

which permits a foreign corporation to establish that qualified shareholders own sufficient shares in the closely-held block of stock to preclude nonqualified shareholders from owning 50 percent or more of the total value of the class of stock for more than half the number of days during the taxable year.

To demonstrate that a class of stock is not closely-held for purposes of § 1.883-2(d)(3)(i), a foreign corporation whose stock is traded on an established securities market in the United States may rely on current Schedule 13G filings with the Securities and Exchange Commission to identify its 5-percent shareholders in each class of stock relied upon to meet the regularly traded test, without having to make any independent investigation to determine the identity of the 5-percent shareholders. § 1.883-4(d)(3)(viii). Commentators suggested that a foreign corporation also be permitted to rely on current Schedule 13D filings with the Securities and Exchange Commission to identify 5-percent shareholders for purposes of meeting the exception contained in § 1.883-2(d)(3)(ii). The final regulations adopt this suggestion.

Under § 1.883-2(d)(3)(iii)(B) of the proposed regulations, an investment company registered under the Investment Company Act of 1940 will not be treated as a 5-percent shareholder if no person owns both 5 percent or more of the value of the outstanding interests in the investment company and 5 percent or more of the value of the shares of the class of stock of the foreign corporation. Commentators suggested that this exception be extended to foreign mutual funds, other investment companies not registered under the Investment Company Act of 1940, and financial institutions with customer or nominee accounts. Commentators also pointed out that it would be difficult for a shipping company to determine the identity of 5-percent owners of a mutual fund because most mutual fund shares are held in street name.

The final regulations eliminate the provision that treats an investment company registered under the Investment Company Act of 1940 as a 5-percent shareholder if a person owns both 5 percent or more of the value of the outstanding interests in the investment company and 5 percent or more of the value of the shares of the class of stock of the foreign corporation. Instead, the final regulations provide that such an investment company shall not be treated as a 5-percent shareholder for purposes of these regulations. The final regulations do not expand the mutual fund exception to include other

types of investment vehicles or financial institutions.

Comments Relating to § 1.883-3: Treatment of Controlled Foreign Corporations

Income Inclusion Test

Section 883(c)(2) provides that the stock ownership test of section 883(c)(1) shall not apply to controlled foreign corporations (CFCs). Under the proposed regulations, a CFC is considered to satisfy the CFC exception of section 883(c)(1) if it meets the requirements of § 1.883-3. One such requirement is the income inclusion test of § 1.883-3(b). This test requires that more than 50 percent of the subpart F income derived by the CFC from the international operation of ships or aircraft be includible in the gross income of one or more U.S. citizens, individual residents of the United States, or domestic corporations.

Commentators restated their objection to the income inclusion test. They argued that the test is too restrictive because it could deny qualified foreign corporation status to CFCs legitimately owned and controlled by U.S. shareholders.

The IRS and Treasury continue to believe that the income inclusion rule contained in the proposed regulations is supported by the legislative history to section 883(c). The Conference report accompanying the legislation that added the CFC exception provides with respect to the exception that "corporations are not considered residents of countries that exempt U.S. persons unless 50 percent or more of the ultimate individual owners are U.S. shareholders of controlled foreign corporations". H.R. Conf. Rep. No. 99-841, 99th Cong., 2d Sess. 598 (1986), reprinted in 1986-3 C.B. vol. 4, at 598 (1986). The intent of the CFC exception, therefore, is for the general ownership requirement of section 883(c)(1) to apply unless the foreign corporation is a CFC and 50 percent or more of the subpart F income of that corporation derived from the international operation of ships or aircraft is includible by U.S. citizens, individual residents, or domestic corporations.

Commentators stated that if the income inclusion test is retained, the regulations should provide that income derived by U.S. tax-exempt organizations holding shares in CFCs should be counted toward satisfying the income inclusion test even though the income is not taxed.

The final regulations do not adopt this suggestion. A U.S. tax-exempt organization is not in substance

different from a U.S. person that is not required to include in its gross income the subpart F income of a CFC.

Comments Relating to § 1.883-4: Qualified Shareholder Stock Ownership Test

A. Qualified Shareholders

A foreign corporation satisfies the stock ownership test of § 1.883-1(c)(2) if more than 50 percent of the value of its outstanding shares is owned, or treated as owned through attribution, for at least half of the number of days in the foreign corporation's taxable year by one or more qualified shareholders. Section 1.883-4(b)(1)(i)(A) of the proposed regulations treats an individual resident in a qualified foreign country as a qualified shareholder, but excludes individuals described in § 1.883-4(b)(1)(i)(E) and (F). Commentators stated that the exclusion of pension fund beneficiaries described in paragraph (b)(1)(i)(E) could be interpreted to prevent the qualification of an individual under paragraph (b)(1)(i)(A). For example, if an individual held stock directly in a shipping company and also was the beneficiary of a pension fund holding stock in the same company, commentators believe that the individual might not qualify under paragraph (b)(1)(i)(A) with respect to the individual's direct ownership. The final regulations clarify that an individual can be a qualified shareholder under paragraph (b)(1)(i)(A) and also be a qualified shareholder under paragraph (b)(1)(i)(E) with respect to a category of income for which a foreign corporation is seeking an exemption.

Under § 1.883-4(b)(1)(i)(D) of the proposed regulations, a not-for-profit organization described in § 1.883-4(b)(4) is treated as a qualified shareholder. Section 1.883-4(b)(4)(iii)(A) requires a not-for-profit organization to expend more than 50 percent of its annual support on behalf of individuals described in § 1.883-4(b)(1)(i)(A).

Commentators suggested that the category of recipients eligible for support be expanded to include other not-for-profit organizations. This suggestion has been adopted in part. The final regulations provide that a not-for-profit organization may be a qualified shareholder if it expends more than 50 percent of its annual support on behalf of U.S. organizations that have received determination letters under section 501(c)(3) and on behalf of individuals described in § 1.883-4(b)(1)(i)(A).