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Treasury and IRS Issue New Temporary Treasury Regulations

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On September 2, 2015, the ***U.S. Department of the Treasury (Treasury)*** and the ***Internal Revenue Service (IRS)*** issued new temporary Treasury regulations addressing the application of Internal Revenue Code Section 956 to certain structures involving foreign partnerships.

Background

Section 956 provides for the accelerated taxation of a controlled foreign corporation's (CFC) earnings when the earnings are invested in certain "U.S. property." In effect, Section 956 provides that, subject to specific rules and exceptions, to the extent CFC earnings are made available for the use or benefit of any U.S. shareholder of the CFC, the U.S. shareholder is subject to current U.S. taxation with respect to such amounts under Section 951(a)(1)(B). For these purposes, the definition of U.S. property includes obligations of U.S. persons.

Anti-Abuse Rule

Temporary Regulation §1.956-1T(b)(4) was issued in temporary form in 1988 (it was never finalized). It provided an anti-abuse rule whereby the IRS had the discretion to treat investments in U.S. property made by a foreign corporation controlled by a CFC as an investment of the CFC itself if one of the principal purposes for creating, organizing or funding (through capital contributions or debt) the foreign corporation was to avoid the application of Section 956.

The new temporary regulations modify and expand the language of the prior anti-abuse rule as it relates to investments in U.S. property made by CFCs through foreign corporations. The new anti-abuse rule is self-executing (no longer subject to IRS discretion), encompasses funding methods beyond capital contributions and debt, and changes the purpose test from "one of *the* principal purposes" to "*a* principal purpose." The new temporary regulations also contain an example that illustrates that a CFC's tax attributes (*e.g.,* earnings and profits, foreign tax credits, *etc*.) will be taken into consideration in determining whether a principal purpose of a particular funding was the abuse of Section 956.

Expansion of Anti-Abuse Rule to Partnership Entities

The new temporary regulations also expand the anti-abuse rule to apply to transactions involving foreign partnerships controlled by CFCs. The preamble to the new temporary regulations states that, under the prior anti-abuse rule, taxpayers were able to use foreign partnerships to structure transactions similar to those covered by the existing rule. To address this concern, the new anti-abuse rule extends the current rules to cover a situation in which a foreign partnership that is controlled by a CFC lends money to a U.S. shareholder of the CFC and the IRS determines that the original funding of the foreign partnership was undertaken with a principal purpose of avoiding the application of Section 956. Thus, under current Treasury Regulation § 1.956-2(a)(3), a CFC that is a partner in a foreign partnership is treated as owning a proportionate share of any U.S. property owned by the partnership, including a U.S. obligation held by the partnership. Under the modified version of the anti-abuse rule, the entire amount of the U.S. obligation held by the partnership, not just a proportionate amount, will be considered U.S. property in the hands of the CFC.

The new temporary regulations include a coordination rule designed to align the anti-abuse rule with the existing tax treatment of similar transactions under Treasury Regulation § 1.956-2(a)(3), described above. The coordination rule clarifies that, under the modified anti-abuse rule, a CFC will only be deemed to own an amount of U.S. property that exceeds the amount that the CFC was already deemed to own under Treasury Regulation § 1.956-2(a)(3).

The new temporary regulations add four examples to illustrate the new rules. Example (4) includes the coordination rule. In the example, a CFC contributes $600x for a 60 percent interest in a foreign partnership, and a U.S. corporation contributes real estate for the remaining 40 percent interest in the partnership. The foreign partnership lends $100x to the U.S. corporation. The example explains that under Treasury Regulation § 1.956-2(a)(3), the CFC is deemed to hold U.S. property worth $60x as a result of the loan from the foreign partnership to the U.S. corporation. The example concludes that under the new anti-abuse rule, the CFC would be considered to hold the entire $100x obligation as U.S. property as if it were held directly by the CFC, because the foreign partnership is controlled by the CFC and the foreign partnership was funded by the CFC with a principal purpose of avoiding the application of Section 956. However, since the CFC is already considered to hold $60x of U.S. property under Treasury Regulation § 1.956-2(a)(3), the coordination rule limits the amount of U.S. property that a CFC is deemed to hold under the anti-abuse rule to $40x.

Note that for purposes of the new temporary regulations, a CFC controls a foreign partnership or a foreign corporation if the CFC and the foreign partnership or foreign corporation are related within the meaning of Section 707(b). The old temporary regulations defined relatedness by reference to Section 267(b), which is a broader rule. The omission of Section 267(b) in the new temporary regulations may have been an error that will be corrected in the future.

Special Rule for Foreign Partnership Distributions Funded by CFCs

In addition to the new partnership anti-abuse rule described above where the CFC is a partner of the partnership that holds the U.S. property, the temporary regulations provide new rules applicable to partnership distributions funded by CFCs. Under these new rules, certain obligations of foreign partnerships to CFCs will be considered the obligation of the partners of the partnership if (i) the foreign partnership distributes an amount of money or property to a partner; (ii) the foreign partnership would not have made the distribution if not for the loan from the CFC; and (iii) the partner is related to the CFC within the meaning of Section 954(d)(3). The amount of the obligation that is considered an obligation of the distributee partner is the lesser of the partnership distribution that would not have been made absent the loan from the CFC or the amount of the loan that is held (or treated as held) by the CFC.

The new temporary regulations contain an example that illustrates this rule. In the example, a CFC lends $100x to a foreign partnership that is owned 70 percent by a U.S. corporation and 30 percent by an unrelated party. The foreign partnership distributes $80x to the U.S. corporation. The example states that the partnership would not have made the distribution to the U.S. corporation if not for the loan from the CFC. Under these facts, the example explains that a portion of the loan from the CFC to the partnership will be treated as an obligation of the U.S. corporation itself (as a partner of the foreign partnership), and will therefore constitute U.S. property in the hands of the CFC for purposes of Section 956. The example concludes that the amount of U.S. property deemed to be held by the CFC is $80x, which is the lesser of the amount of the distribution that would not have been made absent the loan from the CFC ($80) and the amount of the obligation that is held by the CFC ($100).

The temporary regulations apply to tax years of CFCs ending on or after September 2, 2015.

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