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Accountants and Consultants

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Issue:

IRS Notice 2007-9

International Tax Alert

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Issue

IRS guidance on look-thru exception related to dividend, interest, rent, or royalty payments excludable from Foreign Personal Holding Company Income (“FPHCI”) under Section 954.

Date/Timing

On January 11, 2007, the IRS issued Notice 2007-9, which is generally effective for taxable years of foreign corporations beginning after December 31, 2005. Two specific sections of the Notice are effective for taxable years of foreign corporations beginning after December 31, 2006.

The IRS and Treasury Department also intend to issue further guidance concerning Section 954(c)(6) and regulations that incorporate guidance from Notice 2007-9 and any other subsequent guidance.

Affecting

U.S. shareholders of controlled foreign corporations that earn income eligible for the exclusion from foreign personal holding company income under Section 954(c)(6).

Background

Section 951(a)(1) generally provides that each U.S. shareholder of a controlled foreign corporation must include in its gross income, its pro rata share of the corporation’s subpart F income for such year. Section 952(a)(2) provides that subpart F income includes foreign base company income (“FBCI”). Generally, section 954(a)(1) provides that FBCI includes FPHCI, which is comprised of dividends, interest, royalties, rents, and annuities.

The Tax Increase Prevention and Reconciliation Act of 2005 (“TIPRA”), enacted on May 17, 2006, added section 954(c)(6) to the Internal Revenue Code. Section 954(c)(6)(A) provides that for purposes of section 954(c), dividends, interest, rents, and royalties received or accrued from a CFC which is a related person shall not be treated as FPHCI to the extent attributable or properly allocable to income of the related person which is neither subpart F

income nor ECI (section 954(c)(6) exception). Section 954(c)(6)(A) also provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provision, including regulations to prevent the abuse of the purposes of the provision.

Summary of Guidance Provided

Notice 2007-9 serves to clarify several issues in the context of section 954(c)(6). It provides definitions of dividends that qualify for the exception under section 954(c)(6), special rules for partnerships, and allocation and attribution rules for interest, rents, and royalties. Notably, dividends eligible for the FBCI exclusion include amounts treated as dividend distributions in either section 302 or 304. However, any dividend included in income as the “all earnings and profits amount” pursuant to Treas. Reg. §1.367(b)-3(b)(3)(i) is not eligible for the exclusion. Guidance was also provided for instances where amounts are not eligible for section 954(c)(6) when they reduce subpart F or effectively connected income of the payer. The increased certainty provided by this guidance serves to help taxpayers properly analyze the tax results of any transactions or structuring strategies.

The Notice also provide four types of transactions that the Service and Treasury Department consider abusive for purposes of section 954(c)(6). The notice states that it does not represent an exhaustive list of abusive transactions and that future guidance is expected to provide further anti-abuse rules. The abusive transactions described in the notice are the following:

- 1) Amounts that reduce the U.S. income tax base, including factoring income
- 2) Avoidance of section 956
- 3) Use of options or similar interests
- 4) Change of character of income through the use of a conduit entity

The anti-abuse rules provided in the notice limit the availability of the section 954(c)(6) exception outside of the context intended by Congress by looking through the form of certain structures or arrangements to determine if the substance of the underlying transaction is consistent with the intent of section 954(c)(6).

The abusive transactions listed third and fourth above are the exceptions to the general effective date of Notice 2007-9. The anti-avoidance rules related to these items are effective for the taxable years of foreign corporation beginning after December 31, 2006.

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