

On Jabberwocky, Tumtum Trees and the Active Financing Exception to Subpart F

By Matthew Stevens

Matthew Stevens analyzes the criteria necessary to qualify for the active financing exception under Code Sec. 954(h), which provides that “qualified banking or financing income” of an “eligible controlled foreign corporation” does not constitute foreign personal holding company income.

Tw'as brillig, and the slithy toves
Did gyre and gimble in the wabe:
All mimsy were the borogoves,
And the mome raths outgrabe.

“Beware the Jabberwock, my son!
The jaws that bite, the claws that catch!
Beware the Jubjub bird, and shun
The frumious Bandersnatch!”

He took his vorpal sword in hand:
Long time the manxome foe he sought —
So rested he by the Tumtum tree,
And stood awhile in thought.

And, as in uffish thought he stood,
The Jabberwock, with eyes of flame,
Came whiffling through the tulgey wood,
And burbled as it came!

One, two! One, two! And through and through
The vorpal blade went snicker-snack!

He left it dead, and with its head
He went galumphing back.

“And, has thou slain the Jabberwock?
Come to my arms, my beamish boy!
O frabjous day! Callooh! Callay!”
He chortled in his joy.

Tw'as brillig, and the slithy toves
Did gyre and gimble in the wabe:
All mimsy were the borogoves,
And the mome raths outgrabe.¹

I. Introduction

The poem *Jabberwocky* in THROUGH THE LOOKING GLASS provides a perfect metaphor for understanding Section 954(h) of the Internal Revenue Code (“the Code”).² Like Code Sec. 954(h), *Jabberwocky* darkly hints at fantastic constructs. Yet the potential benefits of this subsection are sufficiently great that it is well worth braving the frumious Bandersnatch of the 70/30 test, or the Jubjub bird of the predominantly engaged test in order, finally, to behead the Jabberwock of current income inclusion under Subpart F.

As a general rule, if a controlled foreign corporation (CFC) receives income from interest or dividends, or recognizes gain from the sale of property that produces interest or dividends, such income or gain constitutes

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foreign personal holding company income, which in turn is a type of Subpart F income. Accordingly, the U.S. shareholder of the CFC—I assume throughout this article that there is only one—must generally include such amount in income, after it has been reduced by all properly allocated deductions. However, at least until December 31, 2008, for calendar year taxpayers, Code Sec. 954(h) provides that foreign personal holding company income does not include “qualified banking or financing income” of an “eligible controlled foreign corporation.” The interrelationships between these two principal concepts as well as the policy choices reflected in their elaboration make for some pretty tough tax lawyering. This article will explain why.

The article consists of five main parts. The first part is this introduction.

The second part deals with the requirement for a CFC to be eligible to earn qualified banking or financing income. The third part deals with the definition of qualified banking or financing income itself. The fourth deals with the manxsome anti-abuse rules that gird Code Sec. 954(h). The fifth part makes recommendations for change.

In several instances, taxpayers have been permitted to rely on those so-called phantom regulations, on the theory that the Treasury could not deny a benefit to a taxpayer that Congress clearly wanted the taxpayer to have, merely by failing to write regulations that Congress wanted the Treasury to write.

II. Eligibility

As noted above, the first requirement for slaying the jabberwock of Code Sec. 954(h) is that the CFC earning the income must be an “eligible” corporation. In order to be eligible, the CFC must (1) be predominantly engaged in the active conduct of a banking, financing or similar business and (2) conduct substantial activity with respect to that business.

Predominantly Engaged

The “predominantly engaged” test, in turn, can be satisfied in any of three ways: the licensed bank test, the 70/30 test and the registered securities dealer test.

The Licensed Bank Test

U.S. Licensed Bank

The licensed bank test would, at first blush, seem to be fairly straightforward. Under the statute, the test

will be satisfied if the CFC is engaged in the active conduct of a banking business and either (1) is an institution licensed to do business as a bank in the United States or (2) is any other corporation, not so licensed, that is specified by the Secretary in regulations.³ Putting aside, for the time being, the question of what it means to be engaged in the active conduct of a banking business, the corporation must either be “li-

icensed to do business as a bank in the United States” by federal or state bank regulatory authorities or be another institution described by the Secretary in regulations (none of which have been promulgated, as more fully discussed later).⁴

It is odd, when one thinks about it, that the statute is focused on the legal right of the foreign corporation to conduct a

banking business in the United States. It is generally not regarded as sound tax planning for a U.S.-based multinational to conduct its U.S. based business through a CFC.⁵ Thus, absent tax planning done specifically to qualify a CFC as an active bank, it is not clear that a CFC would normally have a U.S. banking license in the ordinary course of its business. Congress must have understood this when it included holding a U.S. banking license as one method for establishing eligible corporation status. What is not clear, however, is whether Congress believed that the U.S. parent would conduct a portion of its business in the United States through the CFC and accept the substantial tax detriment that came with it, or, instead, believed that the CFC could obtain a U.S. banking license even though it did not intend to conduct any business in the United States.

If the latter is the case, it is not clear that a U.S. federal or state banking regulator would be willing to approve a banking license for a foreign corporation with an avowed intention not to lend money to any U.S. borrowers, or accept deposits from U.S. depositors. It may be possible for the CFC to make a few loans to U.S. customers (perhaps from a treaty jurisdiction with a zero-percent withholding tax rate on interest), and thereby satisfy a regulator’s desire to see some business activity in the United States while avoiding unpleasant tax consequences.

In the alternative, it may also be possible for the CFC to set up a U.S. LLC, obtain a state banking license for it, and then check the box to disregard the LLC for U.S. federal income tax purposes, with the goal of having the CFC that owned the LLC viewed for U.S. federal income tax purposes as having received the license. If this were possible, such an LLC would need to avoid receiving any deposits that are insured under the Federal Deposit Insurance Act or a similar federal statute. Otherwise, it would be a *per se* corporation, and could not elect to be disregarded.⁶ It is possible, however, that the LLC could accept deposits that were not insured by the Federal Deposit Insurance Corporation (FDIC).

“Foreign Licensed Banks”

As noted above, Code Sec. 954(h)(2)(B)(ii) extends the “active conduct of the banking business” designation not only to U.S. licensed banks, but also to “any other corporation not so licensed which is specified by the Secretary in regulations.” Given the potential tax detriment involved in conducting a substantial banking business in the United States through a foreign corporation, on the one hand, or obtaining a license from a state or U.S. federal bank regulator in the absence of such U.S.-based business on the other hand, many taxpayers will consider whether a CFC with a foreign banking license may meet the eligibility criteria for the active financing exception. Those taxpayers will immediately face the unfishy reality that the Treasury has not promulgated any such regulations, nor do any such implementing regulations even appear on the current business plan. Can taxpayers nevertheless go galumphing on down the road in reliance on this provision?

Numerous authorities deal with the issue of whether either the taxpayer or the government may in effect rely on regulations that the government was directed to write, but did not. In several instances, taxpayers have been permitted to rely on those so-called phantom regulations, on the theory that the Treasury could not deny a benefit to a taxpayer that Congress clearly wanted the taxpayer to have, merely by failing to write regulations that Congress wanted the Treasury to write.⁷ And it is quite clear from the

legislative history of Code Sec. 954(h) that Congress did want the Treasury to expand upon the list of sovereign licensing authorities that could, in effect, make a taxpayer an eligible corporation. Congress referred specifically to the proposed regulations then (and now) existing under the active banking exception to the passive foreign investment company rules, stating that:

In general, the Code takes a somewhat schizophrenic approach to allocating interest expense of a corporation that does business through separate legal entities that are disregarded for U.S. income tax purposes.

[i]t generally is intended that these requirements [*i.e.*, in Code Sec. 954(h)] for the active conduct of a banking or securities business be interpreted

in the manner provided in the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. §1.1296-4 and §1.1296-6. Specifically, it is intended that these requirements include the requirements for foreign banks under Prop. Treas. Reg. §1.1296-4, as currently drafted. However, it is not intended that these requirements be considered to be satisfied by a CFC merely because it is a qualified bank affiliate or a qualified securities affiliate within the meaning of the proposed regulations under former section 1296(b).⁸

Thus, the legislative history not only indicates congressional intent generally as to what corporations should satisfy the requirements, but refers specifically to proposed regulations already issued by the IRS in a closely analogous area, and even to modifications that Congress wanted the Treasury to make to the principles embodied in those regulations when it issued regulations under Code Sec. 954(h). Moreover, the proposed regulations under former Code Sec. 1296 have a retroactive effective date. This suggests that the Treasury had a high level of confidence that the positions espoused in those proposed regulations were consistent with the underlying statute. Congress, of course, knew of the retroactive effective date in the proposed regulations when it drafted Code Sec. 954(h) in 1998. This immediate effective date also means that the U.S. shareholders of a foreign corporation with a foreign banking license could clearly achieve deferral under current law if the foreign corporation was not a CFC (*i.e.*, if U.S. persons owning

at least 10 percent of the voting power of the stock of such corporation did not collectively own more than 50 percent of the vote or value of such stock).⁹ Given this outcome, there is no policy justification for requiring current inclusion of the corporation's income in the hands of its U.S. shareholders merely because those U.S. shareholders satisfy the stock ownership threshold of Code Sec. 957(b).

On the other hand, when a delegation of authority provided that a particular Code section "shall apply only to the extent provided in regulations prescribed by the Secretary," the Tax Court has refused to find or apply phantom regulations.¹⁰ It is very difficult to read into the statutory language of Code Sec. 954(h)(2)(B)(ii), as opposed to the legislative history, any intention by Congress to require regulations to be written. On still another hand (how many hands does that make?), courts have not tended to focus on the specific statutory grant of authority (e.g., "shall prescribe" versus "may prescribe"), but have instead sometimes asked whether Congress intended to delegate a policy decision to the Treasury (in which case the court would be less likely to intervene) or instead expressed a clear policy view itself for implementation by the Treasury (in which case the court would be more likely to intervene).¹¹ Here, the detailed language in the Senate Finance Committee Report supports the conclusion that, while Congress did not wish to micromanage the Secretary's workload, it did intend to permit taxpayers to rely on the foreign bank licensing rules contained in the active banking exception for Passive Foreign Investment Companies (PFICs).

In particular, a taxpayer with favorable facts would seem to have a strong likelihood of persuading the IRS not to challenge reasonable positions taken in reliance on the legislative history of Code Sec. 954. Consider a Dutch banking corporation, licensed and heavily regulated by the Dutch banking authorities, that regularly accepts deposits and makes loans to residents of the Netherlands, Belgium and France. Assume further that the corporation does not qualify for the 70/30 test as hereinafter discussed because less than 30 percent of its business is with Dutch customers. Is it really consistent with the intention of Congress in enacting Code Sec. 954(h) that such

a corporation will be denied the deferral benefit of Code Sec. 954(h), until the Treasury gets around to writing regulations on the point? One imagines that, as a practical matter, an international examiner who raised the issue on examination of such a taxpayer's return would be quietly advised by the IRS National Office to drop the issue.¹²

Assuming taxpayers can rely on the intent of Congress as expressed in the Senate Finance Committee Report, the question then becomes one of determining

what is required to satisfy the "licensed bank" test. Under Proposed Reg. §1.1296-4(b)(2), in order for a foreign corporation to be an "active bank," it must meet the licensing requirements of Proposed Reg. §1.1296-4(c), actively conduct a banking business that is a trade

or business within the meaning of Temporary Reg. §1.367(a)-2T(b)(2), meet the deposit-taking requirements of Proposed Reg. §1.1296-4(d), and meet the lending requirements of Proposed Reg. §1.1296-4(e). These requirements are discussed below.

In order to satisfy the licensing requirement of Proposed Reg. §1.1296-4(c), a foreign corporation must be licensed or authorized (1) to accept deposits from residents of the country in which it is chartered or incorporated and (2) to conduct, in that country, one or more of the banking activities described in Proposed Reg. §1.1296-4(f)(2). Disturbingly, the Proposed Regulations provide that in no case will a foreign corporation satisfy the licensing requirements if one of the principal purposes for its obtaining a license or authorization was to satisfy the requirements of the Proposed Regulations. This test of "a principal purpose" may impose a substantial obstacle to routine tax planning. In particular, if a CFC is contemplating obtaining a foreign banking license, and the IRS can show that the foreign corporation knew of the tax benefit that obtaining the license would make possible, the IRS could plausibly argue that the "a principal purpose test" is satisfied. The taxpayer could in response point to the existence of even lower triggers for the application of an "intent" based test, including the "a significant purpose" test found in Code Secs. 6662A and 6662, and the "with a view" test that appears in several places in the Regulations.¹³ The existence of these lower standards indicates that

Because only income from transactions with customers outside the United States constitutes qualified banking or financing income, it is essential to determine the location of a customer.

a principal purpose test should be understood to require a fairly strong showing by the IRS (albeit not as strong as required under “the principal purpose” test), such that the taxpayer should prevail if it could show that it would have gotten the foreign banking license even in the absence of an applicable deferral provision. Nonetheless, the threat potential of this “a principal purpose” argument remains troubling.

In terms of an activity level, the taxpayer must actively conduct a trade or business.¹⁴ Under Temporary Reg. §1.367(a)-2T(b) (2), a trade or business is generally defined as a “specific unified group of activities that constitute

(or could constitute) an independent economic enterprise carried on for profit.” A group of activities must ordinarily include every operation that forms a part of, or a step in, a process by which an enterprise may earn income or profit.¹⁵ One or more activities may be carried on by independent contractors under the direct control of the CFC, although doing so may cause the corporation to fail the “active conduct” test, discussed next.

The “active conduct” element of the test does not focus on the activity level of the business conducted in the name of the corporation; rather, it focuses on the degree to which the corporation itself conducts those activities through its own employees, as opposed to operating through independent contractors. Accordingly, under Temporary Reg. §1.367(a)-2T(b) (2), a corporation generally conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities. Incidental activities may be carried out by independent contractors, but such activities will be disregarded in determining whether the officers and employees of the corporation carry out substantial managerial and operational activities. Thus, it appears that a corporation can contract out many of its activities, but must have at least one employee who exercises oversight functions over the activities performed by the contractors.

The deposit-taking requirement of Proposed Reg. §1.1296-4(d) is considerably more straightforward. To satisfy this requirement, the foreign corporation must, in the ordinary course of its trade or business, regularly accept deposits from customers who are

residents of the country in which it is licensed or authorized, and the amount of deposits shown on the corporation’s balance sheet must be substantial.¹⁶ Whether the amount of deposits (including inter-bank deposits) shown on a corporation’s balance sheet is substantial depends on all of the facts and circumstances, including whether the corporation’s

capital structure and funding sources as a whole are similar to that of banking institutions engaged in the same types of activities and subject to the jurisdiction of the same bank regulatory authorities. It is not clear what constitutes a “deposit” for purposes of this section. This may

depend on the form of the transaction, as well as whether the acceptance of the deposit subjects the corporation to regulatory requirements (e.g., the foreign equivalent of FDIC insurance). This requirement should be relatively easy to satisfy for a CFC that is actively engaged in the banking business, as envisioned by Congress.

Similarly, the lending activities test of Proposed Reg. §1.1296-4(e) is fairly straightforward. To satisfy this test, a corporation must regularly make loans to customers in the ordinary course of its trade or business. This, in turn, requires the extension of credit made pursuant to a loan agreement entered into in the ordinary course of the corporation’s banking business. A debt instrument generally will not be considered a loan for purposes of the “lending activities” test if the instruments are not treated as loans (but rather are treated as securities or other investment assets) for financial statement purposes. The practitioner seeking ready analogies for guidance will find no lack of them here. One particularly relevant analogy, upon which much ink has been spilled,¹⁷ is whether a foreign investor (e.g., a foreign hedge fund) that regularly acquires loans is engaged in the business of lending money to U.S. persons, or whether it instead qualifies for the benefits of the securities trading safe harbor in Code Sec. 864(b)(2).

The 70/30 Test

For taxpayers who are cannot satisfy the U.S. banking license test, and who are unwilling to risk reliance on the foreign bank test (and are not dealers in securities), there is only one choice if they are to hear the

While anti-abuse rules are generally challenging for tax advisors, the Code Sec. 954(h) anti-abuse rules are, as a whole, considerably more worrisome than most other anti-abuse rules, for two reasons.

delightful snicker-snack of the vorpal blade of income deferral. They must gyre (and perhaps also gimble) in the wabe of the so-called 70/30-percent test.¹⁸ Under the “70-percent” component of the 70/30 test, more than 70 percent of the gross income of the CFC must be derived from the active and regular conduct of a lending or finance business from transactions with customers that are not related persons.¹⁹ Transactions with customers located in the United States are not taken into account in determining whether the 70-percent test is satisfied.²⁰ The statute does not provide guidance as to what constitutes the “active and regular conduct” of a lending or finance business. However, a CFC is considered to be engaged in a lending or finance business if it is engaged in the business of (1) making loans; (2) purchasing or discounting accounts receivable, notes (including loans) or installment obligations; (3) engaging in leasing (including entering into leases and purchasing, servicing, and disposing of leases and leased assets); (4) issuing letters of credit and providing guarantees; (5) providing charge and credit card services; or (6) rendering services or making facilities available in connection with the foregoing activities carried on by the corporation rendering such services or facilities, or by another corporation if it is a member of the same affiliated group (determined without regard to the exclusion of the foreign corporation in determining whether a corporation is a member of an affiliate group).²¹ Furthermore, the transactions must be with customers who are not related persons. (The term “customer” is defined *infra* at Part III under heading “The ‘Non-U.S. Customer’ Test,” subheading “Who Is a ‘Customer?’”)

“Brokers and Dealers in Securities”

The final path to qualifying as an “eligible” corporation is being a registered securities broker or dealer. This status will exist if the CFC is engaged in the active conduct of a securities business and is registered as a securities broker or dealer under Section 15(a) of the Securities Exchange Act of 1934 or is registered as a government securities broker or dealer under Section 15C(a) of such Act.²² Additionally, the test will be satisfied if the corporation is any other corporation not so registered that is specified by the Secretary in regulations.²³ This language obviously raises the same concerns regarding the applicability of phantom regulations as the licensed bank test, and those concerns generally should be resolved along the same lines. The legislative history relating to the regulations to be issued governing the registered

broker or dealer test generally reads similarly to the legislative history relating to the regulations to be issued governing foreign licensed banks. Thus, the House Report provides that:

It generally is intended that these requirements for the active conduct of a banking or securities business be interpreted in the manner provided in the regulations proposed under prior law section 1296(b) (as in effect prior to the enactment of the Taxpayer Relief Act of 1997). See Prop. Treas. Reg. Secs. 1.1296-4 and 1.1296-6.

However, the House Report then goes on to state that, “it is intended that these requirements include the requirements for foreign banks under Proposed Treas. Reg. Sec. 1.1296-4 as currently drafted.” The legislative history does not contain a corresponding statement regarding Proposed Reg. §1.1296-6 (dealing with registered securities brokers or dealers), and the argument for attaining securities dealer status based on a foreign broker-dealer license is thus slightly weaker than the argument for attaining bank status based on a foreign banking license. However, because the legislative history does refer to a comprehensively drafted proposed regulation (Proposed Reg. §1.1296-6), a taxpayer may still feel comfortable taking the return position that its CFC is a registered securities broker or dealer within the meaning of Code Sec. 954(h).

“Substantial Activity”

Assuming that the taxpayer is engaged in the “active conduct of a banking, financing, or other similar business,” it must still pass the “substantial activity” test. While the statute does not elaborate on what it means for a CFC to conduct “substantial activity” with respect to the active conduct of a banking, financing or similar business, the legislative history provides some indication of congressional intent.²⁴ Not surprisingly, whether a CFC is considered to conduct substantial activity with respect to a banking, financing or similar business is determined under all of the facts and circumstances. Such facts and circumstances may include the overall size of the CFC; the amount of its revenues and expenses (presumably, a high ratio of revenues to expenses is bad, as it indicates a mere holding or warehousing company, rather than an active financing business); the number of employees (presumably, more is better); the amount of revenue per employee (presumably, less is better); the amount

of property it owns (more, obviously, is better); and the nature, size and relative significance of the applicable activities conducted by the CFC.²⁵

As a part of the facts and circumstances analysis, a CFC is required to conduct substantially all of the activities necessary for the generation of income with respect to the business, which generally include the following: initial solicitation of customers (which includes vendors²⁶); advising customers on financial needs, including funding and financial products; providing financial and technical advice to customers; designing or tailoring financial products to customers' needs; negotiating terms with customers; performing credit analysis on customers and evaluating noncredit risks; providing related services to customers; making loans; entering into leases; extending credit or entering into other transactions with customers that generate income that would be considered derived in the active conduct of a banking, financing or similar business; collecting from customers; performing remarketing activities (including sales) following termination of transactions with customers; responding to customers' failure to satisfy their obligations under transactions, including enforcement or renegotiation of terms; liquidation of collateral, foreclosure and/or institution of litigation; and holding collateral for transactions with customers.²⁷ However, the performance of back-office functions (such as accounting for income or loss, recordkeeping and routine communications with customers) is not to be taken into account in determining whether the substantial activity requirement is satisfied.²⁸ Thus, this activity can be done by another corporation, whether related or unrelated to the debtor, without risking a failure of the "substantially all" test for eligibility.

For purposes of determining whether the substantial activity requirement is satisfied, the legislative history takes a fairly broad view of what activities can be attributed to the CFC. For example, for this purpose, all of the activities of the CFC, including those conducted by qualified business units (QBUs), are taken into account.²⁹ Moreover, activities performed in the country in which the CFC is incorporated (or in the country in which the QBU has its principal office) by employees of a related person of the CFC are taken into account, but only to the extent that the related person is compensated on an arm's-length basis for the services of such employees and such compensation is includible in the related person's income in such country for purposes of such country's income tax laws.³⁰ Of course, the activities of the related person will not

again be taken into account in determining whether another CFC (e.g., the related person itself) satisfies the substantial activity requirement.

III. "Qualified Banking or Financing Income"

As noted above, in order for income to be excluded from the scope of foreign personal holding company income, it is not sufficient that it be earned by an eligible CFC; the income itself must be qualified banking or financing income. This standard requires the income to satisfy four main tests. In a nutshell, they are the "active conduct QBU test," (the "active conduct" test), the "non-U.S. customer" test, the "QBU substantially all" test, and the "home country tax" test. This article discusses each of them in order. The article then discusses two special rules that may further limit the CFC's ability to earn tax-deferred income.

The "Active Conduct QBU" Test

As noted above, the first test for income qualification is that the income must be derived by the eligible CFC in the active conduct of the banking, financing or similar business by the eligible corporation or by its QBU (the "active conduct" test). For this purpose, the qualified banking or financing income of an eligible CFC and each of its QBUs is determined separately for the corporation and each QBU.³¹ This is done in the case of the eligible CFC by taking into account only items of income, deduction, gain or loss, and activities of such corporation not properly allocable or attributable to any QBU of such corporation.³² In the case of a QBU, only items of income, deduction, gain or loss and activities properly allocable or attributable to such unit are taken into account.³³

One question that immediately arises out of this last rule is how the taxpayer is supposed to determine whether "income, deduction, gain, or loss is properly allocable or attributable to such unit" where the unit in question is a QBU. This issue is especially acute in the case of interest expense. In particular, is the interest expense of the CFC to be allocated among the QBUs based on asset value or basis, or based on the location of the indebtedness for local law purposes and on the books and records of the particular QBUs? In general, the Code takes a somewhat schizophrenic approach to allocating interest expense of a corporation that does business through separate legal entities that are disregarded for U.S. income tax purposes. In some circumstances,

the words “allocation” and “apportionment” require an allocation of interest expense to assets within an entire corporation (including disregarded entities).³⁴ This is, indeed, the approach used under Code Sec. 954 generally, and it is likely the most reasonable approach to use in attributing interest income to a QBU.³⁵ Such rules also apply in determining the interest expense attributable to the effectively connected income of foreign corporations, and in determining the foreign source income of U.S. taxpayers.³⁶ On the other hand, the foregoing rules do not specifically contemplate the issuance of debt by a legal entity that is disregarded for U.S. tax purposes but that may be regarded for foreign income tax purposes (*i.e.*, a hybrid entity). Other Code-based rules, such as the recently proposed regulations promulgated under Code Sec. 987,³⁷ and the dual consolidated loss regulations,³⁸ generally treat interest expense as allocable to a disregarded entity if the expense appears on the books and records of the entity. Moreover, respecting the books and records of the QBU is more likely to ensure that the U.S. tax treatment of income matches up with the foreign tax treatment. This results from the fact that the foreign taxing authority is likely more form-driven, and may also consider the QBU to be a separate corporation, in which it would likely not consider debt issued by other QBUs as relevant. There may, therefore, be authority for a taxpayer to take the position that the QBU’s books and records should be respected for interest allocation purposes, so long as it does so consistently.

The legislative history suggests that the following types of activities produce income derived in the active conduct of a banking, financing or similar business (provided that the other requirements for the Code Sec. 954(h) exception are satisfied)³⁹:

1. Regularly making personal, mortgage, industrial or other loans in the ordinary course of the corporation’s trade or business
2. Factoring evidences of indebtedness for customers
3. Purchasing, selling, discounting or negotiating for customers notes, drafts, checks, bills of exchange, acceptances or other evidences of indebtedness
4. Issuing letters of credit and negotiating drafts drawn thereunder for customers
5. Performing trust services, including as a fiduciary, agent or custodian, for customers, provided such trust activities are not performed in connection with services provided by a dealer in stock, securities or similar financial instruments
6. Arranging foreign exchange transactions (including any Code Sec. 988 transaction within the meaning of Code Sec. 988(c)(1)) for, or engaging in foreign exchange transactions with, customers
7. Arranging interest rate or currency futures, forwards, options or notional principal contracts for, or entering into such transactions with, customers
8. Underwriting issues of stock, debt instruments or other securities under best efforts or firm commitment agreements for customers
9. Engaging in leasing (including entering into leases and purchasing, servicing and disposing of leases and leased assets)
10. Providing charge and credit card services for customers or factoring receivables obtained in the course of providing such services
11. Providing traveler’s check and money order services for customers
12. Providing correspondent bank services for customers
13. Providing paying agency and collection agency services for customers
14. Maintaining restricted reserves (including money or securities) in a segregated account in order to satisfy a capital or reserve requirement imposed by a local banking or securities regulatory authority
15. Engaging in hedging activities directly related to another activity described herein
16. Repackaging mortgages and other financial assets into securities and servicing activities with respect to such assets (including the accrual of interest incidental to such activity)
17. Engaging in financing activities typically provided in the ordinary course by an investment bank, such as project financing provided in connection with construction projects, structured finance (including the extension of a loan and the sale of participations or interests in the loan to other financial institutions or investors), and leasing activities to the extent incidental to such financing activities
18. Providing financial or investment advisory services, investment management services, fiduciary services or custodial services
19. Purchasing or selling stock, debt instruments, interest rate or currency futures or other securities or derivative financial products⁴⁰ (including notional principal contracts) from or to customers and holding stock, debt instruments

and other securities as inventory for sale to customers, unless the relevant securities or derivative financial products are not held in a dealer capacity

20. Effecting transactions in securities for customers as a securities broker; and any other activity that the Secretary of the Treasury determines to be a financing activity conducted by active corporations in the ordinary course of their business.

The “Non-U.S. Customer” Test

In order to qualify, the income must be derived from transactions with customers located outside the United States.

Who Is a “Customer”?

“Customer” means, with respect to any CFC or QBU, any person who has a customer relationship with such corporation or such unit and is acting in its capacity as such. Annoyingly, this provision does not define the term “customer,” but merely shifts the question to “customer relationship,” which is then also not defined. In the area of financial services, the concept of “customer” is linked to some degree with the concept of a dealer in stocks or securities. A dealer in stocks or securities is defined as “a merchant of stocks or securities, with an established place of business, regularly engaged as a merchant in purchasing stocks or securities and selling them to customers with a view to the gains and profits that may be derived therefrom.”⁴¹ By contrast, persons who buy and sell, or hold, stocks or securities for investment or speculation, generally are not dealers in stocks or securities.⁴² Another relevant factor in determining whether a particular taxpayer is a “dealer” is whether the taxpayer buys and sells in different markets. Thus, if a taxpayer’s source of supply is the same as his would-be customers, he is less likely to be found to be a dealer.⁴³

One thing to note about the existence of a “customer relationship”: there is a fundamental difference between the customer relationship required to constitute one who deals in stocks and one who lends money. A dealer in securities typically does not take his customers’ credit risk. Thus, one who wishes to make a market in securities may stand ready to buy or sell stocks from anyone wishing to sell or to buy securities of the given type, subject perhaps to a restriction that a customer’s account be above a certain size. In essence, all of those wishing to trade with the dealer are, in some sense, fungible from the

dealer’s perspective. It is this general holding out of oneself as being willing to transact business with all comers (or at least all comers who are willing to enter into a trade of sufficient size), that is the essence of the idealized dealer. The determination of whether a particular taxpayer is a dealer, then, is made by comparison to this idealized type.

By contrast, at least as an initial matter, a lender must generally take the credit risk of those to whom he lends money. Not all borrowers are the same, and even one who is clearly a “dealer” in loans therefore may choose not to lend money to all, or even most, of those who are willing to borrow from him. Therefore, even an idealized lender may not make loans to all customers, even if the loans meet a minimum size requirement. Where the properties of the idealized lender are hard to identify, it may be harder to determine whether a particular lender, as opposed to a dealer, has a customer relationship with a particular borrower.

Another interesting question in this area is whether hedging transactions are entered into “with customers.” Consider a QBU that lends funds at a fixed interest rate to a customer, and then enters into a fixed-to-floating interest rate swap with an unrelated financial institution, which is a dealer in securities. One possibility is for the QBU to make an integration election under Reg. §1.1275-6. But suppose that this is not possible (e.g., because the hedge is not a perfect one). If the swap loses money, there would likely not be a problem under Subpart F, either because the loss will be allocated to the income from the loan⁴⁴ or the loss will reduce the subpart F income of the corporation under the “earnings and profits limitation” of Code Sec. 952(c)(1).⁴⁵ If, however, the swap makes money, such income or gain generally would be treated as “income equivalent to interest,” which is a category of foreign personal holding company income,⁴⁶ unless an exception, such as Code Sec. 954(h), applies. Thus, one must decide whether the swap is a transaction “with customers.” Even though the counterparty might not technically fall within the definition of a customer (e.g., because the counterparty is also a dealer), the income should be treated as a transaction with customers.⁴⁷

When Is a Customer “Outside the United States”?

Because only income from transactions with customers outside the United States constitutes qualified banking or financing income, it is essential to determine the

location of a customer. For example, if a CFC loaned funds to the Irish subsidiary of a U.S. bank with the knowledge that the subsidiary would very likely on-lend those funds to its U.S. parent, could the IRS contend successfully that the “customer” for that purpose was the U.S. bank? Any such contention should be rejected. The location of the customer is relevant apparently because it ensures that the CFC (or QBU) maintains its nexus with its home country, and so is more likely to subject itself to home country tax. The fact that in the hypothetical, the customer on-lent the funds to its U.S. parent should not affect this determination. The IRS has the authority to issue regulations determining the location of a customer, but has not yet issued any regulations or other guidance.

“Substantially All” QBU Test

The CFC or QBU must directly conduct “substantially all activities” in connection with the income in its home country. It is not clear whether the “substantially all activities” test relates only to the activities that are directly connected to the loan (such as soliciting the buyer, negotiating the loan, providing funding and servicing the loan), or also includes “back office” activities, such as financing, payroll and so forth. The better view, however, is that only direct activities need to be conducted in the home country, because these activities should be sufficient to provide a tax nexus to the home country for purposes of its tax laws. This would be consistent with the legislative history of the “substantial activity” requirement of Code Sec. 954(h)(2)(A)(ii).⁴⁸ Additionally, as a practical matter, back office activities are often more economically performed from a centralized location, which need not be the location of the CFC or QBU that was directly involved in making the loan.

“Direct conduct” generally means that the eligible CFC or QBU performs the services itself with its own employees. However, “direct conduct” also includes a situation in which the activity is performed by employees of a related person if (1) the related person is an eligible CFC, the home country of which is the same as the home country of the corporation or unit to which the “direct conduct” test is relevant; (2) the activity is performed in that home country; and (3) the related person is compensated on an arm’s-length basis for the performance of the activity by its employees and such compensation is treated as earned by such person in the home country for purposes of its tax laws.⁴⁹ This provision entered the Code through Section 16(a) of the American Jobs Creation Act of 2004.

The legislative history indicates that it was intended to conform the rules for “qualifying income” to those for “eligible corporations.”⁵⁰ In effect, then, this provision permits the CFC or QBU to perform the activity by means of a related independent contractor in the home country as long as the compensation for such performance is taxed to the independent contractor in the home country.

“Home Country Tax”

In order to be qualifying, income must be treated as earned by such corporation (or by such QBU) in its home country for purposes of such country’s tax laws. It is not clear whether this actually requires the home country to subject the income to tax. Presumably, it does not, because when Congress wishes to provide an exclusion under Subpart F for income that is actually subject to a foreign income tax, it knows how to require this.⁵¹ However, even a country with a purely source-based tax system will subject the income to tax if the income is “earned in the country for purposes of such country’s tax laws.” Of course, the taxpayer could locate its CFC or its QBU in a country that does not impose an income tax even on purely domestic lending transactions. While such countries obviously exist, they are likely to afford a relatively small customer base for the lending or financing activities of the CFC or QBU and could, therefore, be problematic home countries for taxpayers needing to have at least 30 percent of their customers in their home countries in order to meet the 30-percent portion of the 70/30-percent test, as described below.

Two Special Rules

The 30-Percent Test

If, and only if, the eligible corporation is relying on the 70/30-percent test set forth above under “Eligibility,” an additional test applies. Under this additional test, in order for any income of the CFC to be qualified banking or financing income, more than 30 percent of the corporation’s or the QBU’s income must be derived directly from the active and regular conduct of a lending or finance business from transactions with customers that are not related persons and that are located within such corporation’s or unit’s home country. The legislative history somewhat generously suggests that, for this purpose, transactions with customers located in the United States are not taken into account.⁵² (That is,

transactions with customers located in the United States, not surprisingly, do not create good income, but also do not constitute bad income for purposes of the 30-percent test.) This test is applied on a QBU-by-QBU basis.⁵³ For corporations that do not have a U.S. banking license and that are unwilling to take the risk of relying on a banking license by a foreign regulatory authority, this test is likely the most difficult one to satisfy, at least in a tax-efficient manner, because countries that impose low levels of taxation on banking and financing income tend not to have that many customers (e.g., Ireland or Luxembourg). Accordingly, the satisfaction of this test will, as a practical matter, require the taxpayer to pay a substantial amount of foreign tax, which is one of the major goals of Code Sec. 954(h). However, it will also require the taxpayer to set up numerous QBUs.

The “Substantial Activity” Test

Moreover, regardless of which of the three tests for active conduct the taxpayer relies upon, Code Sec. 954(h)(3)(C) provides that income derived from transactions with customers outside the home country of a CFC or its QBU does not count as qualified banking or financing income unless the CFC or QBU conducts “substantial activity” with respect to a banking, financing or similar business in its home country. This requirement is odd in light of the fact that Code Sec. 954(h)(3)(ii)(II) requires a CFC or QBU to conduct “substantially all” activity with respect to a customer transaction with a customer. Apparently, Congress believed that a CFC or QBU could conduct “substantially all” activity in connection with a customer transaction in a country, and yet still not conduct “substantial” activity there. Presumably, the test for “substantiality” here is the same as the test for “substantiality” in the provision that deals with the qualification of a corporation.

Certain Troublesome Definitions

One of the key definitional terms in Code Sec. 954(h) is “home country.” This term is critical to the definition of where the CFC or QBU’s activities must be performed, and where its customers must be located. The term “home country” means, except as provided in regulations, with respect to a CFC, the country under the laws of which the corporation was created or organized, and, with respect to a QBU, the country in which such unit maintains its principal office.⁵⁴ It is not clear what the term “principal office” means

here. Does it mean the office at which most of the QBU’s administrative activity is conducted, or most of its economic activity? Or where it has the largest number of employees? The Treasury is specifically given authority to limit or expand the definition of “home country.”⁵⁵ QBU, in turn, has the meaning given such term by Code Sec. 989(a).⁵⁶ In general, a QBU is any separate and clearly identified unit of a trade or business of a taxpayer, provided that the unit maintains separate books and records.⁵⁷ “Related person” has the same meaning as in Code Sec. 954(d)(3).⁵⁸

IV. The Anti-Abuse Rules

A taxpayer who has navigated the various technical rules of Code Sec. 954(h) must also contend with the anti-abuse rules that apply in this area. Anti-abuse rules generally are the bane of a tax planner’s existence for two reasons. First, anti-abuse rules typically permit the IRS to disregard the plain language of a regulation where the taxpayer has a principal purpose (or sometimes the principal purpose) of achieving an unreasonable result.⁵⁹ Taxpayers and their advisors are frequently uncertain about whether a prohibited purpose exists and, if so, how important it was as a motivating factor in the taxpayer’s decision.⁶⁰ Second, the rules frequently purport to apply where the result violates the purpose of the Code section under which they are promulgated, or some subset of such purpose. Code sections frequently, if not usually, represent compromises among various legislative factions, and it is therefore often difficult to find a single overriding purpose for a Code section.

While anti-abuse rules are generally challenging for tax advisors, the Code Sec. 954(h) anti-abuse rules are, as a whole, considerably more worrisome than most other anti-abuse rules for two reasons. First, the rules do not merely authorize the disallowance of the active financing exception; rather, they require such disallowance once the statutory prerequisites are met. Thus, the IRS technically has no discretion as a legal matter. Of course, the IRS may, as a practical matter, have substantial discretion to avoid applying a particular anti-avoidance rule merely by avoiding making a pre-requisite finding of fact. Second, as noted above, many other anti-abuse rules contain a statutory-intent test, as well as a taxpayer-intent test.⁶¹ That is, regardless of how base was the taxpayer’s motive to avoid

tax, if the result sought was reasonable in light of the intent of Congress in drafting the relevant statutes, the anti-abuse rule would not be brought into play. By contrast, in Code Sec. 954(h), even if the specific structure chosen by the taxpayer is entirely consistent with what would otherwise have appeared to be the intent of Congress, the exemption from Subpart F will be disallowed because of the taxpayer's nefarious intent.

For example, one must disregard any item of income or gain, loss or deduction with respect to any transaction or series of transactions one of the principal purposes of which is to qualify income or gain for the exclusion under Code Sec. 954, including any transaction or series of transactions a principal purpose of which is the acceleration or deferral of any item in order to claim the benefits of such exclusion through the application of Code Sec. 954(h).⁶² One must also disregard any item of income, gain, loss or deduction with respect to any transaction or series of transactions if one of the principal purposes of the transaction or series of transactions is to qualify income or gain for the exclusion under Code Sec. 954(h), and the transaction or series of transactions utilizes, or does business with, one or more entities in order to satisfy any home country requirement under this subsection or a special purpose entity or arrangement, including a securitization, financing or similar entity or arrangement.⁶³

To see the potential impact of this second rule, consider a U.K. CFC with a German QBU and a French QBU. The German QBU, but not the French QBU, is essentially self-sufficient, and satisfies the "substantially all activities" test discussed *supra* at Part III under heading "'Substantially All' QBU Test." For reasons unrelated to tax, the U.K. CFC decides to make a loan to a Dutch customer. As a business matter, the loan could be made out of either the German QBU or the French QBU. However, with a principal purpose of preventing the French QBU from violating the home country requirements, the U.K. CFC decides to make the loan through the German QBU rather than the French QBU. Does this implicate the anti-avoidance rule? It does, if one focuses on the fact that a transaction has occurred, and that the German QBU was used with a principal purpose of satisfying a home country requirement. A more reasonable interpretation, however, would be that the rule applies only if the transaction itself (*i.e.*,

the loan to the Dutch customer), not its location, has as one of its principal purposes qualifying income for the exclusion. Here, the loan would have been made in any event, and the taxpayer should be allowed to choose the location from which it is to be made even if that choice was motivated by tax considerations.⁶⁴

Other anti-avoidance rules seem narrower, and thus less troublesome. Thus, a related person, an officer, a director or an employee with respect to any CFC (or QBU) who would otherwise be treated as a customer of such corporation or unit with respect to any transaction, will not be so treated if a principal purpose of such transaction is to satisfy any requirement of Code Sec. 954(h).⁶⁵ Also, one must disregard any item of income, gain, loss or deduction of an entity that is not engaged in regular and continuous transactions with customers that are not related persons.⁶⁶ It is not clear how an entity that was not so engaged could be viewed as having customers under the general test, and in particular, how it could be viewed as meeting the "customer relationship" test. This particular anti-abuse rule, then, is more baffling than threatening.

V. Summary of Recommendations

Code Sec. 954(h) represents a noble attempt to provide competitive parity between U.S. financial institutions (and subsidiaries of nonfinancial institutions) that provide financial services to their non-U.S. customers. However, it needs a number of changes to fully accomplish that objective. First, and most importantly, Congress should make the provision permanent. Second, a transaction that is entered into to hedge risk from a customer transaction should itself be treated as a customer transaction. Third, the "home country" requirements should be softened in recognition of the fact that taxpayers frequently centralize their regional lending activities in a single country. Fourth, the anti-abuse rules should be clarified to ensure that a taxpayer can intentionally structure its transactions so as to fall within the deferral rules, provided that the result is not inconsistent with the purpose of Code Sec. 954(h). In addition to the suggested legislative changes, the Treasury should promulgate regulations allowing CFCs that have a valid foreign banking license or are registered dealers under foreign law to qualify as "eligible corporations."

ENDNOTES

- ¹ Lewis Carroll, THROUGH THE LOOKING-GLASS, AND WHAT ALICE FOUND THERE (1871).
- ² All section references herein are to the Code, except as otherwise noted.
- ³ Code Sec. 954(h)(2)(B)(ii).
- ⁴ H.R. REP. NO. 105-817 (1998) (the "1998 HOUSE REPORT"), at 37.
- ⁵ For one thing, losses generated by the CFC could not be used to reduce the taxable income of other members of the affiliated group. In addition, the branch profits tax could create additional tax liability that would not arise if the U.S. business were simply conducted by a member of the U.S. affiliated group.
- ⁶ Reg. §301.7701-2(b)(5).
- ⁷ See, e.g., *International Multifoods Corp.*, 108 TC 579, Dec. 52,100 (1997); *First Chicago Corp.*, 88 TC 663, Dec. 43,792 (1987), *aff'd*, CA-7, 88-1 USTC ¶9244, 842 F2d 180; *Occidental Petroleum Corp.*, 82 TC 819, Dec. 41,240 (1984). For a general discussion of these and other cases involving so-called "spurred delegations," see Phillip Gall, *Phantom Tax Regulations: The Curse of Spurred Delegations*, 56 TAX LAW. 413 (Winter 2003), and Amandeep S. Grewal, *Substance Over Form? Phantom Regulations And The Internal Revenue Code*, 7 Hous. BUS. & TAX L.J. 42 (2006).
- ⁸ 1998 HOUSE REPORT, at 37.
- ⁹ See Code Sec. 957(a).
- ¹⁰ *C.F. Alexander*, 95 TC 467, 473, Dec. 46,946 (1990). *Compare Pittway Corp.*, CA-7, 97-1 USTC ¶70,069, 102 F3d 932 (where statute used phrase "under regulations prescribed by the Secretary," Court of Appeals applied phantom regulations).
- ¹¹ For an in-depth discussion of this "whether" versus "how" issue, see Gall, *supra* note 7.
- ¹² This is especially true, given TAM 200447037 (Nov. 30, 2004), in which the IRS expressed the view that "[i]t is the position of the IRS that a statute is not self-executing with respect to a reference to regulations unless the statute itself or the legislative history gives some specific guidance as to what the content of the regulations should be." (Emphasis added.) Given the clarity of the legislative history on this point, the IRS would be hard pressed under this approach to challenge the position taken by the taxpayer that the foreign licensed bank exception should apply (assuming, of course, that the substantive requirements of that test are satisfied, as hereinafter discussed).
- ¹³ See, e.g., Reg. §301.7701(i)-1(g)(1) ("For purposes of determining whether an entity meets the definition of a taxable mortgage pool, the IRS can disregard or make other adjustments to a transaction (or series of transactions) if the transaction (or series) is entered into with a view to achieving the same economic effect as that of an arrangement subject to section 7701(i) while avoiding the application of that section"); Reg. §1.704-3(a)(10) ("allocation method is not reasonable if the contribution of property and the corresponding allocation of tax items with respect to the property are made with a view to shifting the tax consequences of built-in gain or loss among the partners in a manner that substantially reduces the present value of the partners' aggregate tax liability"); Reg. §1.1502-35(g)(1) (multiple rules involving the "with a view" concept).
- ¹⁴ Proposed Reg. §1.1296-4(b)(2).
- ¹⁵ *Id.*
- ¹⁶ Interestingly, this deposit-taking requirement does not explicitly apply under the U.S. licensed bank test. Congress may have assumed that a U.S. bank regulator would not grant a license for an institution that did not take deposits.
- ¹⁷ Ass'n Bar City of New York, Committee on Taxation of Business Entities, *Report Offering Proposed Guidance Regarding U.S. Federal Income Taxation of Certain Lending Activities within the U.S.*, 2007 TNT 88-51 (May 31, 2007); Lee A. Shepard, *Neither a Dealer Nor a Lender Be, Part 2: Hedge Fund Lending*, 108 TAX NOTES 729 (Aug. 15, 2005); Stuart LeBlang and Rebecca Rosenberg, *Toward an Active Finance Standard for Inbound Lenders*, 31 TAX MANG. INT'L J. 131 (2002); John N. Bush and Leonard Zuckerman, *Tax Issues in the Loan Syndication Business*, 84 TAX NOTES 1779 (Sept. 27, 1999).
- ¹⁸ The "30" in the "70/30" is discussed *infra* at Part III under heading "Two Special Rules," subheading "The 30-Percent Test."
- ¹⁹ Code Sec. 954(h)(2)(B)(i).
- ²⁰ Under the statute, the presence of customers within the United States affects the qualification of the income, but not the eligibility of the corporation to earn such income. See Code Sec. 954(h)(3)(A)(ii)(I). The legislative history, however, provides that transactions with such customers are excluded for eligibility purposes as well. 1998 HOUSE REPORT, at 37. See also Joint Comm. on Taxation, 105th Cong., *General Explanation of Tax Legislation Enacted in 1998* (Nov. 24, 1998) at 250. This has the effect of reducing the amount of gross income to which the 70-percent requirement applies.
- ²¹ See Code Sec. 954(h)(4); 1998 HOUSE REPORT, at 38.
- ²² Code Sec. 954(h)(2)(B)(iii).
- ²³ A dealer in securities (within the meaning of Code Sec. 475) who satisfies the definition in the text will nevertheless not be permitted to exclude as active financing income any income described in Code Sec. 954(c)(2)(C)(ii). Code Sec. 954(h)(6). Presumably, this is simply a mechanical provision intended to avoid a double exclusion of the same income, although one would not have thought this would be necessary.
- ²⁴ 1998 HOUSE REPORT, at 35-36.
- ²⁵ *Id.*
- ²⁶ Query whether depositors fall within the term "vendors," since they are in a sense selling the use of money to the CFC. Moreover, depositors of a bank frequently view themselves as "customers" of the bank. If depositors were considered vendors, the CFC would want to conduct activities relating to the solicitation of the deposits itself to achieve greater certainty under the "substantially all activities" test.
- ²⁷ 1998 HOUSE REPORT, at 35-36.
- ²⁸ *Id.*
- ²⁹ 1998 HOUSE REPORT, at 36.
- ³⁰ 1998 HOUSE REPORT, at 36-37.
- ³¹ Code Sec. 954(h)(3)(D).
- ³² Code Sec. 954(h)(3)(D)(i).
- ³³ Code Sec. 954(h)(3)(D)(ii).
- ³⁴ See, e.g., Code Sec. 882(c)(1)(A) (deductions from effectively connected income allowed only if and to the extent that they are connected with income which is effectively connected with the conduct of a trade or business in the United States; and the proper apportionment and allocation of the deductions for this purpose shall be determined under regulations provided by the Secretary); Temporary Reg. §1.882-5T(a)(1)(i) (interest expense of foreign corporation allocated to effectively connected income based on asset values).
- ³⁵ See Reg. §1.954-1(c)(1)(i) (mandating the use of Code Sec. 861 interest allocation principles in computing net foreign base company income).
- ³⁶ See Temporary Reg. §1.861-9T(a) ("method of allocation and apportionment for interest set forth in this section is based on the approach that, in general, money is fungible and that interest expense is attributable to all activities and property regardless of any specific purpose for incurring an obligation on which interest is paid").
- ³⁷ See Proposed Reg. §1.987-2(b)(1) (first sentence) ("[e]xcept as provided in paragraphs (b)(2) and (3) of this section, items [i.e., assets and liabilities, and items of income, gain, deduction and loss] are attributable to an eligible QBU to the extent they are reflected on the separate set of books and records, as defined in §1.989(a)-1(d), of the eligible QBU"); see also Preamble to the Proposed Regulations under Code Sec. 987, 71 FR 52875 (Sept. 7, 2006): "The IRS and the Treasury Department believe that items should be attributed to an eligible QBU (and, if all or a portion of such eligible QBU has a different functional currency than its owner, to a section 987 QBU of such owner) to the extent they are reflected on the books and records of the eligible QBU (books and records method)."
- ³⁸ See Reg. §1.1503(d)-5(c)(3) (books and

records of hybrid entity separate unit are respected, unless employed with a principal purpose of avoiding the principles of Code Sec. 1503(d)).

³⁹ 1998 HOUSE REPORT, at 38–40.

⁴⁰ This term should include, for example, a prepaid forward contract of the type described in Notice 2008-2, IRB 2008-2, 252 (requesting comments on the treatment of prepaid forward contracts).

⁴¹ Reg. §1.864-2(c)(2)(iv)(a).

⁴² *Id.*

⁴³ *G.R. Kemon*, 16 TC 1026, Dec. 18,271 (1951) (“[c]ontrasted to ‘dealers’ are those sellers of securities who perform no such merchandising functions and whose status as to the source of supply is not significantly different from that of those to whom they sell. That is, the securities are as easily accessible to one as the other and the seller performs no services that need be compensated for by a mark-up of the price of the securities he sells. Such sellers are known as ‘traders’”).

⁴⁴ See Reg. §1.954-1(c)(1)(i) (reducing gross items of income by expenses under principles of Code Secs. 861, 864 and 904(d)) and Temporary Reg. §1.861-9T(b)(1) (loss on currency swap allocated in the same manner as interest expense). *Cf.* Code Sec. 954(c)(1)(F) (if notional principal contract entered into to hedge a transaction described in preceding subparagraph of Code Sec. 954(c)(1),

income, gain, loss or deduction from such notional principal contract is taken into account under such other subparagraph).

⁴⁵ See also Reg. §1.954-1(c)(ii).

⁴⁶ Reg. §1.954-2(h)(3) (“income equivalent to interest includes income from notional principal contracts denominated in the functional currency of the taxpayer ... the value of which is determined solely by reference to interest rates or interest rate indices ...”).

⁴⁷ See Code Sec. 954(c)(1)(C) (excluding from definition of foreign personal holding company income certain items of income of dealer, including income from hedging transactions).

⁴⁸ 1998 HOUSE REPORT, at 35–37.

⁴⁹ Code Sec. 954(h)(3)(E).

⁵⁰ H.R. REP. NO. 108-548, pt. 1, at 213 (2004).

⁵¹ See Code Sec. 954(b)(4) (Subpart F income not to include income that taxpayer establishes was subjected to foreign income tax at a specified rate or greater rate).

⁵² 1998 HOUSE REPORT, at 41. The same rule applies, at least according to the House Report, for purposes of determining eligibility of the corporation under the 70-percent test. See *supra* note 20.

⁵³ 1998 HOUSE REPORT, at 41–42.

⁵⁴ Code Sec. 954(h)(5)(B).

⁵⁵ *Id.*

⁵⁶ Code Sec. 954(h)(5)(D).

⁵⁷ Reg. §1.989(a)-1(b)(1).

⁵⁸ Code Sec. 954(h)(5)(E). The 1998 HOUSE

REPORT, at 37 indicates that the Code Sec. 954(d)(3) definition of “related person” would be modified by substituting a stock ownership requirement of “at least 80 percent” for the “more than 50 percent” stock ownership requirement of Code Sec. 954(d)(3). This modification was apparently never incorporated into the statute.

⁵⁹ See, e.g., Reg. §1.1275-2(g).

⁶⁰ See the discussion, *supra*, of the distinction between “a principal purpose,” “the principal purpose,” and other terms of similar, but potentially distinguishable, import.

⁶¹ See Reg. §1.701-2(a) (allowing recharacterizations that are inconsistent with the intent of subchapter K) and Reg. §1.1275-2(g) (allowing recharacterization of certain debt-related transactions that are inconsistent with the purposes of Code sections related to those transactions).

⁶² Code Sec. 954(h)(7)(A).

⁶³ Code Sec. 954(h)(7)(C).

⁶⁴ For the most recent reaffirmation of this principle, see *Countryside Limited Partnership*, 95 TCM 1006, Dec. 57,304(M), TC Memo. 2008-3 (economic substance doctrine not applicable to recast nonmarketable note as a marketable security, merely because parties structured note as nonmarketable securities solely for tax-avoidance reasons).

⁶⁵ Code Sec. 954(h)(7)(D).

⁶⁶ Code Sec. 954(h)(7)(B).

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