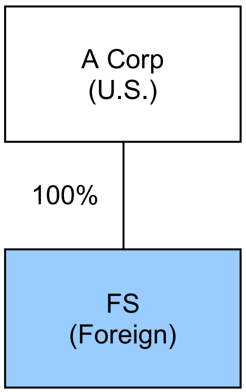
Reg. 1.951A-2(c)(4)(iv)(C), Example 3

Impact of Full Inclusion, High Tax Exception, & Sub F Recapture On Tested Income



	Tested Income	Sub F FBSCI	Total
Gross income	280	720	1,000
Expenses other than income taxes	(124)	(445)	(569)
Pre-tax net income	156	275	431
Income taxes	(26)	(55)	(81)
After-tax net income	130	220	350
Effective tax rate	17%	20%	19%
Potential Sub F recapture from prior year		600	
Actual Sub F recapture for the current year		350	
Tested income for the current year	130		

Not Sub F due to the high tax exception election

Would have been Sub F under the full inclusion rule if the high tax exception election was not made

A Corp, a domestic corporation, owns 100% of the single class of stock of FS, a controlled foreign corporation. A Corp and FS use the calendar year as their taxable year. In Year 1, FS has gross income of $1,000x, of which $720x is general category foreign base company sales income and $280x is general category income from sales within its country of incorporation; FS has expenses of $650x (including creditable foreign income taxes), of which $500x are allocated and apportioned to foreign base company sales income and $150x are allocated and apportioned to sales income from sales within FS's country of incorporation; and FS has earnings and profits of $350x for Year 1. Foreign income tax of $55x is considered imposed on the $220x ($720x−$500x) of net foreign base company sales income, and $26x is considered imposed on the $130x ($280x−$150x) of net income from sales within FS's country of operation. The maximum rate of tax in section 11 for the taxable year is 21%, and FS elects the high tax exception of section 954(b)(4) under Reg. 1.954-1(d)(1) for Year 1 for its foreign base company sales income. In a prior taxable year, FS had losses with respect to income other than foreign base company or insurance income that, by reason of the limitation in section 952(c)(1)(A), reduced the subpart F income of FS (consisting entirely of foreign source general category income) by $600x; as of the beginning of Year 1, such amount has not been recharacterized as subpart F income in a subsequent taxable year under section 952(c)(2).

<u>Foreign base company income</u>. In Year 1, by application of the full inclusion rule in section 954(b)(3)(B) and Reg. 1.954-1(b)(1)(ii), the $280x of gross income earned by FS for sales within its country of incorporation is treated as foreign base company income ($720x of gross foreign base company income exceeds $700x, which is 70% of $1,000x, FS's total gross income for the taxable year). However, the $220x of foreign base company sales income qualifies for the high tax exception of section 954(b)(4) and Reg. 1.954-1(d)(1), because the effective rate of tax with respect to the net foreign base company sales income ($220x) is 20% ($55x/($220x + $55x)) which is greater than 18.9% (90% of 21%, the maximum rate of tax in section 11 for the taxable year). Because the $220x of net

foreign base company sales income qualifies for the high tax exception of section 954(b)(4) and Reg. 1.954-1(d)(1), the $130x of full inclusion foreign base company income is also excluded from subpart F income under Reg. 1.954-1(d)(6).

Recapture of subpart F income. Under section 952(c)(2) and Reg. 1.952-1(f)(2), FS's general category earnings and profits ($350x) in excess of its subpart F income ($0) give rise to the recharacterization of its general category recapture account ($600x) as subpart F income to the extent of current year earnings and profits. Therefore, FS has general category subpart F income of $350x in Year 1, and A Corp has an inclusion of $350x with respect to FS under section 951(a)(1)(A).

Gross tested income. The $720x of gross foreign base company income is excluded from gross tested income under section 951A(c)(2)(A)(i)(III) and Reg. 1.951A-2(c)(1)(iii). However, the $280x of gross sales income earned from sales within FS's country of incorporation is not excluded from gross tested income under either section 951A(c)(2)(A)(i)(II) and Reg. 1.951A-2(c)(1)(ii) or section 951A(c)(2)(A)(i)(III) and Reg. 1.951A-2(c)(1)(iii) of this section. Under Reg. 1.951A-2(c)(4)(iii)(B) , the $280x of gross sales income earned from sales within FS's country of incorporation is not excluded from gross tested income under section 951A(c)(2)(A)(i)(II) and Reg. 1.951A-2(c)(1)(ii), because gross income described in Reg. 1.951A-2(c)(1)(ii) does not include any item of gross income that results in the recharacterization of earnings and profits as subpart F income under section 952(c)(2) and Reg. 1.952-1(f)(2). Further, under Reg. 1.951A-2(c)(4)(iii)(C), the $280x of gross sales income earned from sales within FS's country of incorporation is not excluded from gross tested income under either section 951A(c)(2)(A)(i)(II) and Reg. 1.951A-2(c)(1)(ii) or section 951A(c)(2)(A)(i)(III) and Reg. 1.951A-2(c)(1)(iii), because gross income described in section 951A(c)(2)(A)(i)(II) and Reg. 1.951A-2(c)(1)(ii) or section 951A(c)(2)(A)(i)(III) and Reg. 1.951A-2(c)(1)(iii) does not include full inclusion foreign base company income that is excluded from subpart F income under Reg. 1.954-1(d)(6). Accordingly, FS has $280x of gross tested income for Year 1.