

[4830-01-p]

Published May 13, 2002

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-154920-01]

RIN 1545-BA33

Guidance Regarding the Definition of Foreign Personal Holding Company Income

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide that gain or loss arising from certain commodities hedging transactions and currency gain or loss arising from certain interest-bearing liabilities do not constitute (or are not netted against) foreign personal holding company income. This treatment is proposed because the applicable commodities hedging transactions and interest-bearing liabilities typically offset transactions that do not generate foreign personal holding company income. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by August 21, 2002. Requests to speak (with outlines of oral comments to be discussed) at the public hearing scheduled for September 11, 2002, at 10 a.m. must be submitted by August 21, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-154920-01), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:ITA:RU REG-154920-01, Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at: www.irs.gov/regs. The public hearing will be held in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Kenneth Christman or Ted Setzer at (202) 622-3870; concerning submission and delivery of comments and the public hearing, Treena Garrett, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Background

Section 954(c)(1)(C) of the Internal Revenue Code provides that foreign personal holding company income of a controlled foreign corporation (a CFC) generally includes the excess of gains over losses from transactions in commodities. An exception to this treatment is provided, however, for gains and losses that arise out of “bona fide hedging transactions” entered into by a producer, processor, merchant or handler of commodities. Section 954(c)(1)(C)(i). On September 7, 1995, final regulations were published in the **Federal Register** (60 FR 46500, as corrected at 60 FR 62024) under section 954 governing the definition of a CFC and the definitions of foreign base company income and foreign personal holding company income of a CFC. These regulations address, among other matters, the circumstances in which income from transactions in commodities will be treated as foreign personal holding company income. In particular, the regulations provide that income from a “qualified hedging transaction” is excluded from the definition of foreign personal holding company income. §1.954-2(f)(1)(ii). A qualified hedging transaction is defined in the regulations generally as a bona fide hedging transaction with respect to a sale of commodities in the active conduct of a commodities business by a CFC if substantially all of the CFC’s

business is as an active producer, processor, merchant or handler of commodities. §§1.954-2(f)(2)(iii) and (iv).

Following the publication of the final regulations, some taxpayers have commented that the regulations inappropriately characterize as foreign personal holding company income any gain arising from hedging transactions entered into by a manufacturer to protect itself from fluctuations in the prices of commodities associated with the products that it manufactures. Because the manufacturer would not be considered to be selling the commodities in the active conduct of a commodities business, transactions entered into by the manufacturer could not qualify for the “qualified hedging transaction” exception under the regulations.

The regulations also address the treatment of currency gain or loss for purposes of subpart F. Although the regulations provide that foreign personal holding company income generally includes the excess of foreign currency gains over foreign currency losses, an exception is provided for foreign currency gain or loss “directly related to the business needs of the controlled foreign corporation.” §1.954-2(g)(2)(ii). Notwithstanding this “business needs” exception, the regulations provide that currency gain or loss arising from an interest-bearing liability must be allocated and apportioned between subpart F and non-subpart F income in the same manner that interest expense associated with the liability is allocated and apportioned between subpart F and non-subpart F income under §§1.861-9T and 1.861-12T. §1.954-2(g)(2)(iii).

Some taxpayers have commented that the final regulations inappropriately characterize a portion of foreign currency gain on certain interest-bearing liabilities as foreign personal holding company income. In particular, these taxpayers have noted that securities dealers commonly utilize a technique known as

“match funding” to manage currency exposures associated with their dealer assets. Rather than borrowing in their functional currency to meet their business needs, dealers who utilize this technique attempt to manage their exposure to foreign currencies on their dealer assets by borrowing the funds needed for their business in the currency in which the dealer assets are denominated. As a result, the foreign currency exposure on the dealer assets is offset economically by the foreign currency exposure on the interest-bearing liabilities incurred by the dealer. Under the regulations, foreign currency gain on the dealer assets would qualify for the “business needs” exception and therefore would not be classified as foreign personal holding company income. If the foreign currency gain arose on the offsetting interest-bearing liabilities, however, a portion of the foreign currency gain likely would be treated as subpart F income under the regulations.

Explanation of Provisions

The proposed regulations address each of these issues by refining the relevant exceptions to foreign personal holding company income.

Commodities Hedging Transactions

Section 1.954-2(f)(2)(v), as proposed, would provide that a hedging transaction entered into by a CFC with respect to its business as a producer, processor, merchant or handler of commodities may be a qualified hedging transaction although the hedging transaction is not a hedge with respect to a sale of commodities in the active conduct of a commodities business by a CFC substantially all of whose business is as an active producer, processor, merchant or handler of commodities. The proposed regulation also provides that, for purposes of satisfying the qualified hedging transaction requirements, a producer, processor, merchant or handler of commodities includes (but is not limited to) a CFC that regularly uses

commodities in a manufacturing, construction, utilities, or transportation business. Similar to the regulations currently in effect, the proposed regulations provide that a corporation is not a producer, processor, merchant or handler of commodities (and therefore cannot satisfy the qualified hedging transaction requirements) if its business is primarily financial.

Foreign Currency Gain or Loss on Interest-bearing Liabilities

Section 1.954-2(g)(2)(ii)(C)(2), as proposed, would provide that interest-bearing liabilities of a CFC will be treated as dealer property if the liabilities are denominated in a currency so as to manage the CFC's currency risk with respect to dealer property held by the CFC. This provision would apply only to interest-bearing liabilities identified on the date the liability is incurred. The result of the proposed rule would be to exclude currency gain or loss on interest-bearing liabilities that manage the CFC's currency risk with respect to dealer property from the computation of foreign personal holding company income.

Proposed Effective Dates

Section 1.954-2(f)(2)(v) is proposed to apply to gain or loss realized by a CFC with respect to a qualified hedging transaction entered into on or after the date proposed §1.954-2(f)(2)(v) is published as a final regulation in the **Federal Register**. Section 1.954-2(g)(2)(ii)(C)(2) is proposed to apply to gain or loss from an interest-bearing liability entered into by a CFC on or after the date proposed §1.954-2(g)(2)(ii)(C)(2) is published as a final regulation in the **Federal Register**.

Special Analysis

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

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The IRS and Treasury Department specifically request comments on the clarity of the proposed regulations and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for September 11, 2002, at 10 a.m. in room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the “FOR FURTHER

INFORMATION CONTACT” section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by August 21, 2002. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal authors of these regulations are Kenneth Christman and Ted Setzer of the Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

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

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

Par.2. In §1.954-0, paragraph (b) is amended by:

1. Removing the entry for §1.954-2(f)(2)(iii)(E).
2. Revising the entry for §1.954-2(f)(2)(iv).

3. Adding entries for §1.954-2(f)(2)(iv)(C), (f)(2)(v) and (f)(2)(vi).
4. Revising the entry for §1.954-2(g)(2)(ii)(C).

The additions and revisions read as follows::

§1.954-0 Introduction.

* * * * *

(b) * * *

§1.954-2 Foreign personal holding company income.

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(f) * * *

(2) * * *

(iv) Qualified hedging transaction entered into prior to the date §1.954-2(f)(2)(v) is published as a final regulation in the **Federal Register**.

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(C) Effective date.

(v) Qualified hedging transaction entered into on or after the date §1.954-2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(A) In general.

(B) Exception.

(C) Examples.

(D) Effective date.

(vi) Financial institutions not a producer, etc.

(g) * * *

(2) * * *

(ii) * * *

(C) Regular dealers.

(1) General rule.

(2) Certain interest-bearing liabilities treated as dealer property.

(i) In general.

(ii) Failure to identify certain liabilities.

(iii) Effective date.

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Par. 3. Section 1.954-2 is amended by:

1. Removing paragraph (f)(2)(iii)(E).
2. Revising the heading of paragraph (f)(2)(iv).

3. Adding paragraphs (f)(2)(iv)(C), (f)(2)(v), and (f)(2)(vi).

4. Revising paragraphs (g)(2)(C) and (g)(2)(iii).

The revisions and additions read as follows:

§1.954-2 Foreign personal holding company income.

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(f) * * *

(2) * * *

(iv) Qualified hedging transaction entered into prior to the date §1.954-2(f)(2)(v) is published as a final regulation in the **Federal Register**.

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(C) Effective date. This paragraph (f)(2)(iv) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into prior to the date §1.954-2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(v) Qualified hedging transaction entered into on or after the date §1.954-2(f)(2)(v) is published as a final regulation in the Federal Register--(A) In general. The term qualified hedging transaction means a bona fide hedging transaction, as defined in paragraph (a)(4)(ii) of this section, with respect to one or more commodities transactions reasonably necessary to the conduct of any business by a producer, processor, merchant or handler of commodities in a manner in which such business is customarily and usually conducted by others. For purposes of this paragraph (f)(2)(v), a producer, processor, merchant or handler of commodities includes a controlled foreign corporation that regularly uses commodities in a manufacturing, construction, utilities, or transportation business.

(B) Exception. The term qualified hedging transaction does not include a transaction described in section 988(c)(1) (without regard to section 988(c)(1)(D)(i)).

(C) Examples. The following examples illustrate the provisions of this paragraph (f)(2)(v):

Example 1. CFC1 is a controlled foreign corporation located in country A. CFC1 manufactures and sells machinery in country B using aluminum and component parts purchased from third parties that contain significant amounts of aluminum. CFC1 conducts its manufacturing business in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aluminum used in the machinery it manufactures, CFC1 enters into futures purchase contracts for the delivery of aluminum. These futures purchase contracts are bona fide hedging transactions. As CFC1 purchases aluminum and component parts containing significant amounts of aluminum in the spot market for use in its business, it closes out an equivalent amount of aluminum futures purchase contracts by entering into offsetting aluminum futures sales contracts. The aluminum futures purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aluminum futures purchase contracts is excluded from the computation of foreign personal holding company income.

Example 2. CFC2 is a controlled foreign corporation located in country B. CFC2 operates an airline business within country B in a manner in which such business is customarily and usually conducted by others. To protect itself against increases in the price of aviation fuel, CFC2 enters into forward contracts for the purchase of aviation fuel. These forward purchase contracts are bona fide hedging transactions. As CFC2 purchases aviation fuel in the spot market for use in its business, it closes out an equivalent amount of its forward purchase contracts for cash pursuant to a contractual provision that permits CFC2 to terminate the contract and make or receive a one-time payment representing the contract's fair market value. The aviation fuel forward purchase contracts are qualified hedging transactions as defined in paragraph (f)(2)(v)(A) of this section. Accordingly, any gain or loss on such aviation fuel forward purchase contracts is excluded from the computation of foreign personal holding company income.

(D) Effective date. This paragraph (f)(2)(v) applies to gain or loss realized by a controlled foreign corporation with respect to a qualified hedging transaction entered into on or after the date §1.954-2(f)(2)(v) is published as a final regulation in the **Federal Register**.

(vi) Financial institutions not a producer, etc. For purposes of this paragraph (f), a corporation is not a producer, processor, merchant or handler of commodities if its business is primarily financial. For

example, the business of a controlled foreign corporation is primarily financial if its principal business is making a market in notional principal contracts based on a commodities index.

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(g) * * *

(2) * * *

(ii) * * *

(C) Regular dealers--(1) General rule. Transactions in dealer property (as defined in paragraph (a)(4)(v) of this section) described in section 988(c)(1)(B) or (C) that are entered into by a controlled foreign corporation that is a regular dealer (as defined in paragraph (a)(4)(iv) of this section) in such property in its capacity as a dealer will be treated as directly related to the business needs of the controlled foreign corporation under paragraph (g)(2)(ii)(A) of this section.

(2) Certain interest-bearing liabilities treated as dealer property--(i) In general. For purposes of this paragraph (g)(2)(ii)(C), an interest-bearing liability incurred by a controlled foreign corporation that is denominated in (or determined by reference to) a non-functional currency shall be treated as dealer property if the liability, by being denominated in such currency, reduces the controlled foreign corporation's currency risk with respect to dealer property, and the liability is identified on the controlled foreign corporation's records as a liability treated as dealer property before the close of the day on which the liability is incurred.

(ii) Failure to identify certain liabilities. If a controlled foreign corporation identifies certain interest-bearing liabilities as liabilities treated as dealer property under the previous paragraph but fails to so identify other interest-bearing liabilities that manage its currency risk with respect to assets held that constitute

dealer property, the Commissioner may treat such other liabilities as dealer property if the Commissioner determines that the failure to identify such other liabilities had as one of its principal purposes the avoidance of federal income tax.

(iii) Effective date. This paragraph (g)(2)(ii)(C)(2) applies only to gain or loss from an interest-bearing liability entered into by a controlled foreign corporation on or after the date §1.954-2(g)(2)(ii)(C)(2) is published as a final regulation in the **Federal Register**.

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(iii) Special rule for foreign currency gain or loss from an interest-bearing liability. Except as provided in paragraph (g)(2)(ii)(C)(2) or (g)(5)(iv) of this section, foreign currency gain or loss arising from an interest-bearing liability is characterized as subpart F income and non-subpart F income in the same manner that interest expense associated with the liability would be allocated and

apportioned between subpart F income and non-subpart F income under ' ' 1.861-9T and 1.861-12T.

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Robert E. Wenzel,

Deputy Commissioner of Internal Revenue.