TEMPORARY REGULATIONS ALTER C.F.C.'S ACTIVE RENTS AND ROYALTIES EXCEPTION TO SUBPART F

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The I.R.S. has issued temporary regulations (T.D. 9733)[1] to limit the use of the active rents and royalties exception to foreign personal holding company income ("F.P.H.C.I.") under subpart F of the Internal Revenue Code ("the Code"). The new Treas. Reg. §1.954-2T provides that when a controlled foreign corporation ("C.F.C.") leases or licenses property to an unrelated person, the C.F.C.'s own officers or staff of employees, not a third party, must perform the required functions in order to qualify for the active rents and royalties exception under subpart F. The temporary regulations clarify that a C.F.C. may still qualify for the exception when the officers and employees performing those functions are located in more than one foreign country. Furthermore, the temporary regulations provide that the active rents and royalties exception cannot be met through cost sharing arrangements, and such payments will not count towards determining whether an organization is "substantial" based on its active leasing or licensing expenses.[2]

BACKGROUND

Generally, for a U.S. shareholder of a C.F.C., the *pro rata* share of the C.F.C.'s subpart F income must be included as a deemed dividend in the shareholder's gross income.[3] One type of subpart F income is F.P.H.C.I., which refers to foreign passive income and includes certain rents and royalties.[4] However, rents and royalties that are derived from the active conduct of a C.F.C.'s trade or business, and are received from an unrelated person, are excluded from F.P.H.C.I. treatment.[5] This active rents and royalties exception prevents a C.F.C.'s income from being subjected to the harsh tax regime of subpart F.

Treas. Reg. §§1.954-2(c) and (d) enumerates four scenarios in which a C.F.C.'s rental income is considered active and two in which royalty income is considered active. The newly issued temporary regulations modify three of the six ways that rental or royalty income can qualify for the active exception.

Rents earned by a C.F.C. (acting as the lessor) are considered to be income derived from an active trade or business if they are attributable to:

> (i) Property that the lessor has manufactured or produced, or has acquired and added substantial value to, but only if the lessor is

1 T.D. 9733, 09/01/2015, Treas. Reg. §1.954-2T, Treas. Reg. §1.954-2.

2 T.D. 9733, 09/01/2015, Treas. Reg. §1.954-2T, Treas. Reg. §1.954-2.

3 Code §951.

4 Code §§954(a)(1) and 954(c).

5 Code §954(c)(2)(A) and Treas. Reg. §1.954-2(b)(6).

"The newly issued temporary regulations modify three of the six ways that rental or royalty income can qualify for the active exception."

> regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind [known as the "active development test"];
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> (ii) Real property with respect to which the lessor, through its own officers or staff of employees, regularly performs active and substantial management and operational functions while the property is leased;
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> (iii) Personal property ordinarily used by the lessor in the active conduct of a trade or business, leased temporarily during a period when the property would, but for such leasing, be idle; or
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> (iv) Property that is leased as a result of the performance of marketing functions by such lessor if the lessor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property [known as the "active marketing test"].[6]

Royalties earned by a C.F.C. (acting as the licensor) are considered to be income derived from an active trade or business if they are attributable to:

> (i) Property that the licensor has developed, created, or produced, or has acquired and added substantial value to, but only so long as the licensor is regularly engaged in the development, creation or production of, or in the acquisition of and addition of substantial value to, property of such kind [the "active development test"]; or
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> (ii) Property that is licensed as a result of the performance of marketing functions by such licensor if the licensor, through its own officers or staff of employees located in a foreign country, maintains and operates an organization in such country that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property [the "active marketing test"].[7]

Under a safe harbor provision in the regulations, an organization is considered to be "substantial" if the active leasing or licensing expenses are 25% or more of the adjusted leasing or licensing profits.[8] The regulations generally define active leasing expenses and active licensing expenses as deductions that are properly allocable to rental or royalty income and that would be allowable under Code §162 if the C.F.C. were a domestic corporation, subject to certain exceptions.[9]

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6 Treas. Reg. §1.954-2(c)(1)(i)-(iv).

7 Treas. Reg. §1.954-2(d)(1)(i)-(ii).

8 Treas. Reg. §§1.954-2(c)(2)(ii) and (d)(2)(ii).

9 Treas. Reg. §§1.954-2(c)(2)(iii) and (d)(2)(iii).

TEMPORARY REGULATIONS

The purpose of Treas. Reg. §§1.954-2(c) and (d) is to clarify when rental or royalty income is not merely passive or investment income but is earned from the active business conduct of a C.F.C. The newly issued temporary regulations ensure that the exception from subpart F treatment only applies to active rents and royalties by specifying that the C.F.C.'s employees, not third parties, must perform the required functions in order to qualify for the exception. This modification effectively encourages the local development or creation of property.

The temporary regulations modify what qualifies as active rents and royalties under Treas. Reg. §1.954-2 in the following three ways:

1. The temporary regulations expressly provide that in order for the active rent or royalty exception to apply, the C.F.C. lessor or licensor must perform activities through its own officers or staff of employees.

2. The officers or employees that perform the activities associated with the rents or royalties may be physically located in more than one country.

3. The officers or employees will not be treated as performing the relevant activities if there are payments made by the C.F.C. under a cost sharing arrangement or platform contribution transaction because such arrangements involve another person actually performing the activities. Furthermore, payments made under such arrangements are non-deductible and do not count towards establishing whether an organization has "substantial" active leasing or licensing expenses under the safe harbor provision.[10]

"The purpose of Treas. Reg. §§1.954-2 (c) and (d) is to clarify when rental or royalty income is not merely passive or investment income but is earned from the active business conduct of a C.F.C."

The text of Treas. Reg. §1.954-2T(c)(1)(i) specifies that rents will be deemed active when activities are performed through the C.F.C.'s own officers or employees as follows:

> (i) Property that the lessor, *through its own officers or staff of employees*, has manufactured or produced, or property that the lessor has acquired and, *through its own officers or staff of employees*, added substantial value to, but only if the lessor, *through its officers or staff of employees*, is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;[11]
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> (iv) Property that is leased as a result of the performance of marketing functions by such lessor *through its own officers or staff of employees located in a foreign country or countries*, if the lessor, through its officers or staff of employees, maintains and operates an organization *either* in such country *or in such countries (collectively), as applicable*, that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.[12]

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[10] Treas. Reg. §§1.954-2T(c)(2)(ii) and (viii); Treas. Reg. §§ 1.954-2T(d)(2)(ii) and (v).

[11] Treas. Reg. §1.954-2T(c)(1)(i); emphasis added.

[12] Treas. Reg. §1.954-2T(c)(1)(iv); emphasis added.

The text of Treas. Reg. §1.954-2T(d)(1)(i) specifies that royalties will be deemed active when activities are performed through the C.F.C.'s own officers or employees as follows:

> (i) Property that the licensor, *through its own officers or staff of employees*, has developed, created, or produced, or property that the licensor has acquired and, *through its own officers or staff of employees*, added substantial value to, but only so long as the licensor, *through its officers or staff of employees*, is regularly engaged in the development, creation, or production of, or in the acquisition and addition of substantial value to, property of such kind; or
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> (ii) Property that is licensed as a result of the performance of marketing functions by such licensor through its own officers or staff of employees located in a foreign country *or countries, if the licensor, through its officers or staff of employees*, maintains and operates an organization *either* in such foreign country *or in such foreign countries (collectively), as applicable*, that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.[13]

The temporary regulations under Treas. Reg. §§1.954-2T(c)(2)(ii),(viii) and §§1.954-2T(d)(2)(ii),(v) further clarify that cost sharing arrangements ("C.S.T.") or platform contribution transactions ("P.C.T.") will not enable a C.F.C. to qualify for the active rent or royalty exception:

> C.S.T. Payments or P.C.T. Payments (as defined in §1.482-7(b)(1)) made by the lessor or licensor to another controlled participant (as defined in §1.482-7(j)(1)(i)) pursuant to a C.S.A. (as defined in §1.482-7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the lessor's or licensor's own officers or staff of employees.

By specifying that a C.F.C.'s employees must perform certain functions, the temporary regulations effectively ensure that only active rental and royalty income derived from a C.F.C.'s trade or business will be excluded from F.P.H.C.I.

The effective date of the temporary regulations applies to rents or royalties received or accrued during the tax years of a C.F.C. ending on or after September 1, 2015.[14]

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13 Treas. Reg. §1.954-2T(d)(1)(i)-(ii); emphasis added.

14 Treas. Reg. §1.954-2T(j).