an item of net foreign base company income must be categorized according to the category of adjusted gross foreign base company income from which it is derived. Thus, an item of net foreign base company income must be categorized as a net item of—

(1) Foreign personal holding company income,

(2) Foreign base company sales income,

(3) Foreign base company services income,

(4) Foreign base company shipping income,

(5) Foreign base company oil related income, or

(6) Full inclusion foreign base company income.

(d) *Computation of adjusted net foreign base company income or adjusted net insurance income*—(1) *Application of high tax exception.* Adjusted net foreign base company income (or adjusted net insurance income) equals the net foreign base company income (or net insurance income) of a controlled foreign corporation, reduced by any item of such income (other than foreign base company oil related income as defined in section 954(g)) subject to the high tax exception provided by section 954(b)(4) and this paragraph (d). An item of income is subject to the high tax exception only if—

(i) It is established that the income was subject to creditable income taxes imposed by a foreign country or countries at an effective rate that is greater than 90 percent of the maximum rate of tax specified in section 11 or 15 for the taxable year of the controlled foreign corporation; and

(ii) An election is made under section 954(b)(4) and paragraph (d)(5) of this section to exclude the income from the computation of subpart F income.

See paragraph (d)(4) of this section for the definition of the term "item of income." For rules concerning the treatment for foreign tax credit purposes of amounts excluded from subpart F under section 954(b)(4), see § 904-1.4(c)(1).

(2) *Effective rate at which taxes are imposed.* For purposes of this paragraph (d), the effective rate at which taxes are imposed on an item of income is—

(i) The amount of income taxes paid or accrued (or deemed paid or accrued) with respect to the item of income, determined under paragraph (d)(3) of this section, divided by

(ii) The item of net foreign base company income or net insurance income, determined under paragraph (d)(4) of this section (including the appropriate amount of income taxes referred to in subdivision (i) of this paragraph (d)(2), immediately above).

(3) *Taxes paid or accrued with respect to an item of income*—(i) *Income other than passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of income (other than an item of foreign personal holding company income that is passive income) for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes that would be deemed paid under section 960 with respect to that item if that item were included in the gross income of a U.S. shareholder under section 951(a)(1)(A). For this purpose, the amounts that would be deemed paid under section 960 shall be determined separately with respect to each controlled foreign corporation and without regard to the limitation applicable under section 904(a).

(ii) *Passive foreign personal holding company income.* The amount of income taxes paid or accrued with respect to an item of foreign personal holding company income that is passive income for purposes of section 954(b)(4) and this paragraph (d) is the amount of foreign income taxes paid or accrued or deemed paid by the foreign corporation that would be taken into account for purposes of applying the provisions of § 1.904–4(c) with respect to that item of income.

(4) *Item of income*—(i) *Income other than passive foreign personal holding company income.* The high tax exception applies (when elected) to all income that constitutes a single item under this paragraph (d)(4). A single item of net foreign base company income or net insurance income is an amount of net foreign base company income (other than foreign personal holding company income that is passive income) or net insurance income that:

(A) Falls within a single category of net foreign base company income, as defined in paragraph (c) of this section, or net insurance income, and

(B) Also falls within a single separate limitation category for purposes of sections 904(d) and 960 and the regulations thereunder.

(ii) *Passive foreign personal holding company income*—(A) *In general.* For purposes of this paragraph (d) a single item of net foreign personal holding company income that is passive income is an amount of such income that falls within a single group of passive income under the grouping rules of § 1.904–4(c) (3), (4), and (5).

(B) *Consistency rule.* An election to exclude income from subpart F must be consistently made with respect to all items of passive foreign personal holding company income eligible to be excluded. Thus, high-taxed passive foreign personal holding company income of a controlled foreign corporation must be excluded in its entirety, or remain subject to subpart F.

(5) *Procedure.* The election provided by this paragraph (d) must be made—

(i) By controlling United States shareholders, as defined in § 1.964–1(c)(5), by attaching a statement to such effect with their original or amended income tax returns, and including any additional information required by subsequent administrative pronouncements, or

(ii) In such other manner as may be prescribed in subsequent administrative pronouncements.

An election made under the procedure provided by this paragraph (d)(5) is binding on all United States shareholders of the controlled foreign corporation.

(6) *Illustrations.* The rules of this paragraph (d) are illustrated by the following examples.

Example (1). (i) *Items of income.* During its 1987 taxable year, controlled foreign corporation CFC receives from outside its country of operation portfolio dividend income of $100 and interest income of $100 (consisting of a gross payment of $150 reduced by a third-country withholding tax of $50). For purposes of illustration, assume that the CFC incurs no expenses. None of the income is taxed in CFC's country of operation. The dividend income was not subject to their-country withholding taxes. The interest income was subject to withholding taxes equal to $50, and is therefore high withholding tax interest for purposes of section 960 (pursuant to the operation of section 904). The dividend income is passive income for purposes of section 960. Accordingly, pursuant to paragraph (d)(4) of this section, CFC has two items of income: (1) $100 of FPHC/passive income (the dividends) and (2) $100 of FPHC/high withholding tax income (the interest). The election under paragraph (d)(5) of this section to exclude high-taxed income from the operation of subpart F is potentially applicable to each such item in its entirety.

(ii) *Effective rates of tax.* No foreign tax would be deemed paid under section 960 with respect to item (1). Therefore, the effective rate of foreign tax is 0, and the item may not be excluded from subpart F under the rules of this paragraph (d). Foreign tax of $50 would be deemed paid under section 960 with respect to item (2). Therefore, the effective rate of foreign tax is 33 percent ($50 of creditable taxes paid, divided by $150, consisting of the item of net foreign base company income ($100) plus creditable taxes paid thereon ($50). The highest rate of tax specified in section 11 for the 1987 taxable year is 34 percent. Accordingly, item (2) may be excluded from subpart F pursuant to an election under paragraph (d)(5) of this section, since it is subject to foreign tax at an effective rate that is greater than 30.6 percent (90 percent of 34 percent). However, it remains high withholding tax interest when included.

Example (2). The facts are the same as in Example (1), except that CFC's country of operation imposes a tax of $50 with respect to CFC's dividend income. The interest income is still high withholding tax interest. The dividend income is still passive income (without regard to the possible applicability of the high tax exception of section 904(d)(2)). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) $100 of FPHC/high withholding tax interest income, and (2) $50 of FPHC/passive income (net of the $50 foreign tax). Both items are taxed at an effective rate greater than 31.6 percent. Item 1: Foreign tax ($50) divided by sum ($150) of income item ($100) plus creditable tax thereon ($50) equals 33 percent. Item 2: Foreign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Accordingly, an election may be made under paragraph (d)(5) of this section to exclude either, both, or neither of items 1 and 2 from subpart F.

Example (3). The facts are the same as in Example (1), except that the $100 of portfolio dividend income is subject to a third-country withholding tax of $50, and the $150 of interest income is from sources within CFC's country of operation, is subject to a $10 income tax therein, and is not subject to a withholding tax. Although the interest income and the dividend income are both passive income, under paragraph (d)(4)(ii)(A) of this section they constitute separate items of income pursuant to the application of the grouping rules of § 1.904–4(c). Accordingly, CFC has two items of income for purposes of this paragraph (d): (1) $50 (net of tax) of FPHC/non-country of operation/greater than 15 percent withholding tax income; and (2) $140 (net of $10 tax) of FPHC/country of operation income. Item 1 is taxed at an effective rate greater than 30.6 percent, but Item 2 is not. Item 1: Foreign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Item 2: Foreign tax ($10) divided by sum ($150) of income item ($140) plus creditable tax thereon ($10) equals 6.67 percent. Therefore, an election may be made under paragraph (d)(5) of this section to exclude Item 1 but not Item 2 from subpart F.

Example (4). The facts are the same as in Example (3), except that the $150 of interest income is subject to an income tax of $50 in CFC's country of operation. Accordingly, CFC has two items of income, as in Example (4), but both items are taxed at an effective rate greater than 30.6 percent. Item 1: F reign tax ($50) divided by sum ($100) of income item ($50) plus creditable tax thereon ($50) equals 50 percent. Item 2: Foreign tax ($50) divided by sum ($150) if income item ($100) plus creditable tax thereon ($50) equals 33 percent. Pursuant to the consistency rule of paragraph (d)(4)(ii)(B) of this section, CFC's shareholders must consistently elect or not elect to exclude from subpart F all items of FPHC income that are eligible to be excluded. Therefore, an election may be made to exclude both Item 1 and Item 2 from subpart F, or neither may be excluded.

(e) *Character of an item of income*—(1) *Substance of the transaction.* For purposes of section 954 and the regulations thereunder, items of income shall be characterized in accordance with the substance of the transaction, and not in accordance with the designation applied by the parties to the transaction. For example, an amount received as "rent" which actually constitutes income from the sale of property, royalties, or income from services shall not be characterized as "rent" but shall be characterized as income from the sale of property, royalties or income from services, respectively. Local law shall not be controlling in characterizing an item of income.

(2) *Separable character.* To the extent one of the definitional provisions of section 953 or 954 describes a portion of the income or gain derived from a transaction, that portion of income or gain is so characterized. Thus, a single transaction may give rise to income in more than one category of foreign base company income described in paragraph (a)(2) of this section. For example, if a controlled foreign corporation, in its business of purchasing and selling personal property, receives interest (including imputed interest and market discount) on an account receivable arising from a sale, a portion of the income derived from the transaction by the controlled foreign corporation will be interest, and another portion will be gain (or loss) from the sale of personal property. If the sale is denominated in a currency other than a functional currency as defined in section 985 and the regulations thereunder, the controlled foreign corporation may have additional income in the form of foreign currency gain as defined in section 988.

(3) *Predominant character.* The portion of income derived from a transaction that meets the definition of foreign personal holding company income is always separately determinable, and thus must always be segregated from other income and separately classified under paragraph (2) of this paragraph (e). However, the portion of income derived from a transaction that would meet a particular definitional provision under section 954 or 953 and the regulations thereunder (other than the definition of foreign personal holding company income) in unusual circumstances may be indeterminable. If such portion is indeterminable, it must be classified in accordance with the predominant character of the transaction. For example, if a controlled foreign corporation engineers, fabricates, and installs a fixed offshore drilling platform as part of an integrated transaction, and the portion of income that relates to services is not accounted for separately from the portion that relates to sales, and is otherwise indeterminable, then the classification of income from the transaction shall be made in accordance with the predominant character of the particular integrated arrangement.

(4) *Coordination of categories of gross foreign base company income or gross insurance income.* The definitions of gross foreign base company income and gross insurance income are limited by the following rules (to be applied in numerical order):

(i) If an item of income is included in Subpart F income under section 952(a)(1) and the regulations thereunder as insurance income, it is by definition excluded from any other category of subpart F income.

(ii) If an item of income is included in the foreign base company oil related income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivision (i) of this paragraph (e)(4).

(iii) If an item of income is included in the foreign base company shipping income of a controlled foreign corporation, it is by definition excluded from any other category of foreign base company income, other than as provided in subdivisions (i) and (ii) of this paragraph (e)(4).

(iv) If an item of income is included in foreign personal holding company income of a controlled foreign corporation, it is by definition not included in any other category of foreign base company income, other than as provided in subdivisions (i), (ii), and (iii) of this paragraph (e)(4).

An item of income shall not be excluded from the definition of a category of gross foreign base company income or gross insurance income under this paragraph (e)(4) by reason of being included in the general definition of another category of gross foreign base company income or gross insurance income, if the item of income is excluded from that other category by a more specific provision of section 953 or 954 and the regulations thereunder. For example, income derived from a commodity transaction that is excluded from foreign personal holding company income under § 1.954–2T(f) as income from qualified active sales may be included in gross foreign base company income if it also meets the definition of foreign base company sales income. See § 1.954–2T(a)(2) for the coordination of overlapping categories within the definition of foreign personal holding company income.

§ 1.954-2 [Redesignated as § 1.954A-2]

Par. 5. Section 1.954–2 is redesignated as § 1.954A–2.

Par. 6. The following new section is added:

§ 1.954-2T Foreign Personal Holding Company Income; taxable years beginning after December 31, 1986 (temporary).

(a) *Computation of foreign personal holding company income*—(1) *In general.* Foreign personal holding company income consists of the following categories of income:

(i) Dividends, interest, rents, royalties, and annuities as defined in paragraph (b) of this section;

(ii) Gain from certain property transactions as defined in paragraph (e) of this section;

(iii) Gain from commodities transactions as defined in paragraph (f) of this section;

(iv) Foreign currency gain as defined in paragraph (g) of this section; and

(v) Income equivalent to interest as defined in paragraph (h) of this section.

Paragraph (a)(3) of this section provides rules for determining the use or purpose for which property is held, if a change in use or purpose would affect the computation of foreign personal holding company income under paragraphs (e), (f), and (g) of this section. Paragraphs (c) and (d) of this section provide rules for determining certain rents and royalties that are excluded from foreign personal holding company income under paragraph (b) of this section.

(2) *Coordination of overlapping definitions.* If a particular portion of income from a transaction in substance falls within more than one of the definitional rules of section 954(c) and this section, its character is determined under the rules of subdivision (i) through (iii) of this paragraph (a)(2). The character of loss from a transaction must be similarly determined under the rules of this paragraph (a)(2).

(i) If a portion of the income from a transaction falls within the definition of income equivalent to interest under paragraph (h) of this section and the definition of gain from certain property transactions under paragraph (e) of this section, gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales), or foreign currency gain under paragraph (g) of this section (whether or not derived from a qualified business transaction or a qualified hedging transaction), that portion of income is treated as income equivalent to interest for purposes of section 954(c) and this section.

(ii) If a portion of the income from a transaction falls within the definition of foreign currency gain under paragraph (g) of this section (whether or not derived from a qualified business transaction or a qualified hedging transaction) and the definition of gain from certain property transactions under paragraph (e) of this section, or gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales), that portion of income is treated as foreign currency gain for purposes of section 954(c) and this section.

(iii) If a portion of the income from a transaction falls within the definition of gain from a commodities transaction under paragraph (f) of this section (whether or not derived from a qualified hedging transaction or qualified active sales) and the definition of gain from certain property transactions under paragraph (e) of this section, that portion of income is treated as gain from a commodities transaction for purposes of section 954(c) and this section.

(3) *Changes in the use or purpose with which property is held*—(i) *In general.* Under paragraphs (e), (f), and (g) of this section, transactions in certain property give rise to gain or loss included in the computation of foreign personal holding company income if the controlled foreign corporation holds that property for a particular use or purpose. For purposes of this section, in determining the purpose or use for which property is held, the period shortly before disposition is the most significant period. However, if a controlled foreign corporation held property with a purpose that would have caused its disposition to give rise to gain or loss included in the computation of foreign personal holding company income under this section, and prior to disposition the controlled foreign corporation changed the purpose or use for which it held the property to one that would cause its disposition to give rise to gain or loss excluded from the computation of foreign personal holding company income, then the later purpose or use shall be ignored unless it was continuously present for a predominant portion of the period during which the controlled foreign corporation held the property. Under paragraph (g)(4)(iii) of this section, a currency hedging transaction may be treated as two or more separate hedging transactions, such that each portion is separately considered in applying this paragraph (a)(3).

(ii) *Illustrations.* The following examples illustrate the application of this paragraph (a)(3).

Example (1). At the beginning of taxable year 1, *CFC*, a controlled foreign corporation, purchases a building for investment. During taxable years 1 and 2, *CFC* derives rents from this building that are included in the computation of foreign personal holding company income under paragraph (b)(1)(iii) of this section. At the beginning of taxable year 3, *CFC* changes the use of the building by terminating all leases, and using it in an active trade or business. At the beginning of taxable year 4, *CFC* sells the building at a gain. For purposes of paragraph (e) of this section (gains from the sale or exchange of certain property) the building is considered to be property that gives rise to rents, as described in paragraph (e)(2). Because there was a change of use at the beginning of year 3 that would cause the disposition of the building to give rise to gain or loss excluded from the computation of foreign personal holding company income, the characterization of the gain derived at the beginning of year 4 is determined according to the property's use during the predominant portion of the period from purchase to date of sale. Therefore, gain from the sale of that building is included in the computation of foreign personal holding company income under paragraph (e) of this section.

Example (2). For taxable years 1, 2, and 3, *CFC*, a controlled foreign corporation, is engaged in the active conduct of a commodity business as a handler of gold, as defined in paragraph (f)(e)(iii), and substantially all of its business is as an active handler of gold, as defined in paragraph (f)(3)(iv). At the beginning of taxable year 1, *CFC* purchases 1000 ounces of gold for investment. At the beginning of taxable year 3, *CFC* begins holding that gold in physical form for sale to customers. During taxable year 3, *CFC* sells the entire 1000 ounces of gold in transactions described in paragraph (f)(3)(ii) at a gain. For purposes of paragraph (f), *CFC* is considered to hold the gold for investment, and not in its capacity as an active handler of gold. Thus, under paragraph (f)(3)(i), the gold is not considered to be sold in the active trade or business of the *CFC* as a handler of gold, and gain from the sale is included in the computation of foreign personal holding company income under paragraph (f) of this section.

Example (3). CFC, a controlled foreign corporation, is a regular dealer in unimproved land. The functional currency (as defined in section 985 and the regulations thereunder) of *CFC* is country X currency. On day 1 of its current taxable year, *CFC* enters into an agreement with A to pay $100 for certain real property to be held by *CFC* for investment. On day 10, under its method of accounting, *CFC* accrues the value of $100 in country X currency, but payment will not be made until the first day of the next taxable year (day 366). On day 190, *CFC* determines to hold the property for sale to customers in a transaction that would be a qualified business transaction under paragraph (g)(3) of this section. For purposes of this section, the land is considered to be held for investment, and the foreign currency gain attributable to that transaction is included in the computation of foreign personal holding company income under paragraph (g) of this section.

Example (4). CFC, a controlled foreign corporation, is a regular dealer in widgets. The functional currency (as defined in section 985 and the regulations thereunder) of *CFC* is country X currency. On day 1 of its current taxable year, *CFC* sells widgets held in inventory to A for delivery on day 60. The sales price is denominated in U.S. dollars, and payment is to be made by A on the same day the widgets are to be delivered to A. The remaining facts and circumstances are such that this sale would meet the definition of a qualified business transaction under paragraph (g)(4), the foreign currency gain from which would be excluded from the computation of foreign personal holding company income under paragraph (g). On day 1, *CFC* sells U.S. dollars forward for delivery in 60 days in a transaction that would be a qualified hedging transaction under paragraph (g)(5). On day 25 the sale of widgets to A is cancelled in a transaction that does not result in *CFC* realizing any foreign currency gain or loss with respect to the sale of widgets. However, *CFC* holds the dollar forward contract to maturity. Because the forward contract does not hedge a qualified business transaction during the period shortly before its maturity, it is not to be considered a qualified hedging transaction under paragraph (g), and any foreign currency gain or loss recognized therefrom is included in the computation of foreign personal holding company income under paragraph (g). However, if *CFC* identifies the portion of the foreign currency gain or loss derived from the forward contract that is attributable to days 1 through 25, and the portion that is attributable to days 25 through 60, the forward contract may be considered two separate transactions in accordance with the rules provided by paragraph (g)(4)(ii) of this section. Thus, the forward sale may be separately considered a qualified hedging transaction for day 1 through day 25, and the foreign currency gain or loss attributable to day 1 through day 25 may be excluded from the computation of foreign personal holding company income under paragraph (g) of this section.

Example (5). CFC, a controlled foreign corporation, has country X currency as its functional currency under section 985 and the regulations thereunder. On day 1 of the current taxable year, *CFC*, speculating on exchange rates, sells dollars forward for delivery in 120 days. On day 65, *CFC* sells widgets held in inventory at a price denominated in dollars to be paid on day 120 in a transaction that is a qualified business transaction. *CFC* had not made any other dollar sales between day 1 and day 65 and does not anticipate making any other dollar sales during the taxable year. On day 65, *CFC* accrues the value of $100 in country X currency. On day 120, *CFC* receives $100 payment for the widgets and recognizes foreign currency loss pursuant to that transaction. On day 120 *CFC* also delivers dollars in connection with the forward sale, and recognizes foreign currency gain pursuant to the delivery. Under this paragraph (a)(3) the currency transaction is considered to have been entered into for speculation, and any currency gain recognized by *CFC* on the forward sale of dollars must be included in the computation of foreign personal holding company income under paragraph (g). However, if *CFC* identifies the portion of the forward sale, and the foreign currency gain or therefrom, that is attributable to day 1 through day 64, and the portion that is attributable to day 65 through day 120, the forward sale may be considered two separate transactions in accordance with the rules provided by paragraph (g)(4)(ii) of this section. Thus, the transaction for day 65 through day 120 may be considered a separate transaction that is a qualified hedging transaction, and the foreign currency gain attributable to day 65 through day 120 may be excluded from the computation of foreign personal holding company income under this paragraph (g) if all the other requirements for treatment as a qualified hedging transaction under paragraph (g) are met.

(4) *Definitions.* The following definitions apply for purposes of computing foreign personal holding company income under this section.

(i) *Interest.* The term "interest" includes amounts that are treated as ordinary income, original issue discount or interest income (including original issue discount and interest on a tax-exempt obligation) by reason of sections 482, 483, 864(d), 1273, 1274, 1276, 1281, 1286, 1288, 7872 and the regulations thereunder, or as interest or original issue discount income by reason of any other provision of law. For special rules concerning interest exempt from U.S. tax pursuant to section 103, see paragraph (b)(6) of this section.

(ii) *Inventory and similar property.* The term "inventory and similar property" (or "inventory or similar property") means property that is stock in trade of the controlled foreign corporation or other property of a kind which would properly be included in the inventory of the controlled corporation if on hand at the close of the taxable year (were the controlled foreign corporation a domestic corporation), or property held by the controlled foreign corporation primarily for sale to customers in the ordinary course of its trade or business. Rights to property held in bona fide hedging transactions that reduce the risk of price changes in the cost of "inventory and similar property" are included in the definition of that term if they are an integral part of the system by which a controlled foreign corporation purchases such property, and they are so identified by the close of the fifth day after the day on which the hedging transaction is entered into.

(iii) *Regular dealer.* The term "regular dealer" means a merchant with an established place of business that—

(A) Regularly and actively engages as a merchant in purchasing property and selling it to customers in the ordinary course of business with a view to the gains and profits that may be derived therefrom, or

(B) Makes a market in derivative financial products of property (such as forward contracts to buy or sell property, option contracts to buy or sell property, interest rate and currency swap contracts or other notional principal contracts) by regularly and actively offering to enter into positions in such products to the public in the ordinary course of business.

Purchasing and selling property through a regulated exchange or established off-exchange market (for example, engaging in futures transactions) is not actively engaging as a merchant for purposes of this section.

(iv) *Dealer property.* Property held by a controlled foreign corporation is "dealer property" if—

(A) The controlled foreign corporation is a regular dealer in property of such kind, and

(B) The property is held by the controlled foreign corporation in its capacity as a dealer.

Property which is held by the controlled foreign corporation for investment or speculation is not such property.

(v) *Debt instrument.* The term "debt instrument" includes bonds, debentures, notes, certificates, accounts receivable, and other evidences of indebtedness.

(b) *Dividends, etc.*—(1) *In general.* Foreign personal holding company includes:

(i) Dividends, except certain dividends from related persons as described in paragraph (b)(3) of this section and distributions of previously taxed income under section 959(b) and the regulations thereunder;

(ii) Interest, except export financing interest as defined in paragraph (b)(2) of this section and certain interest received from related persons as described in paragraph (b)(3) of this section;

(iii) Rents and royalties, except certain rents and royalties received from related persons as described in (b)(4) of this section and rents and royalties derived in the active conduct of a trade or business as defined in paragraph (b)(5); and

(iv) Annuities.

(2) *Exclusion of certain export financing*—(i) *In general.* Pursuant to section 954(c)(2)(B), foreign personal holding company income computed under section 954(c)(1)(A) and this paragraph (b) does not include interest that is export financing interest. For purposes of section 954(c)(2)(B) and this section, the term "export financing interest" means interest that is derived in the conduct of a banking business and is export financing interest as defined in section 904(d)(2)(G) and the regulations thereunder. Pursuant to section 864(d)(5)(A)(iii), it does not include income from related party factoring that is treated as interest under section 864(d)(1) or interest described in section 864(d)(6).

(ii) *Conduct of a banking business.* For purposes of this section, export financing interest as defined in section 904(d)(2)(G) and the regulations thereunder is considered derived in the conduct of a banking business if, in connection with the financing from which the interest is derived, the corporation, through its own officers or staff of employees, engages in all the activities in which banks customarily engage in issuing and servicing a loan.

(iii) *Illustration.* The following example illustrates the application of this provision:

Example. DS, a domestic corporation, manufactures property in the United States. In addition to selling inventory (property described in section 1221(1)), *DS* occasionally sells depreciable equipment it manufactures for use in its trade or business, which is property described in section 1221(2). Less than 50 percent of the fair market value, determined in accordance with section 904(d)(2)(G) and the regulations thereunder, of each item of inventory or equipment sold by *DS* is attributable to products imported into the United States. *CFC,* a controlled foreign corporation related (as defined in section 954(d)) to *DS,* provides loans for the purchase of property from *DS,* if the property is purchased exclusively for use of consumption outside the United States.

If, in issuing and servicing loans made with respect to purchases from *DS* of depreciable equipment used in its trade or business, which is property described in section 1221(2) in the hands of *DS, CFC* engages in all the activities in which banks customarily engage in issuing and servicing loans, the interest accrued from these loans would be export financing interest meeting the requirements of paragraph (b)(2) of this section, which would not be included in foreign personal holding company income under section 954(c) and paragraph (b)(1)(ii) of this section. However, interest from the loans made with respect to purchases from *DS* of property which is inventory in the hands of *DS* cannot be export financing interest because it is treated as income from a trade or service receivable under section 864(d)(6) and the regulations thereunder, and thus is included in foreign personal holding company income under paragraph (b)(1)(ii) of this section. See § 1.864–8T(d) for rules concerning certain income from trade and service receivables qualifying under the same country exception of section 864(d)(7).

(3) *Exclusion of dividends and interest from related persons*—(i) *Excluded dividends and interest.* Foreign personal holding company income does not include dividends and interest if—

(A) The payor is a corporation that is a related person as defined in section 954(a)(3),

(B) The payor is created or organized ("incorporated") under the laws of the same foreign country as the controlled foreign corporation, and

(C) A substantial part of the payor's assets are used in a trade or business in the payor's country of incorporation as determined under subdivision (iv) of this paragraph (b)(3).

Except as otherwise provided under this paragraph (b)(3), the principles of section 367(a) and regulations thereunder shall apply in determining whether the payor has a trade or business in its country of incorporation, and whether its assets are used in that trade or business.

(ii) *Interest paid out of adjusted foreign base company income or insurance income.* Interest may not be excluded from the foreign personal holding company income of the recipient under this paragrpah (b)(3) to the extent that the deduction for the interest is allocated under § 1.954–1T(c) to the payor's adjusted gross foreign base company income (as defined in § 1.954–1T(a)(3)), adjusted gross insurance income (as defined in § 1.954–1T(a)(6)), or other categories of income included in the computation of subpart F income under section 952(a), for purposes of computing the payor's net foreign base company income (as defined in § 1.954–1T(a)(4), net insurance income (as defined in § 1.954–1T(a)(6)), or income described in sections 952(a) (3), (4), and (5).

(iii) *Dividends paid out of prior years' earnings.* Dividends are excluded from foreign personal holding company income under this paragraph (b)(3) only to the extent they are paid out of earnings and profits which were earned or accumulated during a period in which the requirements of subdivision (i) of this paragraph (b)(3) were satisfied or, to the extent earned or accumulated during a taxable year of the related foreign corporation ending on or before December 31, 1962, during a period in which the payor was a related corporation as to be controlled foreign corporation and the other requirements of subdivision (i) of this paragraph (b)(3) are substantially satisfied.

(iv) *Fifty percent substantial assets test.* A substantial part of the assets of the payor will be considered used in a trade or business located in its country of incorporation only if, for each quarter during such taxable year, the average value (as of the beginning and end of the quarter) of its assets which are used in the trade or business and are located in such country constitutes over 50 percent of the average value (as of the beginning and end of the quarter) of all the assets of the payor (including assets not used in a trade or business). For such purposes the value of assets shall be determined under subdivision (v) of this paragraph (b)(3), and the location of assets used in a trade or business of the payor shall be determined under subdivisions (vi) through (xi) of this paragraph (b)(3).

(v) *Value of assets.* For purposes of determining whether a substantial part of the assets of the payor are used in a trade or business in its country of incorporation, the value of assets shall be their actual value (not reduced by liabilities), which, in the absence of affirmative evidence to the contrary, shall be deemed to be their adjusted basis.

(vi) *Location of tangible property used in a trade or business*—(A) *In general.* Tangible property (other than inventory and similar property) used in a trade or business is considered located in the country in which it is physically located.

(B) *Exception.* If tangible personal property used in a trade or business is intended for use in the payor's country of incorporation, but is temporarily located elsewhere, it will be considered located within payor's country of incorporation if the reason for its location elsewhere is for inspection or repair, and it is not currently in service in a country other than the payor's country of incorporation and is not to be placed in service in a country other than the payor's country of incorporation following the inspection or repair.

(vii) *Location of intangible property used in a trade or business*—(A) *In general.* The location of intangible property (other than inventory or similar property and debt instruments) used in a trade or business is determined based on the site of the activities conducted by the payor during the current year in connection with using or exploiting that property. An item of intangible property is located in the payor's country of incorporation during each quarter of the current taxable year if the activities connected with its use or exploitation are conducted during the entire current taxable year by the payor in its country of incorporation. For this purpose, the determination of the country in which services are performed shall be made under the principles of section 954(e) and § 1.954–4(c).

(B) *Property located in part in the payor's country of incorporation and in part in other countries.* If the activities connected with the use or exploitation of an item of intangible property are conducted during the current taxable year by the payor in the payor's country of incorporation and in other countries, then a percentage of the intangible (measured by the average value of the item as of the beginning and end of the quarter) is considered located in the payor's country of incorporation during each quarter. That percentage equals the ratio that the expenses of the payor incurred during the entire taxable year by reason of such activities that are conducted in the payor's country of incorporation bear to the expenses of the payor incurred during the entire taxable year by reason of all such activities worldwide. Expenses incurred in connection with the use or exploitation of an item of intangible property are included in the computation provided by this paragraph (b)(3) if they are deductible under section 162 or includible in inventory costs or the costs of goods sold (were the payor a domestic corporation).

(viii) *Location of property held for sale to customers*—(A) *In general.* Inventory or similar property is considered located in the payor's country of incorporation during each quarter of the taxable year if the activities of the payor in connection with the production and sale, or purchase and release, of such property and conducted in the payor's country of incorporation during the entire taxable year. If the payor conducts such activities through an independent contractor, then the location of such activities shall be the place in which they are conducted by the independent contractor.

(B) *Inventory located in part in the payor's country of incorporation and in part in other countries.* If the activities connected with the production and sales, or purchase and resale, of inventory or similar property are conducted by the payor in the payor's country of incorporation and other countries, then a percentage of the inventory or similar property (measured by the average value of the item as of the beginning and end of the quarter) is considered located in the payor's country of incorporation each quarter. That percentage equals the ratio that the costs of the payor incurred during the entire taxable year by reason of such activities that are conducted in the payor's country of incorporation bear to all such costs incurred by reason of such activities worldwide. A cost incurred in connection with the production and sale or purchase and resale of inventory or similar property is included in this computation if it—

(*1*) Must be included in inventory costs or otherwise capitalized with respect to inventory or similar property under section 61, 263A, 471, or 472 and the regulations thereunder (whichever would be applicable were the payor a domestic corporation), or

(*2*) Would be deductible under section 162 (were the payor a domestic corporation) and is definitely related to gross income derived from such property (but not to all classes of gross income derived by the payor) under the principles of § 1.861–8.

(ix) *Location of debt instruments.* For purposes of this paragraph (b)(3), debt instruments are considered to be used in a trade or business only if they arise from the sale of inventory or similar property by the payor or from the rendition of services by the payor in the ordinary course of a trade or business of the payor, but only until such time as interest is required to be charged under section 482 and the regulations thereunder. Debt instruments that arise from the sale of inventory or similar property are treated as having the same location, proportionately, as inventory or similar property that is held during the same calendar quarter. Debt instruments arising from the rendition of services in the ordinary course of a trade or business are considered located on a proportionate basis in the countries in which the services to which they relate are performed.

(x) *Treatment of certain stock interests.* For the purpose of determining the value of assets used in a trade or business in the country of incorporation, stock directly or indirectly owned by the payor within the meaning of section 958(a) in a controlled foreign corporation ("lower-tier corporation"), which is incorporated in the same country as the payor, shall be considered located in the country of incorporation and used in a trade or business of the payor in proportion to the value of the assets of the lower-tier corporation that are used in a trade or business in the country of incorporation. The location of assets used in a trade or business of the lower-tier corporation shall be determined under the rules of this paragraph (b)(3).

(xi) *Determination of period during which property is used in a trade or business.* Property purchased or produced for use in a trade or business shall not be considered used in a trade or business until it is placed in service, and shall cease to be considered used in a trade or business when it is retired from service. The dates during which depreciable property is determined to be in use must be consistent with the determination of depreciation under sections 167 and 168 and the regulations thereunder.

(xii) *Treatment of banks and insurance companies.* [Reserved.]

(4) *Exclusion of rents and royalties derived from related persons*—(i) *In general.* Foreign personal holding company income does not include rents or royalties if—

(A) The payor is a corporation that is a related person as defined in section 954(d)(3), and

(B) The rents or royalties are for the use of, or the privilege of using, property within the country under the laws of which the recipient of the payments is created or organized.

If the property is used both within and without the country under the laws of which the controlled foreign corporation is created or organized, the part of the rent or royalty attributable to the use of, or the privilege of using, the property outside such country of incorporation is, unless otherwise provided, foreign personal holding company income under this paragraph (b).

(ii) *Rents or royalties paid out of adjusted foreign base company income or insurance income.* Rents or royalties may not be excluded from the foreign personal holding company income of the recipient under this paragraph (b)(4) to the extent that deductions for the payments are allocated under section 954(b)(5) and § 1.954–1T(a)(4) to the payor's adjusted gross foreign base company income (as defined in § 1.954–1T(a)(3)), adjusted gross insurance income (as defined in § 1.954–1T(a)(6), or other categories of income included in the computation of subpart F income under section 952(a), for purposes of computing the payor's net foreign base company income (as defined in § 1.954–1T(a)(4)), net insurance income (as defined in § 1.954–1T(a)(6)), or income described in section 952(a) (3), (4), or (5).

(5) *Exclusion of rents and royalties derived in the active conduct of a trade or business.* Foreign personal holding company income shall not include rents or royalties which are derived in the active conduct of a trade or business and which are received from a person other than a related person within the meaning of section 954(d)(3). Whether or not rents or royalties are derived in the active conduct of a trade or business is to be determined from the facts and circumstances of each case; but see paragraph (c) or (d) of this section for specific cases in which rents or royalties will be considered for purposes of this paragraph to be derived in the active conduct of a trade or business. The frequency with which a foreign corporation enters into transactions from which rents or royalties are derived will not of itself establish the fact that such rents or royalties are derived in the active conduct of a trade or business.

(6) *Treatment of tax exempt interest.* Foreign personal holding company income includes all interest income, including interest that is exempt from U.S. tax pursuant to section 103 ("tax-exempt interest"). However, that net foreign base company income of a controlled foreign corporation that is attributable to such tax-exempt interest shall be treated as tax-exempt interest in the hands of the U.S. shareholders of the foreign corporation. Accordingly, any net foreign base company income that is included in the Subpart F income of a U.S. shareholder and that is attributable to such tax-exempt interest shall remain exempt from the regular income tax, but potentially subject to the alternative minimum tax, in the hands of the U.S. shareholder.

(c) *Excluded rents*—(1) *Trade or business cases.* Rents will be considered for purposes of paragraph (b)(5) of this section to be derived in the active conduct of a trade or business if such rents are derived by the controlled foreign corporation ("lessor") from leasing—

(i) Property which the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind,

(ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased,

(iii) Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased during a temporary period when the property would, but for such leasing, be idle, or

(iv) Property which is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and which is substantial in relation to the amount of rents derived from the leasing of such property.

(2) *Special rules*—(i) *Adding substantial value*. For purposes of paragraph (c)(1)(i) of this section, the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization*. An organization in a foreign country will be considered substantial in relation to the amount of rents, for purposes of paragraph (c)(1)(iv) of this section, if active leasing expenses, as defined in paragraph (c)(2)(iii), equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section.

(iii) *Active leasing expenses* The term "active leasing expenses" means the deductions incurred by an organization of the lessor in a foreign country which are properly allocable to rental income and which would be allowable under section 162 to the lessor (were the lessor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the lessor,

(B) Deductions for rents paid or accrued,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the lessor (were the lessor a domestic corporation) under sections other than section 162 (such as sections 167 and 168), and

(D) Deductions for payments made to independent contractors with respect to the leased property.

(iv) *Adjusted leasing profit*. The term "adjusted leasing profit" means the gross income of the lessor from rents, reduced by the sum of—

(A) The rents paid or incurred by the controlled foreign corporation with respect to such gross rental income,

(B) The amounts which would be allowable to such lessor (were the lessor a domestic corporation) as deductions under section 167 or 168 with respect to such rental income, and

(C) The amounts paid to independent contractors with respect to such rental income.

(3) *Illustrations*. The application of this paragraph (c) is illustrated by the following examples.

Example (1). Controlled foreign corporation *A* is regularly engaged in the production of office machines which it sells or leases to others and services. Under paragraph (c)(1)(i) of this section, the rental income of *A* Corporation from the leases is derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example (2). Controlled foreign corporation *D* purchases motor vehicles which it leases to others. In the conduct of its short-term leasing of such vehicles in foreign country X, Corporation *D* owns a large number of motor vehicles in country X which it services and repairs, leases motor vehicles to customers on an hourly, daily, or weekly basis, maintains offices and service facilities in country X from which to lease and service such vehicles, and maintains therein a sizable staff of its own administrative, sales, and service personnel. Corporation *D* also leases in country X on a long-term basis, generally for a term of one year, motor vehicles which it owns. Under the terms of the long-term leases, Corporation *D* is required to repair and service, during the term of the lease, the leased motor vehicles without cost to the lessee. By the maintenance in country X of office, sales, and service facilities and its complete staff of administrative, sales, and service personnel, Corporation *D* maintains and operates an organization therein which is regularly engaged in the business of marketing and servicing the motor vehicles which are leased. The deductions incurred by such organization satisfy the 25-percent test of paragraph (c)(2)(ii) of this section; thus, such organization is substantial in relation to the rents Corporation *D* receives from leasing the motor vehicles. Therefore, under paragraph (c)(1)(iv) of this section, such rents are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example (4). Controlled foreign corporation *E* owns a complex of apartment buildings which it has acquired by purchase. Corporation *E* engages a real estate management firm to lease the apartments, manage the buildings and pay over the net rents to the owner. The rental income of *E* Corporation from such leases is not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example (5). Controlled foreign corporation *F* acquired by purchase a twenty-story office building in a foreign country, three floors of which it occupies and the rest of which it leases. Corporation *F* acts as rental agent for the leasing of offices in the building and employs a substantial staff to perform other management and maintenance functions. Under paragraph (c)(1)(ii) of this section, the rents received by Corporation *F* from such leasing operations are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example (6). Controlled foreign corporation *G* owns equipment which it ordinarily uses to perform contracts in foreign countries to drill oil wells. For occasional brief and irregular periods it is unable to obtain contracts requiring immediate performance sufficient to employ all such equipment. During such a period it sometimes leases such idle equipment temporarily. After the expiration of such temporary leasing of the property, Corporation *G* continues the use of such equipment in the performance of its own drilling contracts. Under paragraph (c)(1)(iii) of this section, rents *G* receives from such leasing of idle equipment are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(d) *Excluded royalties*—(1) *Trade or business cases*. Royalties will be considered for purposes of paragarph (b)(5) of this section to be derived in the active conduct of a trade or business if such royalties are derived by the controlled foreign corporation ("licensor") from licensing— (i) Property which the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation, or production of, or in the acquisition of and addition of substantial value to, property of such kind, or

(ii) Property which is licensed as a result of the performance of marketing functions by such licensor and the licensor, through its own staff of employees located in a foreign country, maintains and operates an organization in such country which is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and which is substantial in relation to the amount of royalties derived from the licensing of such property.

(2) *Special rules*—(i) *Adding substantial value*. For purposes of paragraph (d)(1)(i), the performance of marketing functions will not be considered to add substantial value to property.

(ii) *Substantiality of foreign organization*. An organization in a foreign country will be considered substantial in relation to the amount of royalties, for purposes of paragraph (d)(1)(ii) of this section, if the active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(iii) *Active licensing expenses*. The term "active licensing expenses" means the deductions incurred by an organization of the licensor which are properly allocable to royalty income and which would be allowable under section 162 to the licensor (were the licensor a domestic corporation) other than—

(A) Deductions for compensation for personal services rendered by shareholders of, or related persons with respect to, the licensor,

(B) Deductions for royalties paid or incurred,

(C) Deductions which, although generally allowable under section 162, would be specifically allowable to the licensor (were the controlled foreign corporation a domestic corporation) under sections other than section 162 (such as section 167), and

(D) Deductions for payments made to independent contractors with respect to the licensed property.

(iv) *Adjusted licensing profit.* The term "adjusted licensing profit" means the gross income of the licensor from royalties, reduced by the sum of—

(A) The royalties paid or incurred by the controlled foreign corporation with respect to such gross royalty income,

(B) The amounts which would be allowable to such licensor as deductions under section 167 (were the licensor a domestic corporation) with respect to such royalty income, and

(C) The amounts paid to independent contractors with respect to such royalty income.

(3) *Illustrations.* The application of this paragraph (d) is illustrated by the following examples.

Example (1). Controlled foreign corporation *A*, through its own staff of employees, owns and operates a research facility in foreign country X. At the research facility employees of Corporation A who are full time scientists, engineers, and technicians regularly perform experiments, tests, and other technical activities, which ultimately result in the issuance of patents that it sells or licenses. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *A* for the privilege of using patented rights which it develops as a result of such research activity are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example (2). Assume that Corporation *A* in example (1), in addition to receiving royalties for the use of patents which it develops, receives royalties for the use of patents which it acquires by purchase and licenses to others without adding any value thereto. Corporation *A* generally consummates royalty agreements on such purchased patents as the result of inquiries received by it from prospective licensees when the fact becomes known in the business community, as a result of the filing of a patent, advertisements in trade journals, announcements, and contacts by employees of Corporation *A*, that Corporation *A* has acquired rights under a patent and is interested in licensing its rights. Corporation *A* does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the purchased patents. The royalties received by Corporation *A* for the use of the purchased patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example (3). Controlled foreign corporation *B* receives royalties for the use of patents which it acquires by purchase. The primary business of Corporation *B*, operated on a regular basis, consists of licensing patents which it has purchased "raw" from inventors and, through the efforts of a substantial staff of employees consisting of scientists, engineers, and technicians, made susceptible to commercial application. For example, Corporation *B*, after purchasing patent rights covering a chemical process, designs specialized production equipment required for the commercial adaptation of the process and, by so doing, substantially increases the value of the patent. Under paragraph (d)(1)(i) of this section, royalties received by Corporation *B* from the use of such patent are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

Example (4). Controlled foreign corporation *D* finances independent persons in the development of patented items in return for an ownership interest in such items from which it derives a percentage of royalty income, if any, subsequently derived from the use by others of the protected right. Corporation *D* also attempts to increase its royalty income from such patents by contacting prospective licensees and rendering to licensees advice which is intended to promote the use of the patented property. Corporation *D* does not, however, maintain and operate an organization in a foreign country which is regularly engaged in the business of marketing the patents. Royalties received by Corporation *D* for the use of such patents are not derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A).

(e) *Certain property transactions*—(1) *In general*—(i) *Inclusion in FPHC income.* Foreign personal holding company income includes the excess of gains over losses from the sale or exchange of—

(A) Property which gives rise to dividends, interest, rents, royalties or annuities as described in paragraph (e)(2) of this section, and

(B) Property which does not give rise to income, as described in paragraph (e)(3) of this section.

If losses from the sale or exchange of such property exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (e), and may not be allocated to, or otherwise reduce, other foreign personal holding company income under section 954(b)(5) and § 1.954–1T(c). Gain or loss from a transaction that is treated as capital gain or loss under section 988(a)(1)(B) is not foreign currency gain or loss as defined in paragraph (g), but is gain or loss from the sale or exchange of property which is included in the computation of foreign personal holding company income under this paragraph (e)(1). Paragraphs (e) (4) and (5) of this section provide specific rules for determining whether gain or loss from dispositions of debt instruments and dispositions of options or similar property must be included in the computation of foreign personal holding company income under this paragraph (e)(1). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (e).

(ii) *Dual character property.* Property may only in part constitute property that gives rise to certain income as described in paragraph (e)(2) of this section or property that does not give rise to any income as described in paragraph (e)(3) of this section. In such cases, the property must be treated as two separate properties for purposes of this paragraph (e). Accordingly, the sale or exchange of such dual character property will give rise to gain or loss that in part must be included in the computation of foreign personal holding company income under this paragraph (e), and in part is excluded from such computation. Gain or loss from the disposition of dual character property must be bifurcated for purposes of this paragraph (e)(1)(i) pursuant to the method that most reasonably reflects the relative uses of the property. Reasonable methods may include comparisons in terms of gross income generated or the physical division of the property. In the case of real property, the physical division of the property will in most cases be the most reasonable method available. For example, if a controlled foreign corporation owns an office building, uses 60 percent of the building in its business, and rents out the other 40 percent, then 40 percent of the gain recognized on the disposition of the property would reasonably be treated as gain which is included in the computation of foreign personal holding company income under this paragraph (e)(1). This paragraph (e)(1)(ii) addresses the contemporaneous use of property for dual purposes; for rules concerning changes in the use of property affecting its classification for purposes of this paragraph (e), see paragraph (a)(3) of this section.

(2) *Property that gives rise to certain income*—(i) *In general.* Property the sale or exchange of which gives rise to foreign personal holding company income under this paragraph (e)(2) includes property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (b) of this section, except for rents and royalties derived from unrelated persons in the active conduct of a trade or business under paragraph (b)(5) of this section. The property described by this paragraph (e)(2) includes property which gives rise to export financing interest

described in paragraph (b)(2) of this section and property which gives rise to income from related persons described in paragraphs (b)(3) and (b)(4) of this section.

(ii) *Exception.* Property described in this paragraph (e)(2) does not include—

(A) Dealer property (as defined in paragraph (a)(4)(iv) of this section), and

(B) Inventory and similar property (as defined in paragraph (a)(4)(ii) of this section) other than securities.

(3) *Property that does not give rise to income.* The term "property that does not give rise to income" for purposes of this section includes all rights and interests in property (whether or not a capital asset) except—

(i) Property that gives rise to dividends, interest, rents, royalties and annuities described in paragraph (e)(2) of this section and property that gives rise to rents and royalties derived in the active conduct of a trade or business under paragraph (b)(5) of this section;

(ii) Dealer property (as defined in paragraph (a)(4)(iv) of this section);

(iii) Inventory and similar property (as defined in paragraph (a)(4)(ii)) other than securities;

(iv) Property (other than real property) used in the controlled foreign corporation's trade or business that is of a character which would be subject to the allowance for depreciation under section 167 or 168 and the regulations thereunder (including tangible property described in § 1.167(a)–2 and intangibles described in § 1.167(a)–3);

(v) Real property that does not give rise to rental or similar income, to the extent used in the controlled foreign corporation's trade or business; and

(vi) Intangible property as defined in section 936(h)(3)(B) and goodwill that is not subject to the allowance for depreciation under section 167 and the regulations thereunder to the extent used in the controlled foreign corporation's trade or business and disposed of in connection with the sale of a trade or business of the controlled foreign corporation.

(4) *Classification of gain or loss from the disposition of a debt instrument or on a deferred payment sale*—(i) *Gain.* Gain from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) It is treated as interest income (as defined in paragraph (a)(4)(i) of this section); or

(B) It is treated as income equivalent to interest under paragraph (h) of this section.

(ii) *Loss.* Loss from the sale, exchange, or retirement of a debt instrument is included in the computation of foreign personal holding company income under this paragraph (e) unless—

(A) It is directly allocated to interest income (as defined in paragraph (a)(4)(i) of this section) or income equivalent to interest (as defined in paragraph (h) of this section) under any provision of the Code or regulations thereunder;

(B) It is required to be apportioned in the same manner as interest expense under section 864(e) or any other provision of the Code or regulations thereunder; or

(C) The debt instrument was taken in consideration for the sale or exchange of property (or the provision of services) by the controlled foreign corporation and gain or loss from that sale or exchange (or income from the provision of services) is not includible in foreign base company income under this section.

(5) *Classification of options and other rights to acquire or transfer property.* Subject to the exceptions provided in paragraphs (e)(3) (ii) and (iii) of this section (relating to certain dealer property and inventory property), rights to acquire or transfer property, including property that gives rise to income, are classified as property that does not give rise to income under paragraph (e)(3) of this section. These rights include options, warrants, futures contracts, options on a futures contract, forward contracts, and options on an index relating to stocks, securities or interest rates.

(6) *Classification of certain interests in pass through entities.* [Reserved.]

(f) *Commodities transactions*—(1) *In general.* Except as otherwise provided in this paragraph (f), foreign personal holding company income includes the excess of gains over losses from commodities transactions. If losses from commodities transactions exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (f), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954–1T(a)(4). The terms "commodity" and "commodities transactions" are defined in paragraph (f)(2) of this section. Gains and losses from qualified active sales and qualified hedging transactions are excluded from the computation of foreign personal holding company income under this paragraph (f). The term "qualified active sales" is defined in paragraph (f)(3). The term "qualified hedging transaction" is defined in paragraph (f)(4) of this section. An election is provided under paragraph (g)(5) of this section to include all gains and losses from section 1256 foreign currency transactions, which would otherwise be commodities transactions, in the computation of foreign personal holding company income under paragraph (g) instead of this paragraph (f). A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (f).

(2) *Definitions*—(i) *Commodity.* For purposes of this section, the term "commodity" means:

(A) Tangible personal property of a kind which is actively traded or with respect to which contractual interests are actively traded, and

(B) Nonfunctional currency (as defined under section 988 and the regulations thereunder).

(ii) *Commodities transaction.* A commodities transaction means the purchase or sale of a commodity for immediate (spot) delivery, or deferred (forward) delivery, or the right to purchase, sell, receive, or transfer a commodity, or any other right or obligation with respect to a commodity, accomplished through a cash or off-exchange market, an interbank market, an organized exchange or board of trade, an over-the-counter market, or in a transaction effected between private parties outside of any market. Commodities transactions include, but are not limited to:

(A) A futures or forward contract in a commodity,

(B) A leverage contract in a commodity purchased from leverage transaction merchants,

(C) An exchange of futures for physical transaction,

(D) A transaction in which the income or loss to the parties is measured by reference to the price of a commodity, a pool of commodities, or an index of commodities,

(E) The purchase or sale of an option or other right to acquire or transfer a commodity, a futures contract in a commodity, or an index of commodities, and

(F) The delivery of one commodity in exchange for the delivery of another commodity, the same commodity at another time, cash, or nonfunctional currency.

(3) *Definition of the term "qualified active sales"*—(i) *In general.* The term "qualified active sales" means the sale of commodities in the active conduct of a commodity business as a producer, processor, merchant, or handler of commodities if substantially all of the controlled foreign corporation's business

is as an active producer, processor, merchant, or handler of commodities of like kind. The sale of commodities held by a controlled foreign corporation other than in its capacity as an active producer, processor, merchant or handler of commodities of like kind is not a qualified active sale.

(ii) *Sale of commodities.* The term "sale of commodities" means any transaction in which the controlled foreign corporation intends to deliver to a purchaser a commodity held by the controlled foreign corporation in physical form.

(iii) *Active conduct of a commodities business.* For purposes of this paragraph, a controlled foreign corporation is engaged in the active conduct of a commodities business as a producer, processor, merchant, or handler of commodities only if—

(A) It holds commodities as inventory or similar property (as defined in paragraph (a)(4)(ii)); and

(B) It incurs substantial expenses in the ordinary course of a commodities business from engaging in one of the following activities directly, and not through an independent contractor:

(*1*) Substantial activities in the production of commodities, including planting, tending or harvesting crops, raising or slaughtering livestock, or extracting minerals.

(*2*) Substantial processing activities prior to the sale of commodities including concentrating, refining, mixing, crushing, aerating, or milling; or

(*3*) Significant activities relating to the physical movement, handling and storage of commodities including preparation of contracts and invoices; arranging freight, insurance and credit; arranging for receipt, transfer or negotiation of shipping documents; arranging storage or warehousing, and dealing with quality claims; owning and operating facilities for storage or warehousing or owning or chartering vessels or vehicles for the transportation of commodities.

For purposes of this paragraph (f), a corporation is not engaged in a commodities business as a producer, processor, merchant, or handler of commodities if its business is primarily financial. In general, the business of a controlled foreign corporation is financial if it primarily engages in commodities transactions for investment or speculation, or if it primarily provides products or services to customers for investment or speculation.

(iv) *Substantially all.* Substantially all of the controlled foreign corporation's business is as an active producer, processor, merchant, or handler of commodities if the activities described in paragraph (f)(3)(iii) give rise to 85 percent of the taxable income of the controlled foreign corporation (computed as though the corporation were a domestic corporation). For this purpose, gains or losses from qualified hedging transactions, as defined in paragraph (f)(4), are considered derived from the qualified active sales to which they relate or are expected to relate.

(4) *Definition of the term "qualified hedging transaction."* The term "qualified hedging transaction" means a bona fide hedging transaction that:

(i) Is reasonably necessary to the conduct of business as a producer, processor, merchant or handler of a commodity in the manner in which such business is customarily and usually conducted by others;

(ii) Is entered into primarily to reduce the risk of price change (but not the risk of currency fluctuations) with respect to commodities sold or to be sold in qualified active sales described in paragraph (f)(3) of this paragraph; and

(iii) Is clearly identified on the controlled foreign corporation's records before the close of the fifth day after the day during which the hedging transaction is entered into and at a time when there is a reasonable risk of loss; however, if the controlled foreign corporation does not at such time specifically and properly identify the qualified active sales (or category of such sales) to which a hedging transaction relates, the district director in his sole discretion may determine which hedging transactions (if any) are related to qualified active sales.

(g) *Foreign currency gain*—(1) *In general.* Except as provided in paragraph (g)(2), foreign personal holding company income includes the excess of foreign currency gains over losses (as defined in section 988(b)) attributable to any section 988 transactions. If foreign currency losses exceed gains, the net loss is not within the definition of foreign personal holding company income under this paragraph (g), and may not be allocated to, or otherwise reduce, foreign personal holding company income under section 954(b)(5) and § 1.954–1T(a)(4). To the extent the gain or loss from a transaction is treated as interest income or expense under sections 988(a)(2) or 988(d) and the regulations thereunder, it is not included in the computation of foreign personal holding company income under this paragraph (g). (For other rules concerning income described in more than one category of foreign personal holding company income, see § 1.954–2(a)(2).) A loss that is deferred or that otherwise may not be taken into account under any provision of the Code may not be taken into account for purposes of determining foreign personal holding company income under any provision of this paragraph (g).

(2) *Exceptions*—(i) *Qualified business units using the dollar approximate separate transactions method.* Currency gain or loss determined under the dollar approximate separate transactions method ("DASTM gain or loss") provided by § 1.985–3T is foreign currency gain or loss attributable to a section 988 transaction for purposes of computing foreign personal holding company income under this paragraph (g). For purposes of section 1.954–1T, DASTM gain or loss shall be included in or reduce the category of foreign base company and insurance income to the extent allocated to such income under the rules of this paragraph (g)(2)(i). DASTM gain or loss shall first be allocated pro rata to foreign source gross income in each separate category described in § 1.904–5(a)(1) (section 904(d) category) under the rules of § 1.904–4(j). The amount of DASTM gain or loss that is allocated to each separate 904(d) category shall then be further allocated pro rata to gross foreign source income in each of the following groups within a section 904(d) category:

(A) Foreign base company income (including foreign currency gain or loss other than DASTM gain or loss);

(B) Insurance income;

(C) Other income.

For purposes of § 1.954–1T and this section, the amount of DASTM gain or loss that, under the rules of this paragraph (g)(2)(i), is allocable to foreign base company income within a section 904(d) category shall next be allocated pro rata to foreign source gross income in the categories described in § 1.954–1T(a)(2) that are within the section 904(d) category. Currency gain or loss determined under DASTM does not include currency gain or loss attributable to any transaction involving a third country currency (as described in § 1.985–3T(c)(7)(ii)). Foreign currency gains or losses attributable to third country currency transactions are subject to the treatment provided in paragraph (g)(1) and subdivisions (ii) and (iii) of this paragraph (g)(2).

(ii) *Tracing to exclude foreign currency gain or loss from qualified business and hedging transactions.* A foreign currency gain or loss is excluded from the computation of foreign personal holding company income under this paragraph (g) if it is clearly identified on the records of the controlled foreign corporation as being derived from a qualified business transaction or a qualified hedging transaction. The term "qualified business transaction" is defined in paragraph (g)(3) of this section. The term "qualified hedging transaction" is defined paragraph (g)(4) of this section. However, currency gain or loss of a qualified business unit included in the computation of currency gain or loss under subdivision (i) of this paragraph (g)(2) may not be excluded from foreign personal holding company income under the tracing rule of this paragraph (g)(2)(ii). Furthermore, the tracing rule of this paragraph (g)(2)(ii) will not apply if a controlled foreign corporation makes the election provided by paragraph (g)(2)(iii) of this section.

(iii) *Election out of tracing.* A controlled foreign corporation may elect a method of accounting under which all foreign currency gains or losses attributable to section 988 transactions are included in foreign personal holding company income. The scope and requirements for this election are provided in paragraph (g)(5) of this section. This election does not apply to foreign currency gains or losses of a qualified business unit included in the computation of gain or loss under paragraph (g)(2)(i) of this section.

(3) *Definition of the term "qualified business transaction"*—(i) *In general.* The term "qualified business transaction" means a transaction (other than a "qualified hedging transaction" as described in paragraph (g)(4) of this section) that:

(A) Does not have investment or speculation as a significant purpose;

(B) Is not attributable to property or an activity of the kind that gives rise to subpart F income (other than foreign currency gain under this paragraph (g)), or could reasonably be expected to give rise to subpart F income (including upon disposition); for example, the transaction may not be attributable to stock or debt of another corporation (including related corporations organized and operating in the same country), or property likely to give rise to foreign base company sales or services income; and

(C) Is attributable to business transactions described in subdivision (ii) of this paragraph (g)(3).

A qualified business transaction includes the disposition of a debt instrument that constitutes inventory property under paragraph (a)(4)(ii) or dealer property under paragraph (a)(4)(iv) of this section. The provisions of this paragraph (g)(3) do not apply to the foreign currency gain or loss of a qualified business unit (as determined under § 1.985–3T(d)(2)) included in the computation of gain or loss under paragraph (g)(2)(i) of this section. The provisions of this paragraph (g)(3) do, however, apply to other currency transactions of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency under section 985(b)(3) and § 1.985–2T. Qualified business transactions and the amount of foreign currency gain or loss derived therefrom must be clearly identified on its records by the controlled foreign corporation. If the controlled foreign corporation is unable to specifically identify the qualified business transactions and the foreign currency gain or loss derived therefrom, the district director in his sole discretion may determine which transactions of the corporation giving rise to the foreign currency gains or losses are attributable to qualified business transactions.

(ii) *Specific business transactions.* A transaction of a controlled foreign corporation must meet the requirements of any of subdivisions (A) through (F) of this paragraph (g)(3)(ii) to be a qualified business transaction under this paragraph (g)(3).

(A) *Acquisition of debt instruments.* If the transaction is the acquisition of a debt instrument described in section 988(c)(1)(B)(i) and the regulations thereunder, the debt must be derived from—

(*1*) The sale of inventory and similar property to customers by the controlled foreign corporation in the ordinary course of regular business operations, or

(*2*) The rendition of services by the corporation in the ordinary course of regular business operations.

For purposes of this paragraph (g)(3)(ii)(A), a debt instrument will not be considered derived in the ordinary course of regular business operations unless the instrument matures, and is reasonably expected to be satisfied, within the period for which interest need not be charged under section 482 and the regulations thereunder.

(B) *Becoming the obligor under debt instruments.* If the transaction is becoming the obligor under a debt instrument described in section 988(c)(1)(B)(i) and the regulations thereunder, the debt must be incurred for:

(*1*) Payment of expenses that are includible by the controlled foreign corporation in the cost of goods sold under § 1.61–3 for property held primarily for sale to customers in the ordinary course of regular business operations, are inventoriable costs under section 471 and the regulations thereunder, or are allocable or apportionable under the rules of § 1.861–8 to gross income derived from inventory and similar property,

(*2*) Payment of expenses that are allocable or apportionable under the rules of § 1.861–8 to gross income derived from services provided by the controlled foreign corporation in the ordinary course of regular business operations,

(*3*) Acquisition of an asset that does not give rise to Subpart F income during the current taxable year (other than by application of section 952(c)) and is not reasonably expected to give rise to Subpart F income in subsequent taxable years, or

(*4*) Acquisition of dealer property as defined in paragraph (a)(4)(iv) of this section.

The identification requirements of subdivision (i) of this paragraph (g)(3) will not be met with respect to a borrowing if the controlled foreign corporation fails to clearly identify the debt and the expenses (or categories of expenses) to which it relates before the close of the fifth day after the day on which the expenses are incurred.

(C) *Accrual of any item of gross income.* If the transaction is the accrual (or otherwise taking into account) of any item of gross income or receipts as described in section 988(c)(1)(B)(ii) and the regulations thereunder, the item of gross income or receipts must be derived from:

(*1*) The sale of inventory and similar property in the ordinary course of regular business operations, or

(*2*) The provision of services by the controlled foreign corporation to customers in the ordinary course of regular business operations.

(D) *Accrual of any item of expense.* If the transaction is the accrual (or otherwise taking into account) of any item of expense as described in section 988(c)(1)(B)(ii) and the regulations thereunder, the item of expense must be:

(*1*) An expense that is includible by the controlled foreign corporation in the cost of goods sold under § 1.61–3 for property held primarily for sale to customers in the ordinary course of regular business operations, is an inventoriable cost under section 471 and the regulations thereunder, or is allocable or apportionable under the rules of § 1.861–8 to gross income derived from inventory and similar property, or

(*2*) An expense that is allocable or apportionable under the rules of § 1.861–8 to gross income derived from services provided by the controlled foreign corporation in the ordinary course of regular business operations.

(E) *Entering into forward contracts, futures contracts, options and similar instruments.* If the transaction is entering into any forward contract, futures contract, option or similar financial instrument and if such contract or instrument is not marked to market at the close of the taxable year under section 1256, as described in section 988(c)(1)(B)(iii) and the regulations thereunder, then the contract or instrument must be property held as dealer property as defined in paragraph (a)(4)(ii) of this section.

(F) *Disposition of nonfunctional currency.* If the transaction is the disposition of nonfunctional currency, as described in section 988(c)(1)(C) and the regulations thereunder, then the transaction must be for a purpose described in paragraph (g)(3)(ii)(B), for the payment of taxes not attributable to subpart F income, or must be the disposition of property held as dealer property as defined in paragraph (a)(4)(iv) of this section.

(G) *Transactions in business assets.* The acquisition or disposition of an asset that is used or held for use in the active conduct of a trade or business.

(4) *Definition of the term "qualified hedging transaction"*—(i) *In general.* The term "qualified hedging transaction" means a bona fide hedging transaction meeting all the requirements of subdivisions (A) through (D) of this paragraph (g)(4)(i):

(A) The transaction must be reasonably necessary to the conduct of regular business operations in the manner in which such business operations are customarily and usually conducted by others.

(B) The transaction must be entered into primarily to reduce the risk of currency fluctuations with respect to property or services sold or to be sold or expenses incurred or to be incurred in transactions that are qualified business transactions under paragraph (g)(3) of this section.

(C) The hedging transaction and the property or expense (or category of property or expense) to which it relates must be clearly identified on the records of the controlled foreign corporation before the close of the fifth day after the day during which the hedging transaction is entered into and at a time during which there is a reasonable risk of currency loss.

(D) The amount of foreign currency gain or loss that is attributable to a specific hedging transaction must be clearly identifiable on the records of the controlled foreign corporation or its controlling shareholder (as defined in § 1.964–1(c)(5)).

The provisions of this paragraph (g)(4) do not apply to transactions of a qualified business unit included in the computation of gain or loss under paragraph (g)(2)(i). The provisions of this paragraph (g)(4) do apply, however, to other currency transactions of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency under section 985(b)(3) and § 1.985–3T. If the controlled foreign corporation does not specifically identify the qualified business transactions (or category of qualified business transactions) to which a hedging transaction relates or is unable to specifically identify the amount of foreign currency gain or loss derived from the hedging transactions, the district director in his sole discretion may make the identifications required of the controlled foreign corporation and determine which hedging transactions (if any) are related to qualified business transactions, and the amount of foreign currency gain or loss attributable to the qualified hedging transactions.

(ii) *Change in purpose of hedging transaction.* If a hedging transaction is entered into for one purpose, and the purpose for that transaction subsequently changes, the transaction may be treated as two separate hedging transactions for purposes of this paragraph (g)(4). In such a case, the portion of the transaction that relates to a qualified business transaction is considered a qualified hedging transaction if it separately meets all the other requirements of this paragraph (g)(4) for treatment as a qualified hedging transaction. For purposes of paragraph (g)(4)(i)(C), the foreign corporation must identify on its records the portion of the transaction that relates to a qualified business transaction by the close of the fifth day after the day on which the hedge becomes so related (*i.e.*, either the day on which the hedge is first entered into or on the day on which it first relates to a qualified business transaction due to a change in its purpose). The foreign corporation must identify on its records the portion of the transaction that does not relate to a qualified business transaction by the close of the fifth day after the day on which the purpose for the hedging transaction changes.

(5) *Election out of tracing*—(i) *In general.* A controlled foreign corporation may elect to account for currency gains and losses under section 988 and gains and losses from section 1256 currency contracts by including in the computation of foreign personal holding company income under this paragraph (g) all foreign currency gains or losses attributable to section 988 transactions, and all gains or losses from section 1256 foreign currency contracts. Separate elections for section 1256 foreign currency contracts and section 988 transactions are not permitted. If a controlled foreign corporation makes the election described in this paragraph (g)(5)(i), the election is effective for all related persons as defined in section 954(d)(3) and the regulations thereunder.

(ii) *Exception.* The election provided by this paragraph (g)(5) does not apply to foreign currency gain or loss of a qualified business unit determined under § 1.985–3T(d)(2). It does, however, apply to other foreign currency gains or losses of a qualified business unit that elects (or is deemed to elect) the U.S. dollar as its functional currency.

(iii) *Procedure*—(A) *In general.* The election provided by this paragraph (g)(5) shall be made in the manner prescribed in this paragraph and in subsequent administrative pronouncements.

(B) *Time and manner.* The controlled foreign corporation may make the election by filing a statement with its original or amended information return for the taxable year for which the election is made. The controlling United States shareholders, as defined in § 1.964–1(c)(5), may make the election on behalf of the controlled foreign corporation and related corporations by filing a statement to such effect with their original or amended income tax returns for the taxable year during which the taxable year of the controlled foreign corporation for which the election is made ends. The election is effective for the taxable year of the controlled foreign corporation for which the election is made, for the taxable years of all related controlled foreign corporations ending within such taxable year, and for all subsequent years of such corporations. The statement shall include the following information:

(*1*) The name, address, taxpayer identification number, and taxable year of each United States shareholder;

(*2*) The name, address, and taxable year of each controlled foreign corporation for which the election is effective; and

(*3*) Any additional information to be required by the Secretary by administrative pronouncement.

Each United States shareholder or controlled foreign corporation filing the election must provide copies of the election to all controlled foreign corporations for which the election is effective, and all United States shareholders of such corporations. However, failure to provide such copies will not void (or cause to be voidable) an election under this paragraph (g)(5).

(C) *Termination.* The election provided by this paragraph (g)(5) may be terminated only with the consent of the Commissioner: Attn.: CC:INTL.

(h) *Income equivalent to interest*—(1) *In general.* Foreign personal holding company income includes income that is equivalent to interest. Income equivalent to interest includes, but is not limited to, income derived from the following categories of transactions:

(i) An investment, or series of integrated transactions which include an investment, in which the payments, net payments, cash flows, or return predominantly reflect the time value of money, and

(ii) Transactions in which the payments or a predominant portion thereof are in substance for the use or forebearance of money, but are not generally treated as interest.

However, amounts treated as interest under section 954(c)(1)(A) and paragraph (b) of this section are not income equivalent to interest under this paragraph (h). Income from the sale of property will not be treated as income equivalent to interest for purposes of this paragraph (h), subject to the rule of paragraph (h)(4) of this section, unless the sale is part of an integrated transaction that gives rise to interest or income equivalent to interest. See sections 482, 483 and 1274 for the extent to which such income may be characterized as interest income subject to paragraph (b) of this section. Income equivalent to interest for purposes of this paragraph (h) includes all income attributable to a transfer of securities subject to section 1058. Income equivalent to interest also includes a portion of certain deferred payments received for the purpose of services, in accordance with the provisions of paragraph (h)(5) of this section. Income equivalent to interest does not include income attributable to notional principal contracts such as interest rate swaps, currency swaps, interest rate floor agreements, or similar contracts except to the extent that such contracts are part of an integrated transaction that gives rise to income equivalent to interest. Income derived from notional contracts by a person acting in its capacity as a regular dealer in such contracts will be presumed not to be integrated with an investment.

(2) *Illustrations.* The following examples illustrate the application of this paragraph (h):

Example (1). CFC, a controlled foreign corporation, promises that *A,* an unrelated person, may borrow up to $500 in principal for one year beginning at any time during the next three months at an interest rate of 10 percent. In exchange, *A* pays *CFC* a commitment fee of $2.00. Pursuant to this loan commitment, *CFC* lends $80 to *A*. As a result, the entire $2.00 fee is included in the computation of foreign personal holding company income under this paragraph (h)(1)(ii).

Example (2). (i) At the beginning of its current taxable year, *CFC,* a controlled foreign corporation, purchases at face value a one-year debt instrument issued by *A* having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate ("LIBOR") plus one percentage point. Contemporaneously, *CFC* borrows $100 from *B* for one year at a fixed interest rate of 10 percent, using the debt instrument as security.

(ii) During its current taxable year, *CFC* accrues $11 of interest from *A* on the bond. That interest is foreign personal holding company income under section 954(c)(1) and § 1.954-2T(b), and thus is not income equivalent to interest. During its current taxable year, *CFC* incurs $10 of interest expense with respect to the borrowing from *B*. That expense is allocated and apportioned to, and reduces, foreign base company income or insurance income to the extent provided in sections 954(b)(5), 863(e), and 864(e) and the regulations thereunder.

Example (3). (i) At the beginning of its 1988 taxable year, *CFC,* a controlled foreign corporation, purchases at face value a one-year debt instrument issued by *A* having a $100 principal amount and bearing a floating rate of interest set at the London Interbank Offered Rate ("LIBOR") plus one percentage point payable on the last day of *CFC*'s current taxable year. *CFC* subsequently determines that it would prefer receiving interest at a fixed rate, and, on January 1, 1989, enters into an agreement with *B,* an unrelated person, whereby *B* promises to pay *CFC* on the last day of *CFC*'s 1989 taxable year an amount equal to 10 percent on a notional principal amount of $100. In exchange, *CFC* promises to pay *B* on the last day of *CFC*'s 1989 taxable year an amount equal to LIBOR plus one percentage point on the notional principal amount.

(ii) *CFC* receives a total of $10 from *B,* and pays $9 to *B*. *CFC* also receives $9 from *A*. The $9 paid to *B* is directly allocated to, or is otherwise an adjustment to, the $10 received from *B*. The transactions are considered an intergrated transaction giving rise to $9 of interest income (paid by *A*) and, under paragraph (h)(1)(i), $1 of income equivalent to interest (paid by *B*).

Example (4). The facts are the same as in Example (3), except that *CFC* does not hold any debt obligations. Since the transaction with *B* is not integrated with an investment giving rise to interest or income equivalent to interest, the net $1 of income realized by *CFC* does not constitute income equivalent to interest.

Example (5). (i) *CFC,* a controlled foreign corporation, enters into an agreement with *A* whereby *CFC* purchases commodity X from *A* at a price of $100, and *A* contemporaneously repurchases commodity X from *CFC* for payment and delivery in 3 months at a price of $104 set by the forward market.

(ii) The transaction is in substance a loan from *CFC* to *A* secured by commodity X. Thus, *CFC* accrues $4 of gross income which is included in foreign personal holding company income as interest under section 954(c)(1)(A) and paragraph (b) of this section.

Example (6). (i) *CFC* purchases commodity Y on the spot market for $100 and contemporaneously, sells commodity Y forward for delivery and payment in 3 months at a price of $104 set by the forward market.

(ii) The $100 paid on the spot purchase of commodity Y offsets any market risk on the forward sale so that the $4 of income to be derived predominantly reflects time value of money. Thus, under paragraph (h)(1)(i), the spot purchase of commodity Y and the offsetting forward sale will be treated as an integrated transaction giving rise to $4 of income equivalent to interest.

(3) *Income equivalent to interest from factoring*—(i) *General rule.* Income equivalent to interest includes factoring income. Except as provided in paragraph (h)(3)(ii) of this section, the term "factoring income" includes any income (including any discount income or service fee, but excluding any stated interest) derived from the acquisition and collection or disposition of a factored receivable. The rules of this paragraph (h)(3) apply only with respect to the tax treatment of factoring income derived from the acquisition and collection or disposition of a factored receivable and shall not affect the characterization of an expense or loss of either the person whose goods or services gave rise to a factored receivable or the obligor under a receivable. The amount of income equivalent to interest realized with respect to a factored receivable is the difference (if a positive number) between the amount paid for the receivable by the foreign corporation and the amount that it collects on the receivable (or realizes upon its sale of the receivable).

(ii) *Exceptions.* Factoring income shall not include—

(A) Income treated as interest under section 864(d)(1) or (6) and the regulations thereunder (relating to income derived from trade or service receivables of related persons), even if such income is not treated as described in section 864(d)(1) by reason of the same-country exception of section 864(d)(7);

(B) Income derived from a factored receivable if payment for the acquisition of the receivable is made on or after the date on which stated interest begins to accrue, but only if the rate of stated interest equals or exceeds 120 percent of the Federal short term rate (as defined under section 1274) (or the equivalent rate for a currency other than the dollar) as of the date on which the receivable is acquired by the foreign corporation; or

(C) Income derived from a factored receivable if payment for the acquisition of the receivable by the foreign corporation is made only on or after the anticipated date of payment of all principal by the obligor (or the anticipated weighted average date of payment of a pool of purchased receivables).

(iii) *Factored receivable.* For purposes of this paragraph (h)(3), the term "factored receivable" includes any account receivable or other evidence of indebtedness, whether or not issued at a discount and whether or not bearing stated interest, arising out of the disposition of property or the performance of services by any person, if such account receivable or evidence of indebtedness is acquired by a person other than the person who disposed of the property or provided the services that gave rise to the account receivable or evidence of indebtedness. For purposes of this paragraph (h)(3), it is immaterial whether the person providing the property or services agrees to transfer the receivable at the time of sale (as by accepting a third-party charge or credit card) or at a later time.

(iv) *Illustrations.* The following examples illustrate the application of this paragraph (h)(3).

Example (1). DP, a domestic corporation, owns all of the outstanding stock of FS, a controlled foreign corporation. FS acquires accounts receivable arising from the sale of property by unrelated corporation X. The receivables have a face amount of $100, and after 30 days bear stated interest equal to at least 120 percent of the applicable short term Federal rate (determined as of the date the receivable is acquired). FS purchases the receivables from X for $95 on Day 1 and collects $100 from the obligor under the receivable on Day 40. Income (other than stated interest) derived by FS from the factored receivables is factoring income within the meaning or paragraph (h)(3)(i) of this section and, therefore, is income equivalent to interest.

Example (2). The facts are the same as in example (1), except that FS does not pay X for the receivables until Day 30. Income derived by FS from the factored receivables is not factoring income by reason of paragraph (h)(3)(ii)(B) of this section.

Example (3). The facts are the same as in Example (2), except that it is anticipated that all principal will be paid by the obligor of the receivables by Day 30. Income derived by FS from this "maturity factoring" of the receivables is not factoring income by reason of paragraph (h)(3)(ii)(C) of this section, and therefore does not give rise to income equivalent to interest.

Example (4). The facts are the same as in example (1), except that, rather than collecting $100 from the obligor under the factored receivable on Day 40, FS sells the receivable to controlled foreign corporation Y on Day 15 for $97. Both the income derived by FS on the factored receivable and the income derived by Y (other than stated interest) on the receivable are factoring income within the meaning of paragraph (h)(3)(i) of this section, and therefore, constitute income equivalent to interest.

Example (5). The facts are the same as in example (4), except that FS sells the factored receivable to Y for $99 on Day 45, at which time interest is accruing on the unpaid balance of $100. FS has $4 of net factoring income that is income equivalent to interest. Because interest was accruing at the time Y acquired the receivable at a rate equal to at least 120 percent of the applicable short term Federal rate, income derived by Y from the factored receivable is not factoring income by reason of pargraph (h)(3)(ii)(B).

Example (6). DP, a domestic corporation engaged in an integrated credit card business, owns all of the outstanding stock of FS, a controlled foreign corporation. On Day 1 individual A uses a credit card issued by DP to purchase shoes priced at $100 from X, a foreign corporation unrelated to DP, FS, or A. By prearrangement with DP, on Day 7, X transfers the receivable arising from A's purchase to FS in exchange for $95. FS collects $100 from A on Day 45. Income derived by FS on the factored receivable is factoring income within the meaning of paragraph (h)(3)(i) of this section and, therefore, is income equivalent to interest.

(4) *Determination of sales income.* Income equivalent to interest for purposes of this paragraph (h) does not include income from the sale of property unless the sale is part of an integrated transaction that gives rise to interest or income equivalent to interest. Income derived by a controlled foreign corporation will be treated as arising from the sale of property only if the corporation in substance carries out sales activities. Accordingly, an arrangement that is designed to lend the form of a sales transaction to a transaction that in substance constitutes and advance of funds will be disregarded. For example, if a controlled foreign corporation acquires property on 30-day payment terms from one person and sells that property to another person on 90 day payment terms and at prearranged prices and terms such that the foreign corporation bears no substantial economic risk with respect to the purchase and sale other than the risk of non-payment, the foreign corporation has not in substance derived income from the sale of property.

(5) *Receivables arising from performance of services.* If payment for services performed by a controlled foreign corporation is not made until more than 120 days after the date on which such services are performed, then the income derived by the foreign corporation constitutes income equivalent to interest to the extent that interest income would be imputed under the principles of section 483 or the original issue discount provisions (section 1271 *et seq.*), if—

(A) Such provisions applied to contracts for the performance of services,

(B) The time period referred to in sections 483(c)(1) and 1274(c)(1)(B) were 120 days rather than six months, and

(C) The time period referred to in section 483(c)(1)(A) were 120 days rather than one year.

Par. 7. In section 1.957–1, the heading and text for paragraph (a) are removed and paragraph (a) is reserved.

Par. 8. The following new section is added immediately after § 1.957–1.

§ 1.957–1T Definition of controlled foreign corporation for taxable years beginning after December 31, 1986 (temporary).

(a) *In general.* For purposes of sections 951 through 964, the term "controlled foreign corporation" means any foreign corporation of which more than 50 percent (more than 25 percent, in a case to which section 957(b) applies, and 25 percent or more in a case to which section 953(c) applies) of either—

(1) the total combined voting power of all classes of stock of the corporation entitled to vote, or

(2) the total value of the stock of the corporation,

is owned within the meaning of section 958(a), or is considered as owned by applying the rules of section 958(b) and § 1.958–2, by United States shareholders on any day during the taxable year of such foreign corporation. If the United States shareholders own the requisite percentage of total combined voting power or the requisite percentage of total value in the foreign corporation as described in this paragraph (b), the foreign corporation is a controlled foreign corporation. For definition of the term "United States shareholder," see section 951(b) and the regulations thereunder. For definition of the term "foreign corporation," see § 301.7701–5 of this chapter (Procedure and Administration Regulations). For treatment of associations as corporations, see section 7701(a)(3) and §§ 301.7701–1 and 301.7701–2 of this chapter. For definition of the term "stock," see section 958(a)(3) and 7701(a)(7). For the classification of a member in an association, joint stock company, or insurance company as a shareholder, see section 7701(a)(8).

(b) [Reserved.]

(c) *Illustrations.* The application of this section may be illustrated by the following examples.

Example (1). [Reserved]
Example (2). [Reserved]
Example (3). [Reserved]
Example (4). [Reserved]
Example (5). [Reserved]
Example (6). [Reserved]
Example (7). [Reserved]

Example (8). For its prior taxable year, *JV*, a foreign corporation, had outstanding 1,000 shares of class A stock, which is voting common, and 1,000 shares of class B stock, which is voting nonvoting preferred. *DP*, a domestic corporation, and *FP*, a foreign corporation each owned precisely 500 shares of both class A and class B stock, and each elected 5 of the 10 members of *JV*'s board of directors. The other facts and circumstances were such that *JV* was not a controlled foreign corporation on any day of the prior taxable year. On the first day of the current taxable year, *DP* purchased one share of class B stock from *FP*. *JV* was a controlled foreign corporation on that day because over 50 percent of the total value in the corporation was held by a person that was a United States shareholder under section 951(b) and the regulations thereunder.

Example (9). *X*, a foreign corporation is incorporated under the laws of country *Y*. Under the laws of country *Y*, *X* is considered a mutual insurance company. *X* issues insurance policies that provide the policyholder with the right to vote for directors of the corporation, the right to a share of the assets upon liquidation in proportion to premiums paid, and the right to receive policyholder dividends in proportion to premiums paid. Only policyholders are provided with the right to vote for directors, share in assets upon liquidation, and receive distributions. United States policyholders contribute 25 percent of the premiums and have 25 percent of the outstanding rights to vote for the board of directors. Based on these facts, the United States policyholders are United States shareholders owning the requisite combined voting power and value. Thus, *X* is a controlled foreign corporation as defined in section 953(c).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 9. The authority citation for Part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

§ 602.101 [Amended]

Par. 10. Section 602.101(c) is amended by inserting in the appropriate place in the table "§ 1.954–1T . . . 1545–1068", "§ 1.954–2T . . . 1545–1068".

Lawrence B. Gibbs,
Commissioner of Internal Revenue.

Approved:
June 23, 1988.

Donaldson Chapoton,
Assistant Secretary of the Treasury.

[FR Doc. 88–16205 Filed 7–20–88; 8:45 am]

BILLING CODE 4830-01-M

DEPARTMENT OF DEFENSE

Office of the Secretary

32 CFR Part 203

[DOD Instruction 6015.18]

Smoking in DOD Occupied Buildings and Facilities

AGENCY: Department of Defense.

ACTION: Final rule.

SUMMARY: This action is taken to remove 32 CFR Part 203 in its entirety. DOD Directive 1010.10, "Health Promotion," replaced DOD Instruction 6015.18 (32 CFR Part 203). The replacement document will be printed in the **Federal Register** at a later date. Because 32 CFR Part 203 is no longer valid, this part is removed from the Code of Federal Regulations.

EFFECTIVE DATE: July 18, 1988.

FOR FURTHER INFORMATION CONTACT: Colonel Hagey, Office of the Secretary of Defense (Health Affairs) (PA&QA), Room 3D368, the Pentagon, Washington, DC 20301, telephone (202) 695–6800.

SUPPLEMENTARY INFORMATION:

List of Subjects in 32 CFR Part 203

Federal buildings and facilities, Smoking.

PART 203—[REMOVED]

Accordingly, Title 32, Chapter 1, is amended by removing Part 203.

L.M. Bynum,
Alternate OSD Federal Register Liaison Officer, Department of Defense.

July 18, 1988.

[FR Doc. 88–16436 Filed 7–20–88; 8:45 am]

BILLING CODE 3810-01-M

Corps of Engineers, Department of the Army

33 CFR Parts 209 and 245

Removal of Wrecks and Other Obstructions

AGENCY: Army Corps of Engineers, DoD.

ACTION: Final rule.

SUMMARY: The Corps of Engineers is amending its regulations concerning removal of wrecks and other obstructions in navigable waters. The regulation describes administrative procedures to be used by the Corps, and does not impose new requirements on the public. Revision to the procedures reflects legislative changes from the Water Resources Development Act of 1986, and an interagency agreement with the Coast Guard.

EFFECTIVE DATE: July 21, 1988.

FOR FURTHER INFORMATION CONTACT: Rick Kowalewski, 202–272–0281.

SUPPLEMENTARY INFORMATION:

Background

The marking and removal of wrecks is governed by sections 15, 19 and 20 of the River and Harbor Act of 1899, as amended (33 U.S.C. 409–415). Marking of wrecks is under the purview of the Coast Guard and regulated under 33 CFR Part 64, while removal is under the purview of the U.S. Army Corps of Engineers. To better coordinate federal interests in navigation, the Coast Guard and Corps of Engineers signed a Memorandum of Agreement (MOA) in October 1985, which outlined procedures for making joint determinations of hazards to navigation and for coordinating remedial actions when a hazard to navigation exists.

The Water Resources Development Act of 1986 (Pub. L. 99–662) amended the Rivers and Harbors Act of 1899, by extending jurisdiction to non-negligent sinkings, extending the obligation for marking and removal to vessel operators and lessees (in addition to owners), and providing for reimbursement to the U.S. Treasury for full costs of federal removal and disposal.

The Corps of Engineers has published, for public information, its policies and procedures for wreck removal under 33 CFR Part 209. On June 29, 1987 (52 FR 24177), a proposed rule was published in the **Federal Register**, inviting comments for a period ending July 31, 1987. The proposed rule provided updated procedures to correspond to the interagency MOA and Pub. L. 99–662. Written comments were received from two Coast Guard district offices.

The proposed rule was also reexamined by the Corps of Engineers for clarity and overall integrity. The final rule reflects the comments received, as well as a general reorganization based on internal review.

Changes from proposed rules

Paragraph (a) of § 209.170, "Violations of law protecting navigable waters; Wrecks and similar obstructions," is being deleted in its entirety. This paragraph simply restated and paraphrased the law.

The procedures are being moved from § 209.190 to a new CFR part by itself, to increase visibility and access.

Paragraphs have been reorganized in the final rule to present general policy first, followed by procedures in essentially the sequence they are executed, for improved clarity. General policy and definitions have also been rewritten for clarity. Paragraphs relating to internal Corps of Engineers reports, documentation, and funding procedures are being deleted, since these aspects of the wreck removal program have no impact on the public.

The statement of purpose in the proposed § 209.190 (new Part 245) is clarified to reflect the informational (vs. prescriptive) nature of this part.

Detailed references to marking requirements were deleted to avoid possible conflict with, or apparent preemption of, regulations published by the Coast Guard in 33 CFR Part 64. General references to marking requirements are retained, since marking of wrecks is strongly related to the Corps' wreck removal program.

The paragraph which encouraged people to report obstructions is inconsistent with the purpose of this CFR part, which is the publication of the agency's administrative procedure, and is therefore deleted.

Specific reference to the Memorandum of Agreement between the Corps of Engineers and the Coast Guard, dated October 1985, is deleted to avoid "dating" the CFR. References to interagency agreement are retained.

The paragraph which outlined priorities for removal has been deleted from the final rule. This paragraph was essentially common sense but framed in fairly rigid language, which unnecessarily constrained the District Engineer in making case-by-case judgments using the considerations outlined elsewhere in the regulation. Program priorities are further discussed under the heading "Program priorities" below.

Criteria for establishing abandonment have been rewritten for clarity and greater consistency with the wording in the law.

The final rule specifically addresses certain limits for wrecks which existed before Pub. L. 99–662. For pre-existing wrecks, reimbursement for federal removal remains limited to sinkings which were voluntary or careless, and the obligation for removal is limited to the vessel owner.

Under "Applicability," the reference to the CFR definition of "navigable waters of the U.S." has been revised to correctly reflect the regulatory jurisdiction of the Corps of Engineers as stated in 33 CFR Part 329. The proposed rule referenced a section of the CFR addressing Coast Guard jurisdiction.

Discussion of comments

Two comments were received.

Both commentors objected to the apparent restriction of scope to federal project limits, and one comment noted that the exclusion of "private wharves or canals" was too broad. The final rule removes the restrictive wording concerning priorities for removal, in favor of more balanced judgments by the local District Engineer considering all relevant factors, as outlined under "Determination of hazard to navigation" and "Determination of remedial action."

One Coast Guard district requested specific notifications whenever the District Engineer knows of any change in conditions which were originally considered, and whenever the owner's marking or removal efforts are determined to be not diligent. The Coast Guard district also requested an information copy of the notice which is sent to the owner requiring marking and removal. These comments were not incorporated in the final rule, since notifications generally have been removed from the CFR. All of these concerns will be incorporated in an internal policy directive (Engineer Regulation) instead.

One commentor objected to wording which indicated the Corps would make independent determinations of hazards to navigation and of the need for marking, in conflict with the MOA. The final rule reflects that these are joint determinations at the field level, and outlines the process for conflict resolution. The Corps of Engineers still retains the ultimate authority and responsibility for making determinations which impact its activities. The final rule indicates that independent determinations can be made only after referral to the director of Civil Works.

Program priorities

Removal of obstructions to navigation at federal expense is generally limited to cases where the safety or sustainment of general navigation is affected (not merely an obstruction to a private dock or canal, or merely aesthetically displeasing). Priority is given to wrecks located within navigation channels or shipping lanes, or endangering structures that facilitate navigation, or having a reasonably high potential for moving into any area of general navigation. The sustainment of commercial navigation is also given priority. Alternatives to removal, such as marking and charting, are also evaluated as possible remedies in lieu of federal removal if an adequate level of safety can be achieved.

The primary obligation for removal of wrecks belongs to the owner, operator or lessee. The policy of the Corps of Engineers (except in some emergency cases where impractical) is to pursue removal by these parties before undertaking removal at federal expense. This may include seeking a court judgment to require removal. If the responsible parties cannot be determined or do not take appropriate action, and a hazard to navigation exists which requires removal, the Corps may proceed with federal removal. Reimbursement is then sought from the owner, operator or lessee.

Regulatory Requirements

This rule relates to internal agency management. Therefore, pursuant to 5 U.S.C. 553, this rule may become effective less than 30 days after publication in the **Federal Register.**

List of Subjects

33 CFR Part 209

Accidents, Administrative practice and procedure, Intergovernmental relations, Law enforcement, Navigation, Waterways.

33 CFR Part 245

Accidents, Administrative practice and procedure, Intergovernmental relations, Law enforcement, Navigation, Waterways.

Dated June 30, 1988.

Robert W. Page,

Assistant Secretary of the Army (Civil Works).

For the reasons set out in the preamble, Title 33, Chapter II of the Code of Federal Regulations, is amended as follows:

PART 209—ADMINISTRATIVE PROCEDURE

1. The authority citation for Part 209 is revised to read as follows:

Authority: 5 U.S.C. 301; 33 U.S.C. 1; 10 U.S.C. 3012.

2. In § 209.170, paragraph (a) is removed and reserved.

§ 209.190 [Redesignated as Part 245 and revised]

3. Section 209.190 is redesignated as Part 245 and revised to read as follows:

PART 245—REMOVAL OF WRECKS AND OTHER OBSTRUCTIONS

Sec.

Authority: 5 U.S.C. 301; 33 U.S.C. 1, 409, 411–415; 10 U.S.C. 3012.

§ 245.1 Purpose.

This part describes administrative procedures and policy used by the Corps of Engineers in exercising its authority for wreck removal. Procedures are intended to insure that the impacts of obstructions are minimized, while recognizing certain rights of owners, operators and lessees.

§ 245.3 Applicability.

(a) These procedures apply to the removal of wrecks or other obstructions within the navigable waters of the United States, as defined in Part 329 of this chapter.

(b) This part does not apply to the summary removal or destruction of a vessel by the Coast Guard under authority of the Clean Water Act (33 U.S.C. 1321), or to any removal actions involving obstructive bridges which are subject to separate regulation under Part 114 of this title.

(c) For vessels which were sunk or wrecked prior to November 17, 1986, the statutory obligation to remove belongs solely to the owner (not the operator or lessee), and the owner's obligation to reimburse the U.S. Treasury for federal removal is limited to cases of voluntary or careless sinking.

§ 245.5 Definitions.

Abandonment means the surrendering of all rights to a vessel (or other obstruction) and its cargo by the owner, or owners if vessel and cargo are separately owned.

Hazard to navigation is an obstruction, usually sunken, that presents sufficient danger to navigation so as to require expeditious, affirmative action such as marking, removal, or redefinition of a designated waterway to provide for navigational safety.

Obstruction is anything that restricts, endangers or interferes with navigation.

Responsible party means the owner of a vessel and/or cargo, or an operator or lessee where the operator or lessee has substantial control of the vessel's operation.

Vessel as used in this part includes any ship, boat, barge, raft, or other water craft.

§ 245.10 General policy.

(a) *Coordination with Coast Guard.* The Corps of Engineers coordinates its wreck removal program with the Coast Guard through interagency agreement, to insure a coordinated approach to the protection of federal interests in navigation and safety. Disagreements at the field level are resolved by referral to higher authority within each agency, ultimately (within the Corps of Engineers) to the Director of Civil Works, who retains the final authority to make independent determinations where Corps responsibilities and activities are affected.

(b) *Owner responsibility.* Primary responsibility for removal of wrecks or other obstructions lies with the owner, lessee, or operator. Where an obstruction presents a hazard to navigation which warrants removal, the District Engineer will attempt to identify the owner or other responsible party and vigorously pursue removal by that party before undertaking Corps removal.

(c) *Emergency authority.* Obstructions which impede or stop navigation; or pose an immediate and significant threat to life, property, or a structure that facilitates navigation; may be removed by the Corps of Engineers under the emergency authority of section 20 of the Rivers and Harbors Act of 1899, as amended.

(d) *Non-emergency situations.* In other than emergency situations, all reported obstructions will be evaluated jointly by the District Engineer and the Coast Guard district for impact on safe navigation and for determination of a course of action, which may include the need for removal. Obstructions which are not a hazard to general navigation will not be removed by the Corps of Engineers.

(e) *Corps removal.* Where removal is warranted and the responsible party cannot be identified or does not pursue removal diligently, the District Engineer may pursue removal by the Corps of Engineers under section 19 of the Rivers and Harbors Act of 1899, as amended, following procedures outlined in this CFR part.

§ 245.15 Delegation.

District Engineers may undertake removal without prior approval of the Chief of Engineers provided the cost does not exceed $100,000. Removals estimated to cost above $100,000 require advance approval of the Director of Civil Works.

§ 245.20 Determination of hazard to navigation.

(a) Upon receiving a report of a wreck or other obstruction, District Engineers will consult with the Coast Guard district to jointly determine whether the obstruction poses a hazard to navigation.

(b) Factors to be considered, as a minimum, include:

(1) Location of the obstruction in relation to the navigable channel and other navigational traffic patterns.

(2) Navigational difficulty in the vicinity of the obstruction.

(3) Clearance or depth of water over the obstruction, fluctuation of water level, and other hydraulic characteristics in the vicinity.

(4) Type and density of commercial and recreational vessel traffic, or other marine activity, in the vicinity of the obstruction.

(5) Physical characteristics of the obstruction, including cargo, if any.

(6) Possible movement of the obstruction.

(7) Location of the obstruction in relation to existing aids to navigation.

(8) Prevailing and historical weather conditions.

(9) Length of time the obstruction has been in existence.

(10) History of vessel accidents involving the obstruction.

§ 245.25 Determination of remedial action.

(a) *Consultation with Coast Guard.* After a determination has been made that an obstruction presents a hazard to navigation, District Engineers will consult with the Coast Guard district to determine appropriate remedial action for the specific situation.

(b) *Options.* The following options, or some combination of these options, may be considered:

(1) No action.

(2) Charting.

(3) Broadcast notice to mariners and publication of navigational safety information.

(4) Marking.

(5) Redefinition of navigational area (e.g., channel, fairway, anchorage, etc.).

(6) Removal.

§ 245.30 Identification of responsible parties.

(a) *Investigation.* When marking or removal are determined to be appropriate remedial action and no emergency situation exists, the District Engineer will investigate to determine the owner or, if the owner cannot be determined, the lessee or operator. If cargo is involved, ownership will be separately determined.

(b) *Notification.* If the owner or other responsible party can be determined, the District Engineer and/or the Coast Guard will send a notice, via certified mail, advising them of their legal obligation to mark (referencing Coast Guard requirements) and to remove the obstruction, and of the legal consequences for failure to do so, with a request for prompt reply of intent.

(c) *Public notice.* If the owner or responsible party cannot be determined from investigation, the District Engineer will publish a legal advertisement in a newspaper nearest the location of the obstruction and in a newspaper of at least 25,000 circulation, addressed "To Whom It May Concern," requiring removal by the owner, lessee or operator. The advertisement will be published at least once a week for 30 days.

§ 245.35 Judgments to require removal.

When the owner or responsible party has been identified, and refuses or fails to take prompt action toward removal, the District Engineer may seek a judgment by the district court requiring removal.

§ 245.40 Removal by responsible party.

(a) *Corps monitoring.* If the owner, lessee or operator agrees to remove a hazard to navigation, the District Engineer should ascertain that:

(1) Marking is accomplished promptly and is maintained,

(2) The plan for removal and disposal is reasonable and acceptable to the District Engineer,

(3) Removal operations do not unreasonably interfere with navigation,

(4) All conditions of the Corps of Engineers permit are met, and

(5) Removal operations are pursued diligently.

(b) *Deficiencies.* If the removal actions are not proceeding satisfactorily, the District Engineer will notify the responsible party of the deficiencies and provide a reasonable time for correction. If not corrected promptly, the District Engineer may declare the wreck "abandoned" and proceed with actions toward Corps removal.

§ 245.45 Abandonment.

(a) *Establishing abandonment.* Abandonment is the surrendering of all rights to a vessel (or similar obstruction) and its cargo by the owner, or owners if vessel and cargo are separately owned. In all cases other than emergency, abandonment will be established as a precondition to Corps removal, to avoid a "taking" of private property for public purposes. Abandonment is established by either:

(1) Affirmative action on the part of the owner declaring intention to abandon, or

(2) Failure to commence immediate removal of the obstruction and prosecute such removal diligently.

(b) *Owner declaration.* The Corps of Engineers will not "accept" a notice of abandonment. Any notice of abandonment received by the Corps of Engineers will be acknowledged only, and will stand by itself as a declaration. Abandonment by the operator or lessee alone does not constitute abandonment.

(c) *Non-diligence.* The determination of whether removal is commenced immediately and prosecuted diligently will be made by the District Engineer based on the degree of hazard to navigation, the difficulty and complexity of the removal operation, and the appropriateness of the removal effort. When no removal actions are being undertaken and the District Engineer is unable to identify the owner through investigation or 30 days of public notice, abandonment is presumed.

(d) *Cargo.* If vessel and cargo are separately owned, or ownership of cargo is uncertain, abandonment of vessel and cargo will be established separately.

(e) *Later claims.* After abandonment is established, the owner may no longer undertake removal or make any claim upon the vessel (or other obstruction) or its cargo, unless expressly permitted by the District Engineer.

(f) *Continuing owner liability.* The abandonment of a wreck or other obstruction does not remove the owner's liability for the cost of removal and disposal if removal is undertaken by the Corps of Engineers, except in cases of nonnegligent sinking which occurred prior to November 17, 1986.

§ 245.50 Removal by Corps of Engineers.

(a) *Non-emergency situations.* In non-emergency situations, the District Engineer may undertake removal action (within the limits of delegation) after all of the following conditions have been met:

(1) A determination has been made, in consultation with the Coast Guard, that the obstruction is a hazard to navigation,

(2) The District Engineer and the Coast Guard agree on a course of action which includes the need for removal (or, if a conflict exists, the need for removal has been resolved at higher level),

(3) The District Engineer has made a reasonable attempt to identify the owner, operator, or lessee, and

(4) Abandonment of the wreck or obstruction has been established.

(b) *Emergency actions.* In emergency situations, the District Engineer may bypass (within the limits of delegation) any or all of the four conditions in the preceding paragraph if, in his judgment, circumstances require more immediate action, and if either one of the following conditions are met:

(1) The obstruction impedes or stops navigation, or

(2) The obstruction poses an immediate threat to life, property, or a structure that facilitates navigation.

§ 245.55 Permit requirements.

(a) *Permits for removal.* Marking and removal operations by the owner, operator or lessee are normally permitted under nationwide permits for such activities as outlined in Part 330 of this chapter. The activities must meet certain conditions as stated in those regulations, and additional permits may still be required from state or local agencies.

(b) *Special conditions.* The Corps of Engineers may add individual or regional conditions to the nationwide permit, or require an individual permit on a case-by-case basis.

§ 245.60 Reimbursement for removal costs.

The Corps of Engineers will seek reimbursement from the owner, operator, or lessee, if identified, for all removal and disposal costs in excess of the value of the recovered vessel (or other obstruction) and cargo.

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ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 52

[FRL-3390-8]

Approval and Promulgation of Air Quality Implementation Plans; Arkansas; Visibility Protection; Long-Term Strategy and Implementation Control Strategies

AGENCY: Environmental Protection Agency (EPA).