

ACTIVE FINANCE EXCEPTIONS UNDER SUBPART F

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TOPICS

- Review of the Big Picture
- Section 954(h) - Active Finance Exception
 - History
 - Section 954(h) Rules and Examples
 - Related Provisions
- Export Finance Exception

THE BIG PICTURE:

- **Competing Considerations (Deferral vs. No Deferral):**
 - Cons: shift income/investments offshore & erode US tax base
 - Pro: Make US corps more competitive
- **The Sub F Compromise:**
 - No deferral for passive income (highly mobile/no pro argument)
 - Deferral for active income w/rules against base shifting
- **The Problem with Active Finance Income**
 - hard to define
 - highly mobile

**SECTION 954(h)
INCOME DERIVED
IN ACTIVE CONDUCT
OF BANKING, FINANCE, OR
SIMILAR BUSINESS**

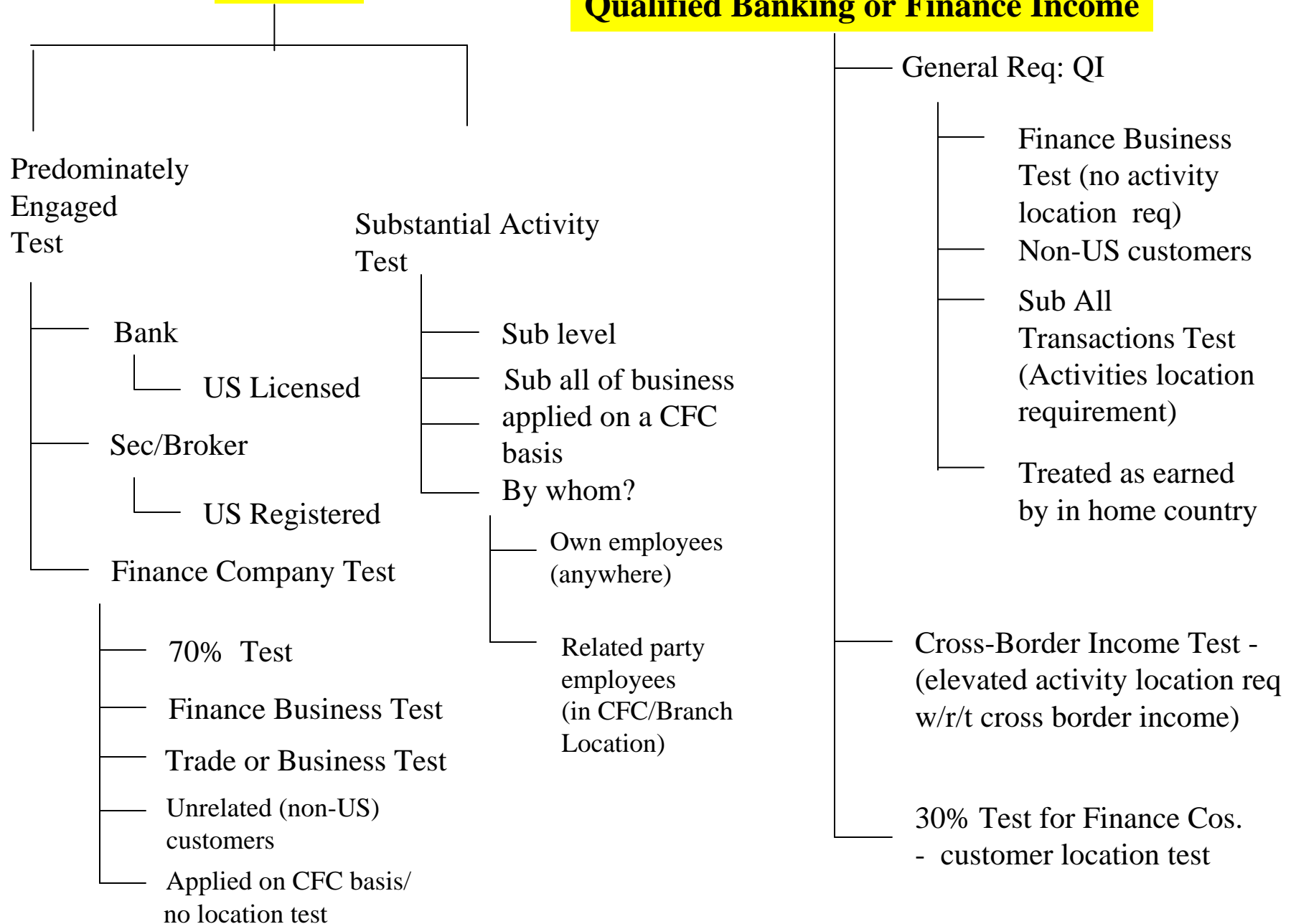
*Section 954(h) Active Finance Exception
History*

- 1986 - 1986 Act repeals similar exception
- 1997 - TRA of 1997 passed one-year temp. exception
- 1997 - Pres. Clinton exercises line item veto
- 1998 - Supreme Ct reinstates (June 1998)
- 1998 - Congress rewrites 954(h) and extends one year (See Tax and Trade Relief Extension Act of 1998)
- 1999 - Tax Relief Extension Act 1999 extends for two year
- 2002 - Congress extends five additional years
- 2006 - Congress extends additional two years through December 31, 2008
- 2007 - Legislative proposal to make permanent (S. 2380)

Eligible CFC

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Qualified Banking or Finance Income



FPHCI does not include:

1. “qualified banking or financing income”
2. of an “eligible CFC”

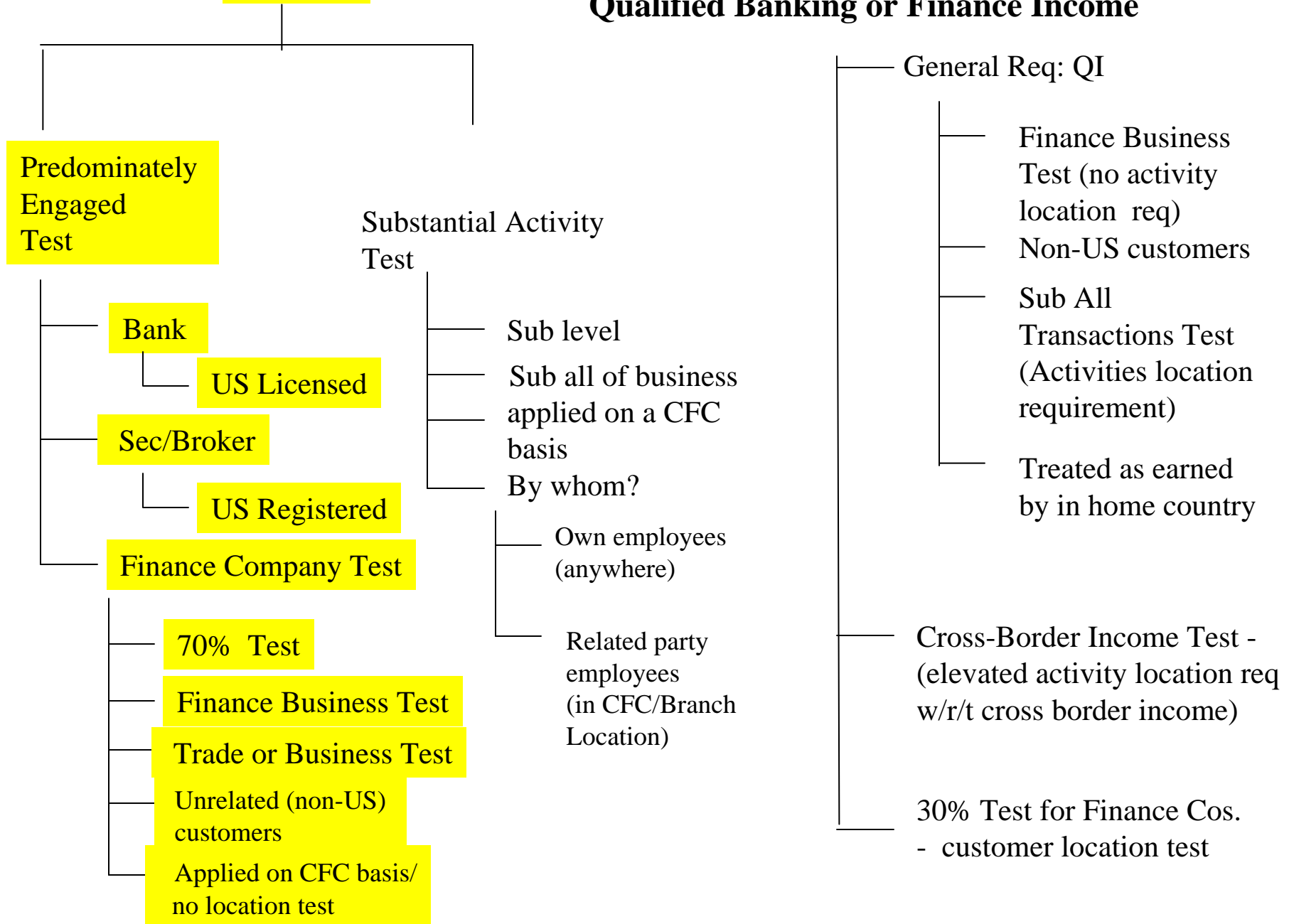
An eligible CFC is a CFC:

1. That is “**predominately engaged**” in the active conduct of a banking, financing, or similar business, and
2. Conducts “**substantial activity**” with respect to such business

Eligible CFC

&

Qualified Banking or Finance Income



Section 954(h) Active Finance Exception
Eligible CFC Requirement
Predominately Engaged - Overview

A CFC is “predominately engaged” in a banking, finance, or similar business if it is a:

- Finance Company
- Bank
- Securities Dealer/Broker

Section 954(h) Active Finance Exception
Eligible CFC Requirement
Predominately Engaged – Bank

To be a bank, a CFC must be:

- engaged in active conduct of “banking business” and
- licensed as bank in US (or unlicensed corporation as may be provided in regs)
- Legislative History to 1998 Act states that Bank Test should be interpreted in a manner provided in Prop. Treas. Reg. §§1.1296-4 and 1.1296-6

Section 954(h) Active Finance Exception
Eligible CFC Requirement
Predominately Engaged – Bank

Under the PFIC regs, a bank must:

- Be licensed as a bank in US (Rep office not sufficient)
- OR be a foreign corp that:
 - actively conducts T/B within meaning of 367 regs,
 - is licensed or authorized under local law to accept deposits,
 - deposits must be substantial,
 - perform one or more of a list of banking activities in country of incorporation, and
 - makes loans

To be a broker/dealer, the CFC must:

- be actively engaged in securities business
- and must be registered under '34 ACT
- Legislative History to 1998 Act states that Broker Test should be interpreted in a manner provided in Prop. Treas. Reg. §§1.1296-4 and 1.1296-6

Under the PFIC Regs, a broker must:

- be licensed as a securities broker or dealer under '34 Act
- OR be a foreign corp that:
 - is a “securities broker” or a “securities dealer,”
 - actively conducts one or more of a list of security activities as a T/B,
 - is licensed or authorized under local law to conduct one or more securities activities to resident of its country of incorporation, and
 - must be subject to bona-fide regulation/oversight

Section 954(h) Active Finance Exception
Eligible CFC Requirement
Predominately Engaged – Finance Company

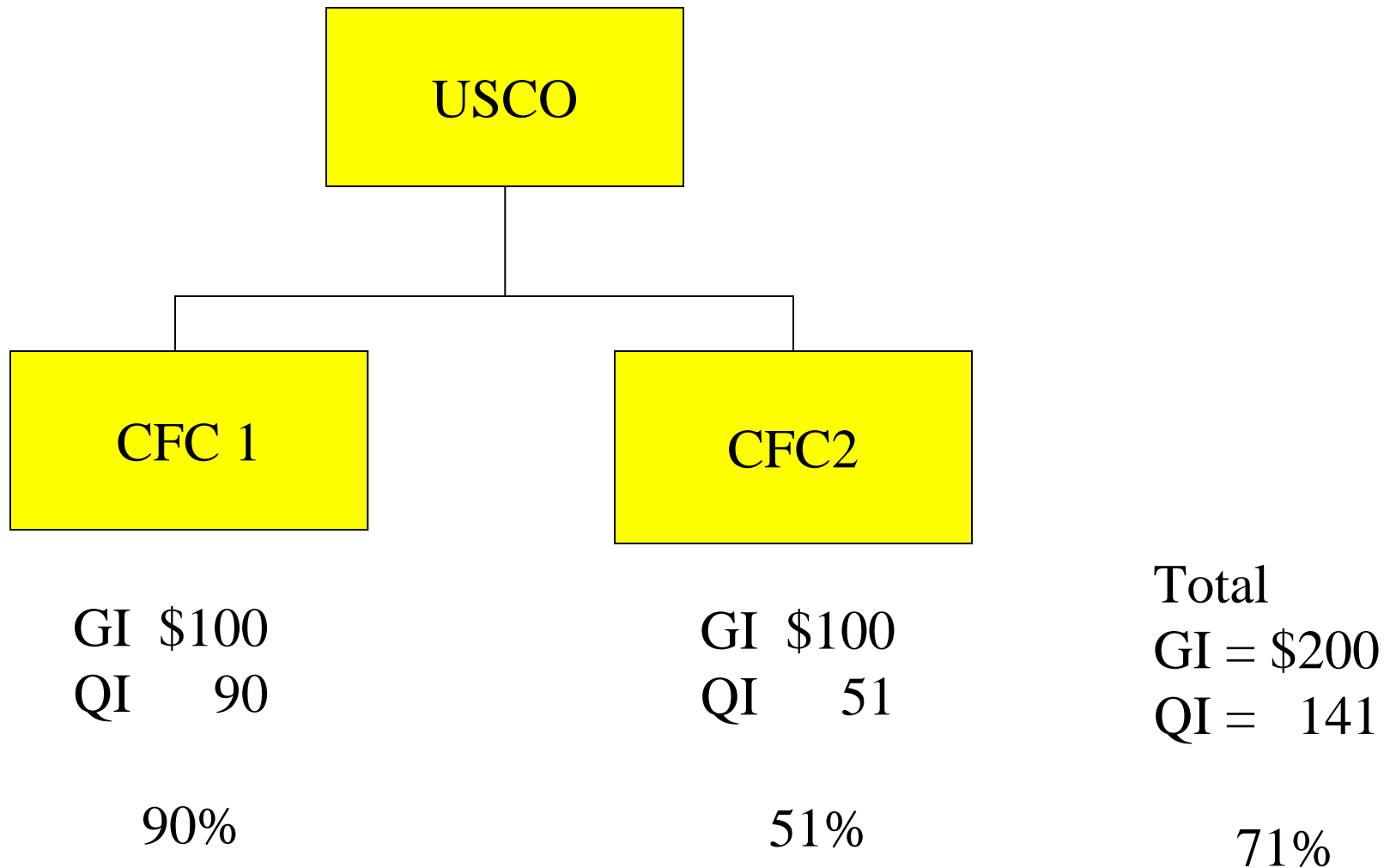
To be a finance company:

1. More than 70% of CFC's gross income (**"70% Test"**)
2. must be derived in the "active and regular conduct" (**"T/B Test"**)
3. of a "lending or finance business" (**"Finance Business Test"**)
4. from transactions with unrelated parties

Section 954(h) Active Finance Exception

Eligible CFC Requirement

Predominately Engaged – Finance Company – 70% Test



Section 954(h) Active Finance Exception

Eligible CFC Requirement

Predominately Engaged – Finance Company – Finance Business Test

Sec. 954(h)(4) “Lending or Finance Business” means the business of:

- making loans
- purchasing or discounting A/R, notes, installment obligations
- engaging in leasing
- issuing LOCs and providing guarantees
- charge and credit card services
- providing related services or making facilities available to corp engaged in the above activities

Section 954(h) Active Finance Exception

Eligible CFC Requirement

Predominately Engaged – Finance Company – Finance Business Test

Possible sources of further guidance:

904(d) : FSI includes income “derived in the active conduct of banking, **finance**, or similar **business**”

1.904-4(e): FSI income is income earned by FSE from one of 25 activities

FSE is entity “**predominately engaged**” in active conduct of a banking, insurance, financing or similar business

542(c): PHC excludes a “lending or finance company”

542(d) states that “**lending or finance business**” means a business of”

1.864-4: provides special rules for determining when certain income is effectively connected to active conduct of banking, **finance**, or similar **business**

1.864-4(c)(5) defines “banking, **finance**, or similar **business**.” (emphasis on “for the public.”)

Trade or Business Test: How much is enough????

- CFC must be engaged in “active and regular conduct... of abusiness”
- Possible sources of further guidance
 - ECI
 - §166 cases
 - PTP

Trade or Business Test: How much is enough????

First Analogy: Section 864(b)/(c) ECI Cases

- Non-US persons subject to US tax on ECI
- Isolated vs. active & continuous

Pasquel v. Commissioner, 12 T.C.M. 1431 (1953)

Tax court stated that one isolated financing transaction was not sufficient to establish a T/B because T/B requires “sustained and continuous activity.”

Another analogy: Section 166 Cases

- Ord. Ded. for bad debts incurred in T/B
- Passive vs. active lending

Factors considered in section 166 cases:

- regular and continuous lending activity
- number and amount of loans
- whether TP actually collected interest
- purpose of loans
- TP had reputation of a lender
- were transactions with unrelated parties?
- advertised

Eligible CFC Requirement

Predominately Engaged – Finance Company – T/B Req.

Yet another analogy: Section 7704(d)(2)

- A Pship is treated as Corp if it is publicly traded
- Except if 90% of its income is “qualifying income”
- Finance income is not qualifying income

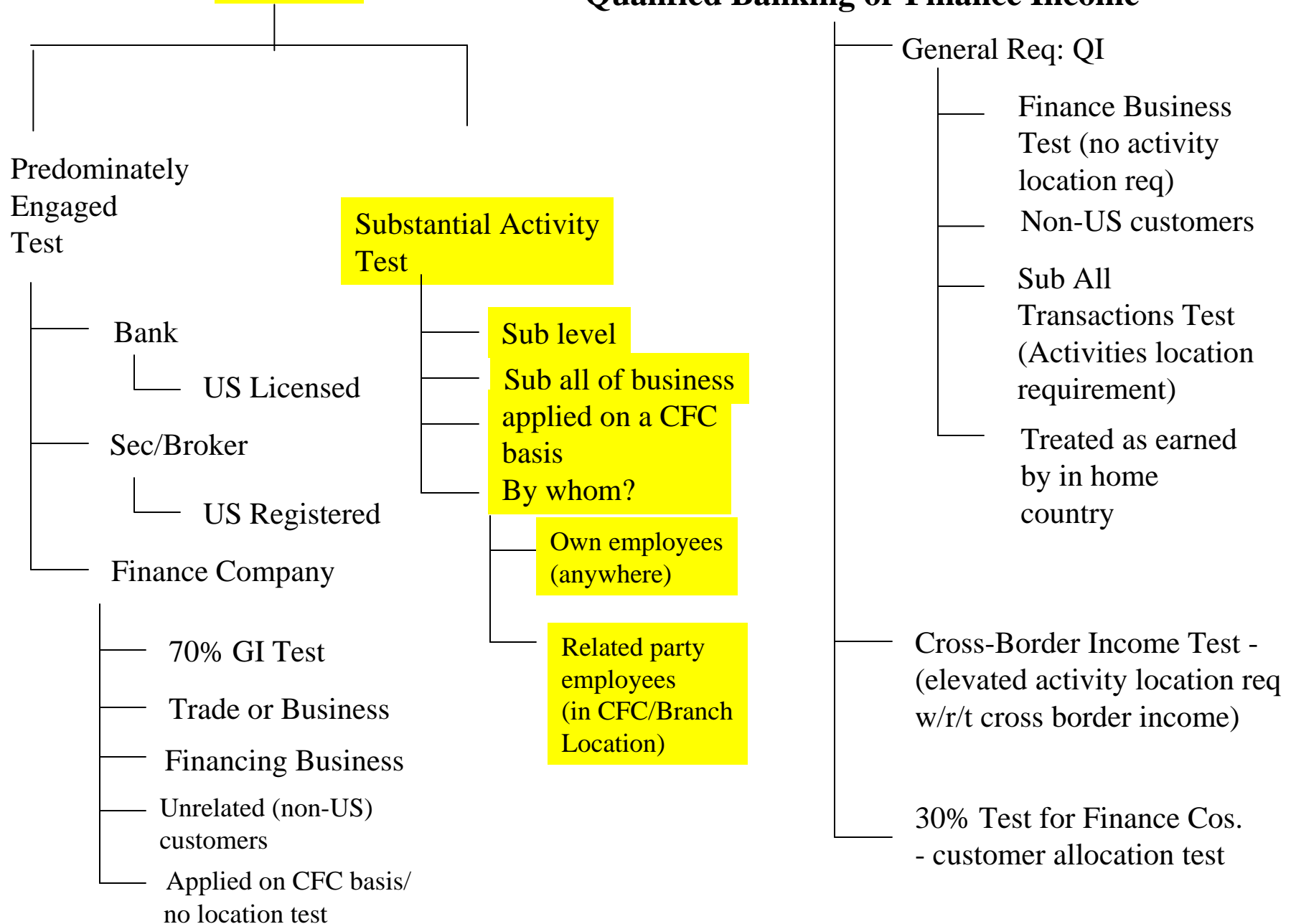
PLR 9701006:

- expected to maintain two or fewer employees
- hold mortgage loans that it originates until maturity or refinancing
- would not hold loans or other assets for sale to customers
- but would sell foreclosure property
- expected to average no more than 5 new mortgages per year over any given 5 year period
- mortgages finance construction projects that employed labor union partners

Eligible CFC

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Qualified Banking or Finance Income



CFC (as a whole) must perform “Substantial Activity” with respect to its business

- Anti-base shifting rule
- Facts and circumstances test
- Quantitative and qualitative elements

Quantitative - Factors considered in determining substantiality:

- overall size of the CFC
- amount of revenues and expenses
- number of employees
- ratio of its revenue per employee
- amount of property owned
- nature, size, and relative significance of activities performed by CFC

**Qualitative - CFC (as a whole) must conduct
“substantially all” of the necessary activities**

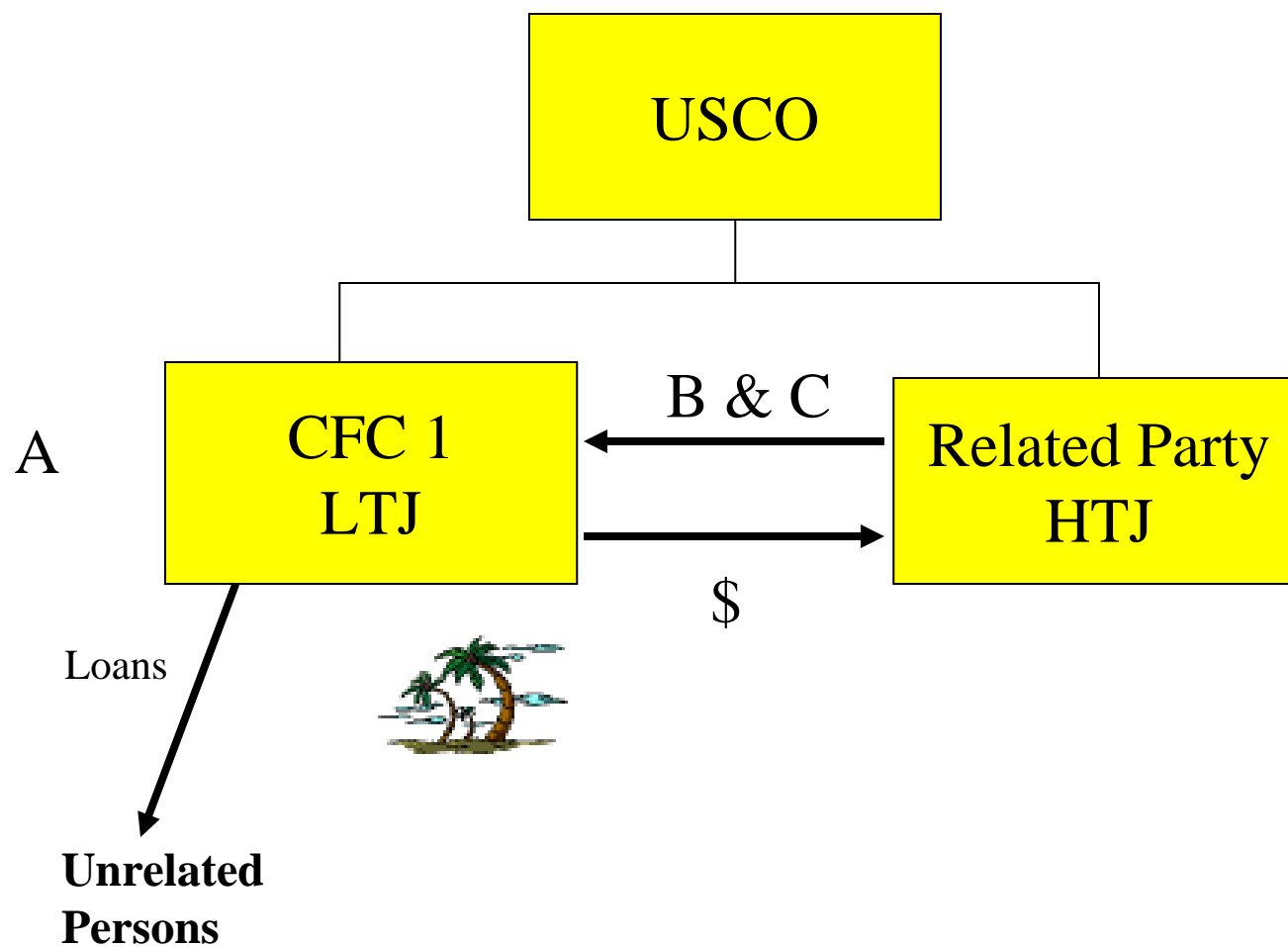
Including:

- initial solicitation of customers and vendors
- negotiating terms with customers
- credit checks
- making the loans/leases/providing the services
- collections
- foreclosing

Who can perform these activities?

- Employees of CFC/QBU/Branches (anywhere)
- Employees of person related to CFC/QBU if:
 - person is related within meaning of section 954(d)(3) (Leg. History but not Code says substitute “at least 80%” for “more than 50%”);
 - employees perform activities in the CFC/QBU’s country; and
 - related person receives arm’s length compensation and such compensation is includible in the related person’s income under its home country’s tax laws

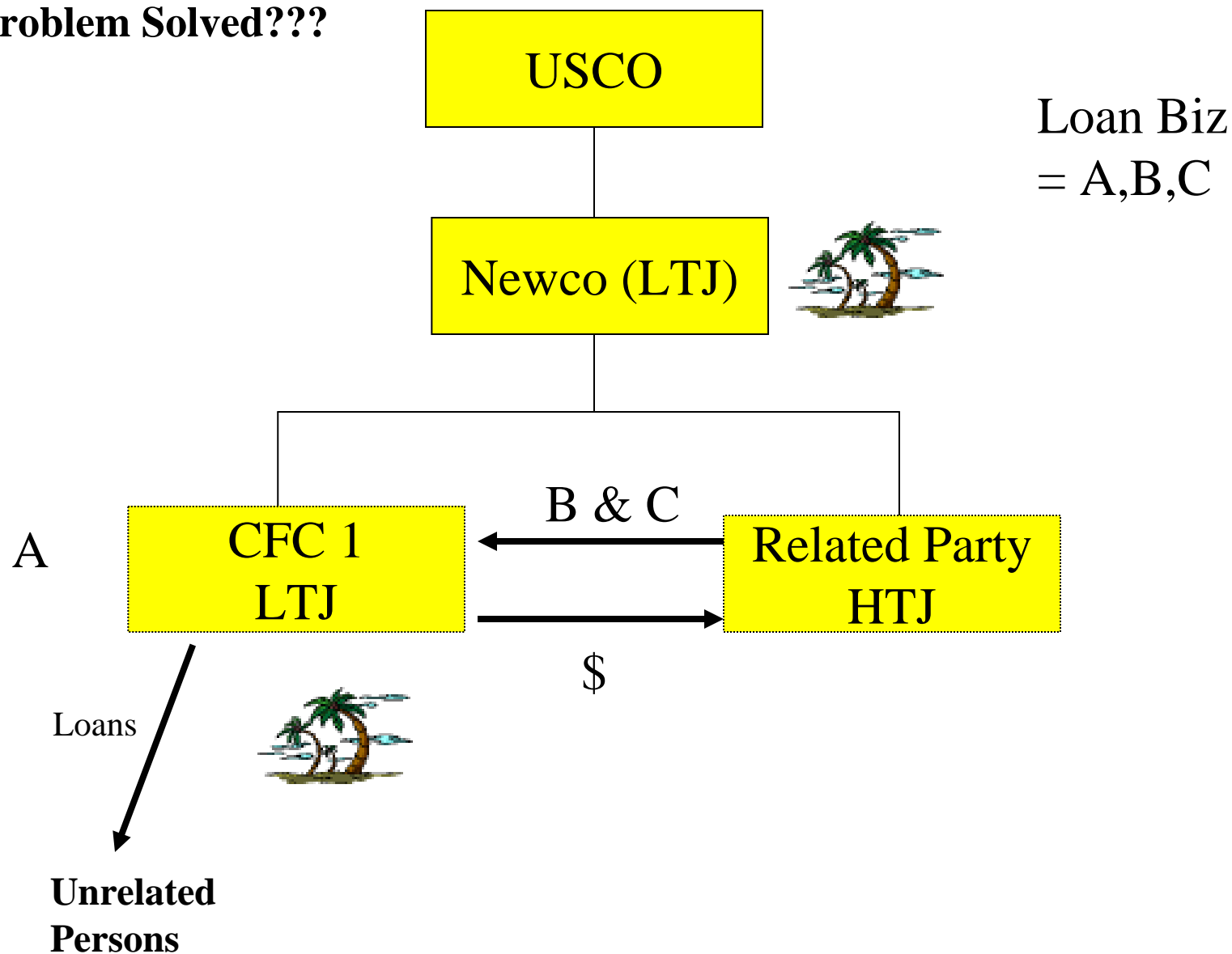
*Section 954(h) Active Finance Exception
Eligible CFC Requirement
Substantial Activity Test*



Loan Biz
= A,B,C

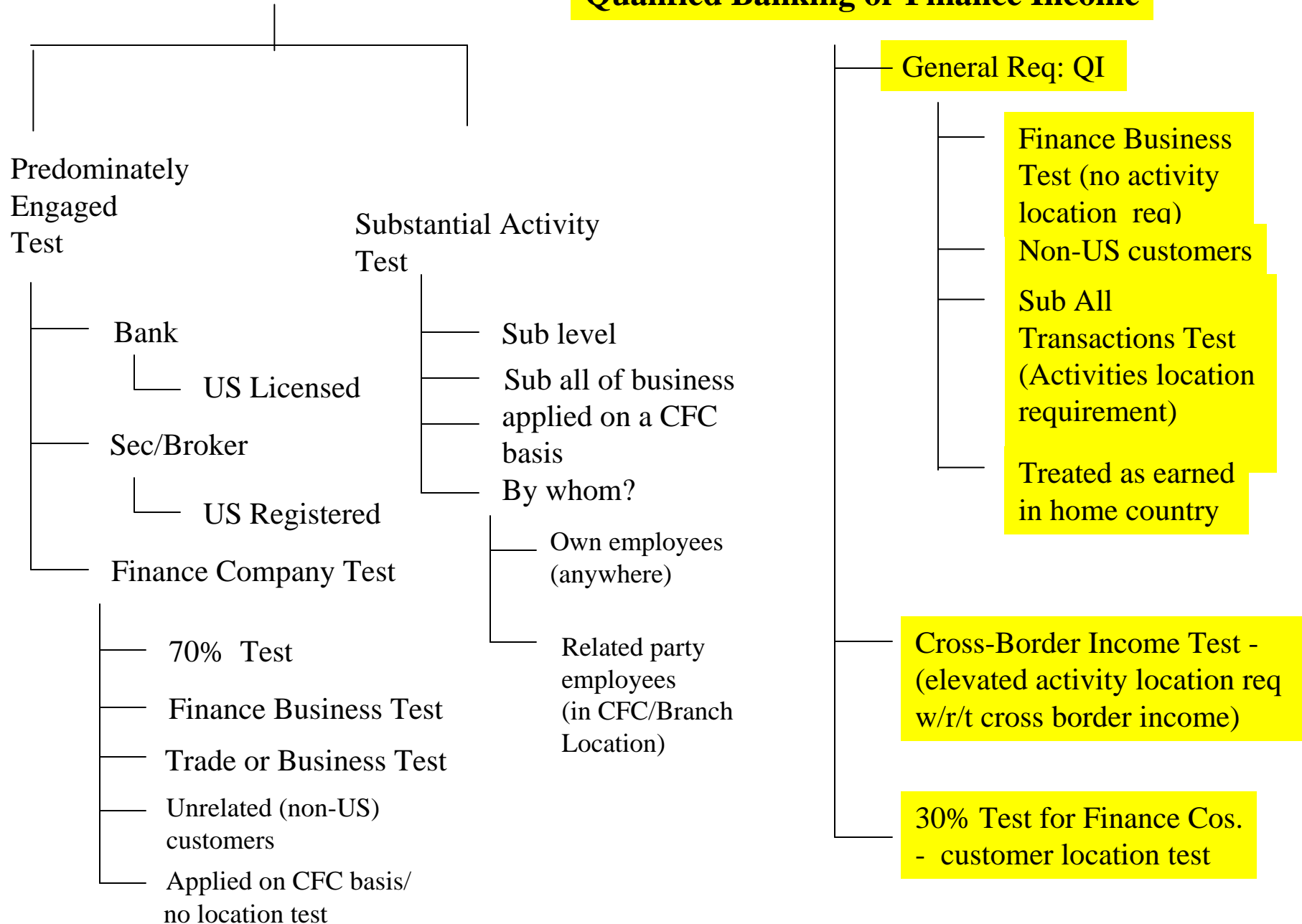
*Section 954(h) Active Finance Exception
Eligible CFC Requirement
Substantial Activity Test*

Problem Solved???



Eligible CFC &

Qualified Banking or Finance Income



Only “Qualifying Banking or Finance Income” of an Eligible CFC is Excluded.

General Requirements:

1. Finance Business Test - Must be derived in active conduct of banking, finance, or similar business by the Eligible CFC or its QBU
 - No location requirement with this test (but see Cross-Border Test)
2. Derived from transactions with customers located outside U.S.
3. Sub All Transactions Test – The Eligible CFC or its QBU must conduct “substantially all” of the activities related to the transaction in its home country AND
 - Originally just employees of Eligible CFC/QBU
 - Subsequent legis. permits employees of a “related person” [954(h)(3)(E)]
4. Must be treated by home country’s tax laws as earned in CFC/QBU’s home country

Cross-Border Income Test (954(h)(3)(C)): For cross-border income of an Eligible CFC/QBU:

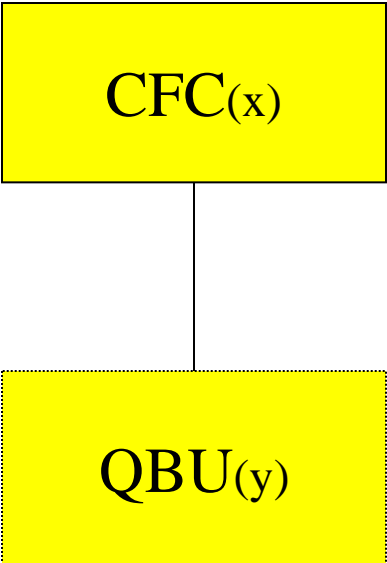
- The CFC/QBU must satisfy the Substantial Activity Requirement on a stand-alone basis in its home country. (i.e., CFC/QBU must conduct substantial activity with respect to the financial service business in each unit's home country)
- Note: focus on location of customer and QBU's activities

The 30 Percent Test (954(h)(3)(B)) - A further limitation on cross-border income for Finance Companies:

- Applies to eligible CFCs that are Finance Companies.
- States that NO income of such CFC/QBU is qualifying income unless:
 - More than 30% of CFC/QBU's gross income
 - is derived in active conduct of lending and finance business
 - with unrelated, **in-country** customers

Section 954(h) Active Finance Exception
 Comprehensive Example – Finance Company

Sub All Activities = A, B, C

	Loans	Location of Customer	Location of Activities	
			In country	Outside
 <p>CFC_(x)</p> <p>QBU_(y)</p>	1 Loan	X	A, B, C	NA
	1 Loan	Z	A, B, C	NA
	3 Loans	Z	N/A	A, B, C
	<hr/>			
	100 loans	29 loans - Y 71 loans - Z	A,B,C	NA

Eligible CFC (CFC Basis):

- Finance Company Test
 - 70% Test
 - Trade or Business
 - Lending/Finance
 - Unrelated, non-US parties
- Substantial Activity Test (sub/ Sub all)

Qualifying Income (QBU Basis):

- Finance Business Test
- Non-US Customers
- Sub All Transaction Test (Act. Loc Test)
- Cross-Border Income Test (Sub All/QBU Basis)
- 30% Test (in-country customers)

The Anti-Abuse Rules (954(h)(7)):

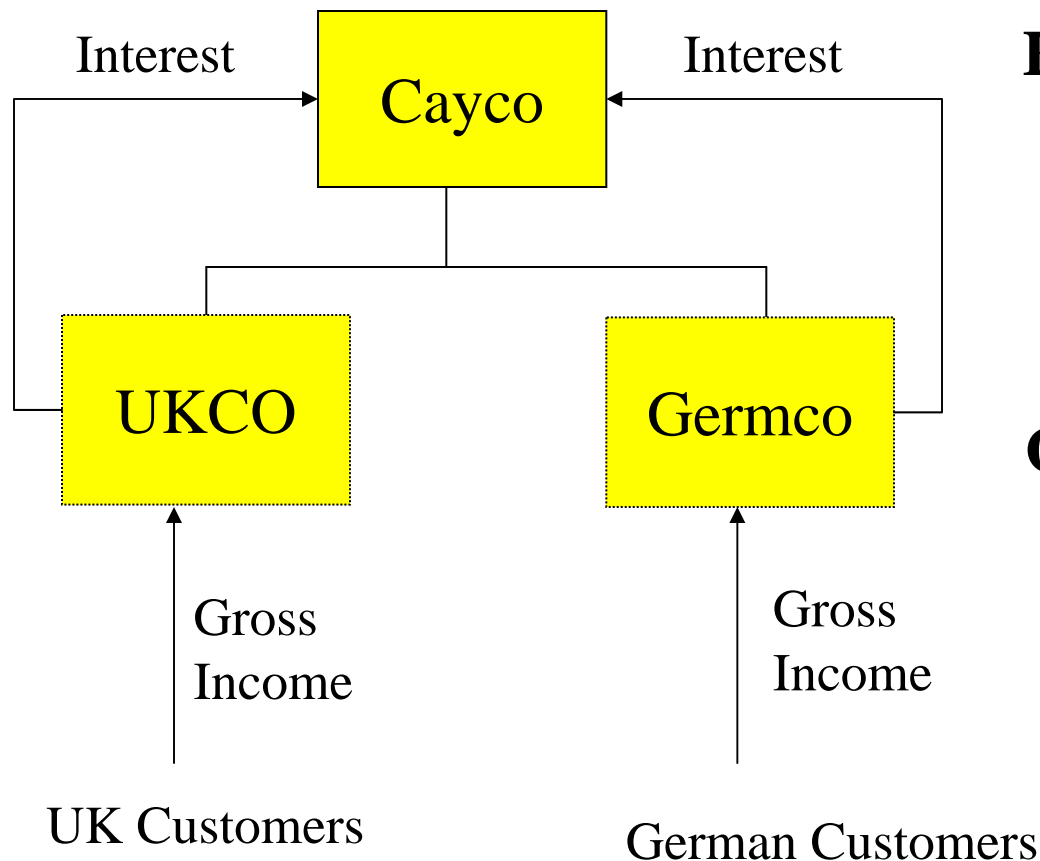
- No tax motivated transactions to accelerate or defer tax items to qualify for this exception.
- Ignore entities not regularly and continuously engaged in transactions with unrelated customers.
- No tax motivated transactions to qualify income by utilizing entities to satisfy any home country requirement or SPVs.
- No tax motivated transactions with employees, O & Ds, and related persons to avoid rules.

- Treasury concerned above financial services income because:
 - involves types of income that are generally passive
 - involves entities that are highly mobile
 - involves types of income that are highly mobile
- States that the Active Finance Exception rules are designed to address these concerns, but there are holes
- Fixing holes would increase complexity and uncertainty for taxpayers

Specific Comments:

- Definition of Finance Company is too broad
- Tests based on location of activities may become obsolete
- Base shifting still possible

THE BIG LOOPHOLE:



Eligible CFC

- Finance Company
- Sub Activity/Sub All

Qualifying Income

- QBU Sub All Trans Test
- C/B Income Test
- 30% Test

Anti-Abuse Rules?

Related Provisions:

- Sec. 954(c)(1)(B)(i) – FPHCI does not include gain from the sale of assets that produce Active Finance Income
- Sec. 954(e)(2) – FBCSI does not include Active Finance Income
- Active Finance Exception does not apply to dealer income described in 954(c)(2)(C)(ii)

**SECTION 954(c)(2)(B)
EXPORT FINANCE
EXCEPTION TO
FPHCI**

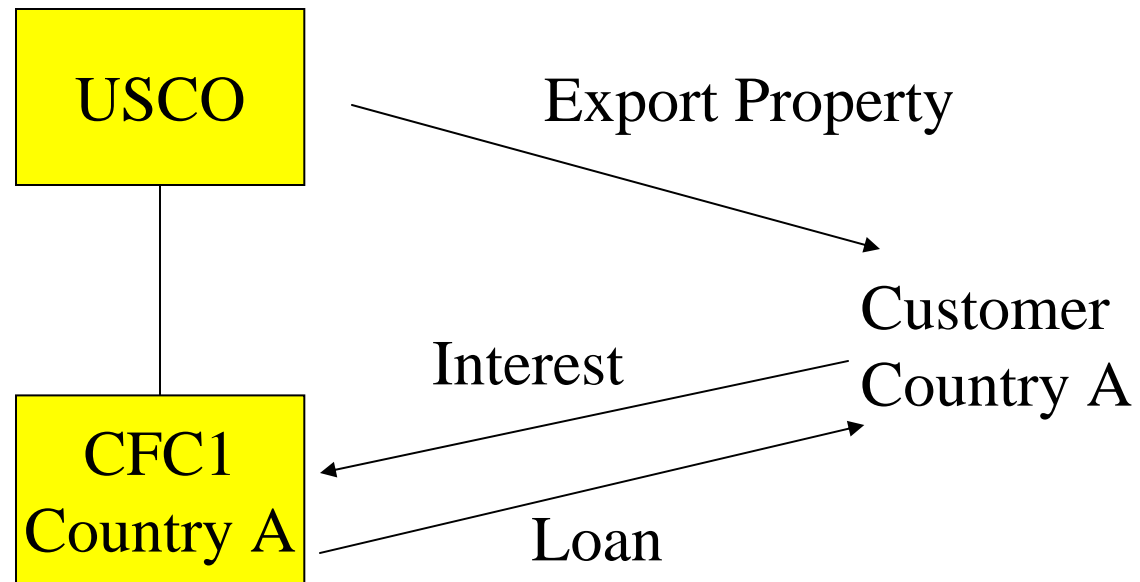
EXPORT FINANCE EXCEPTION (954(c)(2)(B)), applies to:

- Interest
- derived in conduct of “banking business”
- that finances the sale of export property
- and does not constitute related party factoring income

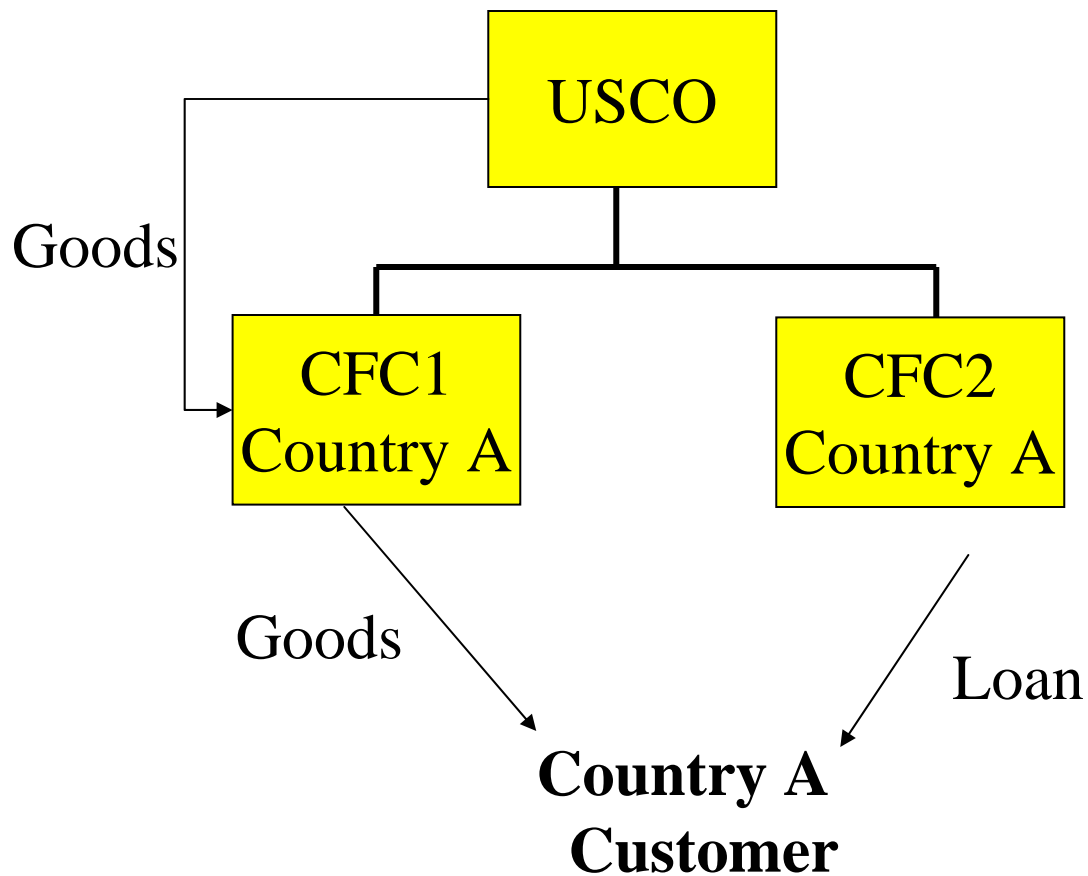
Interest cannot be related party factoring income:

- Typical – CFC buys receivable at a discount from related party
- Loan from CFC to customer of related party to finance sale of inventory or services provided by related party
- Exception: Seller and CFC finance company located in same country

Export Finance Exception
Basic Requirements
Related Party Factoring Income



Export Finance Exception
Basic Requirements
Related Party Factoring Income



THE END

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