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New York State Bar Association Tax Section

Report on Proposed and Temporary Regulations on United States Property Held by Controlled Foreign Corporations in Transactions Involving Partnerships

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Contents

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This report[1] provides comments on proposed and temporary regulations published by Treasury and the Internal Revenue Service (the "**IRS**") on September 2, 2015, regarding the treatment of United States property held by a controlled foreign corporation (a "**CFC**") under Section 956 in connection with certain transactions involving partnerships (the "**Proposed Regulations**" and "**Temporary Regulations**", respectively).[2]

This report is divided into three parts. Part I contains a general summary of our recommendations. Part II includes a brief summary of the statutory framework of Section 956 and a general description of the Proposed and Temporary Regulations. Part III sets forth our comments and recommendations with respect to the Proposed and Temporary Regulations.

I. SUMMARY OF RECOMMENDATIONS

A. Recommendations Relating to Obligations of Foreign Partnerships

1. The Proposed Regulations include an "obligation rule", dealing with the application of Section 956 to an obligation of a foreign partnership to a CFC, which adopts an aggregate approach to an obligation of a foreign partnership. We considered whether to recommend that Treasury and the IRS revisit the aggregate approach of the obligation rule, and consider adopting regulations that apply an entity approach to an obligation of a foreign partnership, with anti-abuse rules that would subject the obligation to Section 956 in circumstances where the proceeds of the obligation are made available to U.S. partners that are related to the CFC. A substantial minority of our members supported a recommendation that the regula-

[1] The principal author of this Report is Peter F.G. Schuur, with substantial assistance from Lena Smith. Helpful comments were received from Kimberly S. Blanchard, Andrew H. Braiterman, Marcy G. Geller, Stephen B. Land, Michael L. Schler and Yaron Z. Reich. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or House of Delegates.

[2] T.D. 9733, *United States Property Held by Controlled Foreign Corporations in Transactions Involving Partnerships*, 80 Fed. Reg. 52,976 (Sept. 2, 2015); Notice of Proposed Rulemaking, *United States Property Held by Controlled Foreign Corporations in Transactions Involving Partnerships*, REG-155164-09, 80 Fed. Reg. 53,058 (Sept. 2, 2015).

tions adopt an entity approach in this context. On balance, we concluded that the concerns identified by Treasury and the IRS in the preamble to the Proposed Regulations, that failing to treat an obligation of a foreign partnership as an obligation of its partners could allow deferral of U.S. tax on CFC earnings and profits in a manner inconsistent with the purposes of Section 956, constitute an appropriate basis for the general aggregate approach of the Proposed Regulations. However, we recommend adding a new *de minimis* exception to the regulations, pursuant to which an obligation of a foreign partnership would not be treated as an obligation of a U.S. partner if the U.S. partner (and its related persons) owns less than a specified percentage of the profits and capital interests in the foreign partnership.

2. We recommend that the regulations apply a liquidation value approach to determine the partners' shares of a partnership obligation, rather than the approach based on the partners' interests in partnership profits in the Proposed Regulations.

3. A partner's share of partnership obligations should be measured on an annual basis, subject to a rule requiring quarterly determinations if a principal purposes of structuring the obligation through a partnership is to avoid quarterly determinations.

B. Recommendations Relating to Property Held by a Foreign Partnership

1. We support the Proposed Regulations' liquidation value approach for determining a partner's attributable share of partnership property for purposes of Section 956. We note that determining a partner's share of partnership property based on a special allocation may give rise to results that are inconsistent with the general liquidation value approach of the Proposed Regulations because special allocations inherently reflect future allocations of profit and loss, which may be different than the partners' current liquidation value in the relevant property.

2. We recommend that a partner's attributable share of partnership property should be measured on an annual basis, subject to a rule requiring quarterly determinations if the principal purpose of holding property through a partnership is to avoid quarterly determinations.

3. The anti-avoidance rule in the Temporary Regulations relating to acquisitions of property by a partnership controlled by a CFC should apply only with respect to property held indirectly through a partnership by one or more foreign corporations that are controlled by the funding CFC. Property that is acquired by a partnership in which the funding CFC is a partner should not be the subject of the anti-avoidance rule because this property is subject to the general property rules in the Proposed Regulations.

II. OVERVIEW OF SECTION 956 AND GENERAL DESCRIPTION OF PROPOSED AND TEMPORARY REGULATIONS

Section 956 was enacted in 1962 as part of subpart F, which provides an integrated set of rules designed to prevent the use of foreign corporate subsidiaries to defer the recognition of income under certain circumstances.[3] Subpart F has two primary provisions requiring the recognition of income by a "**United States shareholder**"[4] in a CFC. First, Section 951(a)(1)(A) requires United States shareholders of a CFC to include in taxable income their allocable portions of any "subpart F income" recognized by the CFC. Second, Section 951(a)(1)(B) requires a United States shareholder of a CFC to include in income its allocable portion of certain investments made or deemed made by the CFC that are described in Section 956—investments that Congress determined constitute *de facto* distributions by the CFC.

Section 956 is aimed at transactions which are considered to give United States shareholders of a CFC access to the CFC's untaxed earnings and profits in circumstances that are economically similar to receiving a dividend.[5] The amount of a Section 956 inclusion is determined by reference to the relevant United States shareholder's *pro rata* share of any increase in the amount of the CFC's undistributed earnings invested, directly or indirectly, in "**United States property**" for the relevant year (based on the average of quarter-end balances), but only to the extent those earnings were not previously included in gross income under Section 951.[6] For this purpose, United States property includes (i) tangible property located in the United States, (ii) stock of a domestic corporation, (iii) an obligation of a U.S. person or (iv) any right to use a patent or copyright, an invention, model or design, a secret formula or process or any other similar right in the U.S.[7] Section 956(d) provides that, under regulations prescribed by Treasury, a CFC will be treated as holding an obligation of a U.S. person if a CFC acts as a pledgor or guarantor of the obligation.[8]

3 A detailed discussion of Section 956 is set out in a recent Tax Section report. *See* N.Y. ST. BA. ASS'N, TAX SEC., *Report on the Operation of Section 956(d) in the Context of Multiple Guarantors / Pledgors in Respect of a Single Obligation of a U.S. Person* (Dec. 22, 2015).

4 A United States shareholder is defined in Section 951(b) as a U.S. person who owns or is considered as owning (directly, indirectly or constructively) 10% or more of the total combined voting power of all classes of stock entitled to vote.

5 *See* S. Rep. No. 87-1881, at 80, 87–88 (1962), 1962-3 C.B. 707, at 794 ("Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them.").

6 I.R.C. § 956(a).

7 I.R.C. §§ 956(a), (c).

8 I.R.C. § 956(d).

Section 956(c)(2) provides several exceptions to the definition of United States property for transactions that Congress considered to be "normal commercial transactions without intention to permit the funds to remain in the United States indefinitely" or with respect to earnings that were excluded from subpart F income under Section 952(b) because the earnings were already subject to U.S. corporate tax.[9] For example, United States property generally does not include obligations of the United States, deposits with qualifying banks, stock and obligations of a U.S. corporation that is not a United States shareholder of the CFC or a related person to the CFC or obligations of a non-corporate U.S. person that is not a United States shareholder of the CFC and, in the case of a partnership, estate or trust, in which the CFC or a related person does not hold an interest.[10]

As mentioned above, Section 956(a) applies to United States property that is held "directly and indirectly" by a CFC. The legislative history to the Tax Reform Act of 1976, which added several exceptions to the definition of United States property, includes the following example of an indirect investment United States property: if a CFC "facilitated a loan to or borrowing by, a [United States] shareholder, the [CFC] is considered to have made a loan to (or acquired the obligation of) the [United States] shareholder."[11] Judicial decisions and administrative guidance provide additional color, and each of the following funding arrangements has been determined to constitute an indirect investment in United States property: (i) a parent CFC funding its subsidiary CFC's purchase of certificates of deposits (when the subsidiary CFC did not have earnings and profits),[12] (ii) a CFC indirectly funding a loan to its U.S. parent by depositing funds in a foreign bank, which the foreign bank then loaned to a sister CFC which ultimately loaned the funds to the U.S. parent[13] and (iii) a CFC indirectly funding a loan to its U.S. parent by depositing funds in a bank which then loaned the funds to the U.S. parent at a higher interest rate.[14]

9 S. Rep. No. 87-1881, at 80, 87–88 (1962), 1962-3 C.B. 707, at 794. Congress has periodically modified the exceptions to the definition of United States property both by adding new exceptions (*e.g.*, by providing an exception certain securities held by a CFC securities dealers) and by tailoring the scope of existing exceptions (*e.g.*, to modify the requirements for the bank deposit exception in light of a taxpayer favorable decision in *The Limited, Inc. v. Comm'r*, in which the Sixth Circuit concluded that a U.S. subsidiary of a United States shareholder was carrying the banking business even though its banking activities were limited). I.R.C. §§ 956(c)(2)(L) and (c)(2)(A); H.R. Rep. No. 4520, at 197–98 (2004).

10 I.R.C. §§ 956(c)(2)(A); (c)(2)(F); (c)(2)(L).

11 H.R. Rep. No. 94-658, at 216–18 (1976), 1976-3 C.B. 217, fn. 22.

12 The Limited, Inc. v. Comm'r, 113 T.C. 169 (1999), *rev'd on other grounds*, 286 F.3d 324 (6th Cir. 2002).

13 Rev. Rul. 76-192, 1976-1 C.B. 205.

14 Rev. Rul. 87-89, 1987-2 C.B. 195.

The current Treasury regulations do not address the circumstances in which an obligation of a foreign partnership to a CFC should be treated as an indirect investment by the CFC in United States property.[15] The current Treasury regulations do provide guidance regarding the application of the indirect ownership rule to property that is held by a partnership in which a CFC is a partner. Specifically, if a CFC is a partner in a partnership that owns property that would be United States property if owned directly by the CFC, the CFC will be treated as holding its proportionate share of the United States property.[16] However, the current Treasury regulations do not specify how the CFC partner's proportionate share of property should be determined for this purpose.

The Proposed Regulations provide rules dealing with obligations of foreign partnerships and also provide a separate set of rules for determining a CFC's indirect interest in United States property that the CFC holds through partnerships. The Temporary Regulations provide two anti-avoidance rules, one that extends to foreign partnerships an existing anti-avoidance rule dealing with certain acquisitions of property by corporations controlled by a CFC, and a second rule relating to distributions from foreign partnerships that are funded by an obligation that is held (or is treated as held) by a CFC. Each of these rules is discussed in greater detail below.

A. Obligation Rule

The Proposed Regulations generally treat an obligation of a foreign partnership as an obligation of its partners for purposes of Section 956 (the "**Obligation Rule**"), subject to an exception that applies if neither the lending CFC nor any related person is a partner in the foreign partnership.[17] If the Obligation Rule applies, a CFC that makes a loan to a foreign

15 The current statutory framework treats an obligation of a domestic partnership as United States property for Section 956 purposes irrespective of whether the partners in the partnership are foreign or U.S. persons. Under Section 956(c)(1)(C), a CFC is treated as holding United States property if it holds an obligation of a U.S. person, as defined by reference to Section 7701(a)(30) (which includes domestic partnerships). Prop. Treas. Reg. § 1.956-4(e) confirms this interpretation and provides that "[f]or purposes of section 956, an obligation of a domestic partnership is an obligation of a United States person."

16 Treas. Reg. § 1.956-2(a)(3) (treating the CFC as holding an interest in the property "equal to its interest in the partnership").

17 Prop. Treas. Reg. § 1.956-4(c)(1); Prop. Treas. Reg. § 1.956-4(c)(2). For this purpose "related person" is defined by referenced to Section 954(d)(3). Under Section 954(d)(3), a person is related with respect to a CFC if such person is an individual, corporation, partnership, trust or estate which controls, or is controlled by, the CFC or such person is a corporation, partnership, trust or estate which is controlled by the same person or persons which control the CFC. Control in this definition means, the ownership, directly or indirectly, of stock possessing more than 50% of the total voting power of all classes of stock entitled to vote or of the total value of stock of a corporation or the ownership, direct-

partnership will be treated as holding a separate obligation of each of the partners to the extent of each partner's share of the obligation, which is determined in accordance with the partners' interests in partnership profits, taking into account all facts and circumstances relating to the economic arrangement of the partners.[18] The preamble states that this determination will be made as of the close of each quarter of the CFC's taxable year in connection with the calculation of United States property held by the CFC, based on the partners' interests in partnership profits at the close of the quarter.[19] However, the rule providing for quarterly determinations of interests in partnership profits does not appear to be included within the text of the Proposed Regulations.

The Proposed Regulations also include a "**Funding Rule**" that may increase the portion of a partnership obligation that is treated as United States property under the Obligation Rule if certain requirements are satisfied. Generally, the Funding Rule applies if (i) a CFC loans funds to (or guarantees a loan of) a foreign partnership, (ii) the foreign partnership makes a distribution to a U.S. partner that is related to the CFC, (iii) the foreign partnership would not have made the distribution but for the funding of the partnership by the CFC and (iv) the distribution exceeds the partner's share of the partnership obligation as determined under the general Obligation Rule.[20] If the Funding Rule applies, the distributee partner's share of the partnership obligation is the greater of (i) the partner's share of such obligation determined under the Obligation Rule and (ii) the lesser of the amount of the distribution that would not have been made but for the funding by the CFC and the amount of the obligation.[21]

The Proposed Regulations also address pledges and guarantees of obligations of foreign partnerships as well as pledges and guarantees of obligations of U.S. persons by domestic and foreign partnerships.

1. Pledges and Guarantees of Obligations of Foreign Partnerships

The Proposed Regulations revise the current regulations under Section 956 to clarify that a CFC that is a pledgor or guarantor of an obligation of a U.S. person *is treated as hold-*

ly or indirectly, of more than 50% (by value) of the beneficial interests in a partnership, trust, or estate. IRC § 954(d)(3).

18 Prop. Treas. Reg. § 1.956-4(c)(1).

19 Prop. Treas. Reg. § 1.956-4(c)(1); REG-155164-09, *supra* note 2, at 53,059.

20 Prop. Treas. Reg. § 1.956-4(c)(3). Temp. Treas. Reg. § 1.956-1T(b)(5), released concurrently with the Proposed Regulations, also addresses this funded distribution fact pattern and is expected to be withdrawn when the Proposed Regulations are finalized.

21 Prop. Treas. Reg. § 1.956-4(c)(3).

ing the obligation and therefore is eligible for the exceptions from United States property that may be available under Section 956 to a CFC that holds an obligation of a U.S. person.[22]

The Proposed Regulations in effect provide for a two-step approach in situations in which a CFC (whether or not a partner in the partnership) directly or indirectly guarantees an obligation of a foreign partnership to an unrelated lender. First, pursuant to the Obligation Rule, the obligation of the foreign partnership is treated as a separate obligation of each of its partners to the extent of each partner's share of the obligation.[23] Second, as a result of the CFC's pledge or guarantee, the CFC is treated as holding the deemed obligations of the U.S. partners.[24] As a result, the CFC will be treated as holding United States property unless one of the exceptions in Section 956(c)(2) is available.

2. Pledges and Guarantees of Obligations of U.S. Persons by Domestic and Foreign Partnerships

The Proposed Regulations provide that, if a domestic or foreign partnership pledges or guarantees, directly or indirectly, an obligation of a U.S. person, the partnership will be treated as holding the obligation for purposes of Section 956.[25] Under the partnership property rule discussed in Part II.B below, each partner of the partnership will then be treated as holding its share of the obligation for purposes of Section 956.[26] Thus, if a CFC is a member of a partnership and the partnership guarantees an obligation of a U.S. person, the CFC will be treated as holding its proportionate share of the obligation.

B. Property Rule

Under the existing Treasury regulations, if a CFC is a partner in a partnership that owns property that would be United States property if owned directly by the CFC, the CFC is treated as holding its proportionate share of that property.[27] The Proposed Regulations follow

22 *See* I.R.C. § 956(c)(2); *see also supra* notes 9–10 and accompanying text (discussing the exceptions to the definition of United States property provided in Section 956(c)(2)).

23 Prop. Treas. Reg. § 1.956-4(c)(1).

24 Prop. Treas. Reg. § 1.956-2(c)(1).

25 Prop. Treas. Reg. § 1.956-2(c).

26 Prop. Treas. Reg. § 1.956-4(b).

27 Treas. Reg. § 1.956-2(a)(3). This is commonly known as one of the Brown Group regulations that were issued in response to the Eighth Circuit's holding in *Brown Group, Inc. v. Comm'r*, 77 F.3d 217 (8th Cir. 1996). In *Brown Group*, a Cayman Islands partnership with a CFC partner earned commission income from sales of inventory purchased in Brazil on behalf of the CFC's U.S. parent that would have been included in the CFC's subpart F income had the CFC earned the commission directly. The Eighth Circuit held that the CFC's distributive share of this income was not subpart F income.

the approach of the existing regulations, but provide additional guidance for determining the amount of United States property that a CFC is considered to hold in these circumstances. Under the Proposed Regulations, a CFC that is a partner in a partnership is treated as holding its attributable share of any property that is held by the partnership (the "**Property Rule**").[28] More specifically, a partner's attributable share of the tax basis of each item of partnership property is based on the partner's "**liquidation value percentage**", which is the amount of cash the partner would receive with respect to its interest if the partnership sold all of its assets for cash equal to the fair market value of those assets, paid an unrelated party to assume all of its liabilities in a fully taxable transaction and then liquidated.[29] A partner's liquidation value percentage is only determined upon the occurrence of a revaluation event described in the Section 704(b) regulations (a "**revaluation event**").[30] If a partnership agreement provides for special allocations of income (or, where appropriate, gain) from partnership property, then a partner's attributable share of that property is determined solely by reference to the partner's special allocation with respect to the property if the special allocation does not have a principal purpose of avoiding the purposes of Section 956.[31]

C. Temporary Regulations

The Temporary Regulations include two anti-avoidance rules under Section 956 dealing with partnerships. First, the Temporary Regulations modify and expand the scope of an anti-avoidance rule which targets certain transactions of foreign corporations controlled by a CFC. Under the prior anti-avoidance rule, at the discretion of the district director, a CFC was considered to hold indirectly investments in United States property acquired by any other foreign corporation controlled by the CFC if one of the principal purposes for creating, organizing or funding (through capital contributions or debt) such other foreign corporation was to avoid the application of Section 956.[32] The Temporary Regulations modify the rule so that it applies to the funding of a foreign corporation through any means and without requir-

[28] Prop. Treas. Reg. § 1.956-4(b)(1).

[29] Prop. Treas. Reg. §§ 1.956-4(b)(2), -4(b)(3), Ex. 1.

[30] For this purpose, a revaluation event includes (i) the contribution of money, property or services to the partnership by a new or existing partner as consideration for a partnership interest, (ii) the liquidation of the partnership or a distribution of money or other property to a retiring or continuing partner as consideration for a partnership interest, (iii) the issuance or exercise of noncompensatory options or (iv) revaluations under generally accepted industry accounting practices for certain partnerships holding instruments readily tradable on an established securities market. Treas. Reg. §§ 1.704-1(b)(2)(iv)(*f*)(5), -1(b)(2)(iv)(*s*).

[31] Prop. Treas. Reg. § 1.956-4(b)(1).

[32] Temp. Treas. Reg. § 1.956-1T(b)(4)(B).

ing the discretion of the district director.[33] The Temporary Regulations expand the rule by including within its scope transactions involving the acquisition of property by partnerships controlled by a CFC, rather than limiting the rule to acquisitions of property by foreign corporations.[34] Thus, under the Temporary Regulations, a CFC will be considered to indirectly hold investments in United States property acquired by a partnership controlled by the CFC if one of the principal purposes for creating, organizing or funding, through any means, the other partnership is to avoid the application of Section 956.[35]

The Temporary Regulations include a separate anti-avoidance rule that is similar to the Funding Rule discussed in Part II.A above. Under the funding rule in the Temporary Regulations, a partnership obligation that is held by a CFC will be treated as a separate obligation of a partner in the partnership if the foreign partnership makes a distribution to a partner that is related to the CFC and the foreign partnership would not have made the distribution but for the funding of the partnership by the CFC.[36] The amount that is treated as obobligation of the distributee partner is equal to the lesser of the amount of the distribution that would not have been made but for the funding and the obligation of the foreign partnership that is held by the CFC.[37] The Temporary Regulations also apply to an obligation of a foreign partnership that would be treated as held by a CFC under Treasury regulations Section 1.956-2(c), if the obligation were an obligation of a U.S. person. As a result, an obligation of a foreign partnership with respect to which the CFC is a pledgor or guarantor also would be subject to this anti-abuse rule.

The funding rule in the Temporary Regulations is expected to be withdrawn when the Proposed Regulations are finalized.[38] We believe that Treasury and the IRS intend for the two funding rules to be the same in substance. The difference between the two rules is that the Funding Rule in the Proposed Regulations is intended to operate within the framework of the aggregate approach of the Obligation Rule and therefore also includes a floor that is equal

[33] Temp. Treas. Reg. § 1.956-1T(b)(4)(B).

[34] Temp. Treas. Reg. § 1.956-1T(b)(4)(C). A CFC is treated as controlling a foreign partnership if the CFC and the partnership are related within the meaning Section 267(b) or 707(b) (applying a modified definition of "controlled group"). As a result, a CFC generally will control a partnership if the same persons own (directly or constructively) more than 50% (by value) of the stock of the CFC and more than 50% of the capital or profits interests in the partnership or if the CFC owns (directly, indirectly or constructively) more than 50% of the capital or profit interests of the partnership.

[35] Temp. Treas. Reg. § 1.956-1T(b)(4)(C).

[36] Temp. Treas. Reg. § 1.956-1T(b)(5).

[37] Temp. Treas. Reg. § 1.956-1T(b)(5)(ii).

[38] T.D. 9733, *supra* note 2, at 52,978.

to the partner's share of the partnership obligation, as determined under the Obligation Rule.[39]

III. DISCUSSION OF RECOMMENDATIONS

A. Obligation Rule

The Proposed Regulations generally treat a foreign partnership as an aggregate for purposes of the Obligation Rule, subject to the exception that is available if neither the lending CFC nor any person related to the lending CFC is a partner in the partnership. The aggregate approach reflects a determination by Treasury and the IRS that failing to treat an obligation of a foreign partnership as an obligation of its partners could allow deferral of U.S. tax on CFC earnings and profits in a manner inconsistent with the purposes of Section 956.[40] The preamble to the Proposed Regulations identifies two situations in which an obligation of a foreign partnership may result in earnings and profits of a CFC being made available to its United States shareholders unless the obligation is treated as an obligation of the foreign partnership's partners. First, Treasury and the IRS are concerned that CFC earnings may be available to a United States shareholder when the United States shareholder conducts operations through a foreign partnership using deferred CFC earnings. Second, because assets of a foreign partnership generally are available to its partners without additional tax, a United States shareholder could access deferred CFC earnings lent to a foreign partnership in which the United States shareholder is a partner.[41]

1. General Aggregate Approach; Funding Rule

We support the efforts of Treasury and the IRS to curtail the ability of United States shareholders of a CFC to access the CFC's earnings through the use of foreign partnerships.

In our 2006 Report on the Application of Section 956 to Partnership Transactions (the "**2006 Report**"), we recommended that a loan by a CFC to a related foreign partnership generally should not be treated as an investment in United States property for Section 956 purposes (irrespective of whether the partners in the foreign partnership are U.S. or foreign persons) if the loan proceeds are not invested in United States property or distributed to any U.S. partners in the partnership.[42] The recommendation in our 2006 Report, which would treat a partnership as an entity rather than an aggregate for purposes of applying Section 956

39 Prop. Treas. Reg. § 1.956-4(c)(3).

40 REG-155164-09, *supra* note 2, at 53,059.

41 *Id.*

42 N.Y. ST. BA. ASS'N, TAX SEC., *Report on the Application of Section 956 to Partnership Transactions* 12–13 (June 30, 2006).

to obligations of a foreign partnership, included two anti-abuse rules. The first anti-abuse rule would treat a loan made by a CFC to a related foreign partnership as United States property if one of the principal purposes for creating, organizing or funding the partnership is to avoid the application of Section 956 with respect to the CFC. This rule would apply, for example, if in a transaction that satisfies the principal purpose test, a CFC makes a loan to a related foreign partnership that uses the loan proceeds to make a loan to a U.S. partner that is a United States shareholder in the CFC.[43] The second anti-abuse rule would treat a loan made by a CFC to a foreign partnership as a loan to a U.S. person if the partnership distributes loan proceeds to a U.S. partner that is a United States shareholder of the CFC and one of the principal purposes for creating, organizing or funding the foreign partnership is to avoid the application of Section 956 with respect to the CFC.[44] This rule would apply to cash distributed at any time after the loan is made and to cash distributed before the loan if such distribution was made in contemplation or anticipation of the loan.[45]

In light of the recommendations in our 2006 Report, we considered whether to recommend that the IRS and Treasury revisit the aggregate approach of the Obligation Rule, and consider adopting regulations that would apply an entity approach to an obligation of a foreign partnership but would also include anti-abuse rules, such as the Funding Rule, that would subject the obligation of a foreign partnership to Section 956 in circumstances where the proceeds of the obligation are made available to U.S. partners that are related to the CFC. A substantial minority of our members supported a recommendation that, consistent with our 2006 Report, the regulations should adopt an entity approach, with anti-abuse rules. Ultimately, we decided not to recommend that the regulations adopt a general entity approach to obligations of a foreign partnership. However, we continue to have concerns regarding the administrative burden of the aggregate approach of the Obligation Rule. In particular, under the Obligation Rule, United States shareholders of a CFC would be required to determine, on a quarterly basis and with respect to each foreign partnership in which the CFC or a related person is a partner, the portion of the partnership's obligations that is treated as United States property. This determination would take into account obligations incurred by the foreign partnership in the ordinary course of its business and could treat obligations of the foreign partnership as United States property for purposes of Section 956 even if the proceeds of the obligations are held for use in the partnership's business and are subject to the claims of other creditors of the foreign partnership, and therefore are not available to U.S. partners as a practical matter. We note that the quarterly determinations may be difficult to make in practice if a CFC has multiple obligations to foreign partnerships or if the CFC and the partners that are

[43] *Id.* at 12–13.

[44] *Id.* at 15–16.

[45] *Id.* at 16.

related to the CFC do not control the foreign partnership. We also believe that the principles of subchapter K, which generally is concerned with maintaining a system of pass-through taxation for partnerships through rules addressing allocations of partnership income and loss, contributions and distributions, and transfers of partnership interests, do not always correspond with the purposes of Section 956, which is intended to prevent a CFC from using its untaxed earnings and profits to invest in United States property in circumstances that are economically similar to distributing a dividend to United States shareholders.[46] As discussed in more detail below,[47] applying subchapter K principles, such as special allocations and the rules allocating partnership obligations under Section 752 to determine whether transactions involving partnerships should be subject to Section 956, may lead to results that are inconsistent with the aims of Section 956.

On the balance, we believe that the concerns identified by Treasury and the IRS in the preamble to the Proposed Regulations, that failing to treat an obligation of a foreign partnership as an obligation of its partners could allow deferral of U.S. tax on CFC earnings and profits in a manner inconsistent with the purposes of Section 956, constitute an appropriate basis for the general aggregate approach of the Obligation Rule. We believe these concerns are particularly acute in situations where a CFC is controlled by U.S. partners that are related to the CFC and are able to access earnings of the foreign partnership. We also note that an obligation of a foreign partnership will increase the tax basis of its partners in their partnership interests under Section 752 and that the increased basis may be used to support tax-deferred distributions or allocations of deductions or loss to U.S. partners.

As discussed in more detail below,[48] in order to ease the burden of the aggregate approach of the Proposed Regulations in situations where we believe there is less opportunity for abuse, we recommend adding a new *de minimis* exception, which would provide that an obligation of a foreign partnership is not treated as an obligation of a U.S. partner if the U.S. partner (and its related persons) owns less than a specified percentage of the profits and capital interests in the foreign partnership.

We support the Funding Rule in the Temporary Regulations and the changes that it makes to the recommendation in our 2006 Report because we believe the but-for test in the Funding Rule is a better approach for determining when a foreign partnership makes the proceeds of an obligation to a CFC available to related U.S. partners.

[46] The legislative history of subchapter K indicates that, for purposes of interpreting provisions that are outside of subchapter K, a partnership may either be treated as an aggregate of its partners or as an entity, depending on which characterization is more appropriate to carry out the purpose of the Code section at issue. H.R. Conf. Rep. No. 2543, at 59 (1954).

[47] *See* Parts III.A.3 and III.B.1 *infra*.

[48] *See* Part III.A.2 *infra*.

2. *De Minimis* Exception

We believe that the administrative burden of the aggregate approach of the Obligation Rule could be mitigated by adding a *de mimimis* exception. As discussed above, the preamble to the Proposed Regulations states that Treasury and the IRS believe that CFC earnings may be available to a United States shareholder whenever a United States shareholder conducts operations through a foreign partnership using deferred CFC earnings.[49] This analysis appears to assimilate a loan to a foreign partnership in which a United States shareholder is a partner to a loan from a CFC to a foreign branch of the United States shareholder. However, we believe there is a meaningful difference between a United States shareholder's ability to access the proceeds of a loan to a foreign branch and a U.S. partner's ability to access proceeds of a loan to a foreign partnership. The difference is particularly significant if the U.S. partners do not control the foreign partnership.

Under a *de minimis* exception, an obligation of a foreign partnership would not be treated as an obligation of a U.S. partner if the U.S. partner owns less than a specified percentage of the profits and capital interests in the foreign partnership (say, 10% or 20%). To avoid concerns regarding common control, the *de minimis* ownership threshold could be tested on an aggregate basis, taking into account all interests held by related persons within the meaning of Section 954(d)(3). This *de minimis* exception would afford relief in situations in which U.S. partners that are related to the CFC do not have unrestricted access to the partnership's assets because, as a practical matter, their ability to take distributions will be constrained by the interests of the unrelated partners. The presence of unrelated partners also differentiates the foreign partnership from a foreign branch of a United States shareholder.

3. Partners' Shares of a Partnership Obligation

Under the Obligation Rule, an obligation of a foreign partnership is treated as a separate obligation of each of the partners to the extent of each partner's interest in partnership profits, unless neither the CFC nor any related person is a partner in the foreign partnership.[50] The Proposed Regulations provide that the partners' interests in partnership profits are determined by taking into account all facts and circumstances relating to the economic arrangement of the partners.[51] The Proposed Regulations do not include a specific rule regarding the timing for the determination of the partners' shares of a partnership obligation. However, the preamble states that the partners' interests in partnership profits will be determined as of the close of each quarter of the CFC's taxable year in connection with the

[49] REG-155164-09, *supra* note 2, at 53,059.

[50] Prop. Treas. Reg. § 1.956-4(c)(1).

[51] *Id.*

calculation of the amount of United States property held by the CFC pursuant to Section 956(a)(1)(A).[52]

The preamble to the Proposed Regulations states that Treasury and the IRS also considered determining the partners' shares of a partnership obligation based on the regulations under Section 752 or based on the partners' liquidation value percentages, which the Property Rule uses to measure a partner's share of partnership property.[53] Treasury and the IRS concluded, however, that a determination based on profits interests is preferable because profits interests reflect how profits from the investment of the proceeds of partnership borrowing will be shared by the partners.[54]

We believe that the partners' interests in partnership profits may not the best method for determining the extent to which an obligation of a foreign partnership should be treated as United States property for purposes of Section 956. Partners' shares in partnership profit allocations may vary substantially from year to year in a manner that does not reflect the partners' overall economic interests in the partnership. For example, if a partnership agreement provides for a preferred return to the partners in proportion to their capital contributions to the partners and then provides for one or more tiers of allocations of partnership profits based on various internal rate of return hurdles, the allocations of profits in any fiscal year may be substantially different than prior year allocations and from the partners' liquidation value percentages. As a result, profit allocations for a particular testing period may not accurately reflect a partner's overall economic interest in the foreign partnership.

On balance, we believe that the liquidation value approach is a better method for determining the partners' shares of a partnership obligation than a method that is based on the partners' interests in partnership profits. Section 956 treats an obligation of United States shareholder or a related U.S. person that is held by a CFC as an investment of the CFC's earnings in United States property because the CFC is considered to have made its earnings available to the United States shareholder or the related person. Under the aggregate approach of the Obligation Rule, the CFC's earnings are treated as having been made available to the U.S. partner in the partnership based on their proportionate shares of the partnership's obligation. Within this framework, we believe that liquidation value provides the better measure of how the proceeds of the obligation—which are assets of the partnership—have

[52] REG-155164-09, *supra* note 2, at 53,059.

[53] *Id.*

[54] *Id.*

been made available to the U.S. partners.[55] Using liquidation value to determine a partner's share of a partnership obligation also has the benefit of consistency with the use of the liquidation approach for purposes of the Property Rule.

We considered whether it would be appropriate to determine the partners' shares of a partnership's obligations under Section 752. A method based on Section 752 would align the Obligation Rule with the rules in Subchapter K for determining partners' shares of partnership obligations, and with the outside tax basis in the partnership interests attributable to partnership obligations. However, we are concerned that these principles may not be consistent with the purposes of Section 956. In particular, Section 752 principles seek to allocate partnership obligations to partners based on the portion of an obligation for which each partner bears the economic risk of loss.[56] A partner generally bears the economic risk of loss for a partnership obligation to the extent the partner would ultimately have to make a payment in respect of such obligation (and would not be entitled to reimbursement from another partner or a person related to another partner) if all of the partnership's liabilities became payable in full and, with the exception of any property securing an obligation, all of the partnership's assets became worthless.[57] In contrast, Section 956 focuses on whether a U.S. person has the economic benefit of the proceeds of an obligation. Using Section 752 principles could allow taxpayers to shift a partner's share of a partnership obligation in a manner that is not consistent with the partners' sharing of the proceeds of the loan through the use of guarantees or other arrangements to shift economic risk of loss. For these reasons, we prefer the liquidation value approach to an approach that is based on Section 752.

4. Timing for Determining Partners' Interests in Partnership Profits

As discussed above, the preamble to the Proposed Regulations indicates that the determination of the partners' interests in partnership profits will be made as of the close of each quarter of the CFC's taxable year in connection with the 956(a)(1)(A) calculation.[58] However, a rule providing for quarterly determinations of partners' interests in partnership profits does not appear to be included within the text of the Proposed Regulations.

We believe that a requirement to determine the partners' shares of partnership obligations on a quarterly basis would be unduly burdensome. Consistent with our recommendation for testing a CFC's share of partnership property under the Property Rule, we believe that the

[55] Our proposed liquidation value approach would be backstopped by the Funding Rule, which would apply if proceeds are actually made available to a partner in excess of its proportionate share of the obligation under the liquidation rule.

[56] Treas. Reg. § 1.752-2(a).

[57] Treas. Reg. § 1.752-2(b).

[58] Prop. Treas. Reg. § 1.956-4(c)(1); REG-155164-09, *supra* note 2, at 53,059.

regulations should provide expressly that the partners' interests in partnership profits—and therefore their shares of partnership obligations—generally should be measured on an annual basis.[59] This rule providing for annual determinations could be backstopped by requiring partners to determine their share of partnership obligations on a quarterly basis if a principal purpose of structuring the obligation through a partnership is to avoid quarterly determinations under Section 956.

B. Property Rule

Under the Property Rule, for purposes of Section 956, a CFC that is a partner in a partnership is treated as holding its attributable share of any property that is held by the partnership.

1. Determining a Partner's Share of Partnership Property

The Property Rule provides that a partner's attributable share of the tax basis of each item of partnership property is based on the partner's liquidation value percentage. If a partnership agreement provides for the special allocation of income (or, where appropriate, gain), from partnership property, a partner's attributable share of partnership property generally is determined by reference to the partner's special allocation of income (or, where appropriate, gain) with respect to the property.[60] However, allocations that would be disregarded or reallocated under any Code section, regulation or judicial doctrine, or that are made with a principal purpose of avoiding Section 956, are not taken into account in this calculation. The preamble to the Proposed Regulations states that Treasury and the IRS determined that this method is a reasonable measure of a partner's economic interest in partnership property.[61]

The Proposed Regulations include two examples illustrating the application of the special allocation rule. In the first example, a partner has an 80% special allocation percentage of income with respect to United States property with a tax basis of $100*x*. The example states that the special allocation does not have a principal purpose of avoiding the purposes of Section 956. The example concludes that the partner is treated as holding $80*x* of United States property.[62] In the second example, a partner has an 80% special allocation percentage of income with respect to United States property with a tax basis of $100*x* but a second partner has a special allocation percentage of gain with respect to the same United States property of 80%. The second example illustrates that, in the case of a partnership agreement that provides for a special allocation of gain with respect to property held by the partnership

59 *See* Part III.B.2 *infra*.

60 Prop. Treas. Reg. § 1.956-4(b)(2).

61 REG-155164-09, *supra* note 2, at 53,062.

62 Prop. Treas. Reg. § 1.956-4(b)(3), Ex. 2.

that is anticipated to appreciate in value but generate relatively little income, the special allocation of gain should be used to determine the partners' attributable share of such partnership property, rather than the special allocation of income.[63]

We agree with Treasury and the IRS that liquidation value percentages are an appropriate metric for determining a partner's economic interest in items of partnership property for purposes of Section 956, and we support the use of the liquidation value percentage method for purposes of the Property Rule. We note, however, that the rule dealing with special allocations may produce results that are inconsistent with the principles of the liquidation value approach because special allocations inherently reflect future allocations of profit and loss, which may be different than the partners' current liquidation value in the relevant property. More specifically, a special allocation of income or gain will have economic significance to the partners in a partnership only to the extent that the relevant partnership property actually generates income or gain. However, the examples in the Proposed Regulations indicate that a partner's attributable share of partnership property should be determined based on the percentages in which income (or, where appropriate, gain) would be allocated, even if the relevant property has not appreciated. This approach may lead to significant distortions if the partners' capital contributions are not aligned with their special allocation percentages.

For example, assume that (i) CFC1 and CFC2 make $50*x* and $50*x* of capital contributions, respectively, to foreign partnership FPRS, (ii) FPRS acquires United States Property for $50*x* and Foreign Property for $50*x*, (iii) the partnership agreement provides that income and gain from the United States Property will be specially allocated on a 90%–10% basis to CFC1 and CFC2, respectively, while income from the Foreign Property will be specially allocated on a 10%–90% basis to CFC1 and CFC2, respectively, and (iv) net losses will be allocated in proportion to the partners' capital account balances. Under the Property Rule, unless the special allocations have a principal purpose of avoiding the purposes of Section 956, upon the formation of the partnership, CFC1's and CFC2's attributable share of United States Property will be $90*x* and $10*x*, respectively, which is substantially disproportionate to their initial relative economic interest in the property, which initially is $50*x* and $50*x*, respectively. Moreover, the partners' economic interests will only change on an incremental basis as a result of future appreciation (and not at all if there is no appreciation). For example, after $20*x* of appreciation in the value of United States Property, the partners' relative economic interests in the United States Property will be $52*x* and $68*x*, respectively).

One approach to addressing this issue would be to provide that the effect of a special allocation is limited to the portion of the liquidation value that represents actual appreciation

[63] Prop. Treas. Reg. § 1.956-4(b)(3), Ex. 3.

in partnership property, and that the special allocation should not apply for purposes of determining the partners' shares of the initial book value of partnership property. We note, however, that this approach could result in partners being treated as owning partnership property for purposes of Section 956 in proportions that are different with their expected sharing of future allocations of profits and losses from the property, as in the case of the example described above. Depending on the circumstances, the application of this liquidation value approach could result in a CFC holding having more or less United States Property than the special allocation approach.

2. Dates for Determining a Partner's Share of Partnership Property

Under the Property Rule, a partner's liquidation valuation percentage is determined immediately after the formation of the partnership and upon the occurrence of each revaluation event described in Treasury Regulations § 1.704-1(b)(2)(iv)(*f*)(5) or (*s*)(1). However, the Section 704(b) regulations do not require partnerships to book up (or book down) partnership capital accounts in connection with a revaluation event. Instead, the regulations provide that a partnership agreement *may* provide that, upon the occurrence of a revaluation event, the partnership will increase or decrease the partners' capital accounts to reflect a revaluation of property on the partnership's books.[64] In our experience many partnerships do not book up partnership capital accounts in connection with these events.

We believe the Proposed Regulations, as drafted, are not clear as to whether a redetermination of a partner's attributable share of partnership property would be required upon the occurrence of a revaluation event if the partnership does not actually implement a book up (or book down). However, rather than requiring taxpayers to determine a partner's liquidation value upon the occurrence of a revaluation event, even if the partnership itself does not actually book up (or book down) partner capital accounts, we believe that a more practical approach would be to require partners to determine their proportionate shares of partnership property on an annual basis. A rule that provides for annual determinations would also take into account changes in the partners' economic interests that do not result from revaluation events (which may be the case, for example, if a partnership agreement provides for different profit sharing percentages that apply based on different hurdles). This annual determination rule could be backstopped by a quarterly determination period if the principal purpose of holding property through a partnership is to avoid quarterly determinations under Section 956.

64 Treas. Regs. § 1.704-1(b)(2)(iv)(*f*).

C. Extension of Anti-Avoidance Rule to Acquisitions of Property by a Partnership Controlled by a CFC

The Temporary Regulations include an anti-avoidance rule that may apply to property acquired by a partnership that is controlled by a CFC. Under the anti-avoidance rule, United States property indirectly held by a CFC includes property acquired by a controlled partnership if (i) the property would be United States property if held directly by the CFC and (ii) a principal purpose of creating, organizing or funding by any means (including through a capital contribution or debt) the partnership is to avoid the application of Section 956.[65] The partnership anti-avoidance rule is based on a similar anti-avoidance rule in the Temporary Regulations (and in prior, temporary Treasury regulations), which applies if the tests described above are satisfied with respect to the acquisition of property by a foreign corporation that is controlled by a CFC.[66]

The Temporary Regulations include only one example illustrating the application of the controlled partnership anti-avoidance rule (discussed below). However, we believe that the examples in the Temporary Regulations illustrating the application of the foreign corporation anti-avoidance rule are useful in considering the application of the partnership anti-avoidance rule.

The controlled corporation anti-avoidance rule applies if, with a principal purpose of avoiding the application of Section 956, a CFC makes a loan to a subsidiary or sister foreign corporation that does not have earnings and profits and is controlled by the CFC, and the subsidiary or sister corporation acquires property that would be treated as United States property if held directly by the CFC.[67] Absent the application of the Temporary Regulations, since the subsidiary or sister corporation does not have earnings and profits, United States shareholders would not be required to take into account a Section 956 inclusion under Section 951(a)(1)(B). The Temporary Regulations also apply if, with a principal purpose to avoid the application of Section 956, a CFC lends money to a sister CFC to acquire United States property, even if both CFCs have untaxed earnings and profits, if the sister CFC has tax attributes (such as foreign income taxes) that would enable a United States shareholder in

[65] As discussed above, for this purpose, control is determined based on the related person rules in Sections 267(b) and 707(b).

[66] Temp. Treas. Regs. § 1.956-1T(b)(4)(B). The prior foreign corporation anti-avoidance rule was narrower than the foreign corporation anti-avoidance rule in the Temporary Regulations because the prior rule only applied at the District Director's direction and only applied if a CFC funded the CFC through a capital contribution or debt.

[67] *See* Temp. Treas. Regs. § 1.956-1T(b)(4)(iv), Ex. 2 (CFC1 provides funding to sister CFC2 which acquires United States property with a principal purpose of avoiding the application of Section 956 with respect to CFC1).

the sister CFC to reduce the U.S. income taxes that are required to be paid in respect of a Section 956 inclusion attributable to the United States property under Section 960.[68]

The Temporary Regulations applicable to foreign corporations that are controlled by a CFC do not take into account differences in the ownership by United States shareholders in the CFC and the controlled corporation. So, for example, if the Temporary Regulations apply to a CFC that is 100% owned by a single United States shareholder and that provides funds to a subsidiary foreign corporation that is controlled by the CFC but is 51% owned (indirectly) by the United States shareholder and 49% owned by an unrelated shareholder, the United States shareholder will take into account 100% of the resulting 956 inclusion even though it owns, indirectly, less than 100% by value of the United States property. This approach may produce a section 956 inclusion in excess of the United States shareholder's economic interest in the underlying property.

Unlike a CFC that funds a foreign corporation that does not have earnings and profits, a CFC cannot avoid a Section 956 inclusion by funding a controlled partnership in which the CFC has an ownership interest. In these circumstances, the CFC would take into account its proportionate share of any United States property held by the foreign partnership under the Property Rule, which applies regardless of whether there is a principal purpose of avoiding the application of Section 956 with respect to the CFC. As a result, in the case of a controlled partnership in which the CFC holds an interest, the effect of the anti-avoidance rule is to require United States shareholders to take into account under Section 951(a)(1)(B) 100% of the United States property held indirectly through a controlled partnership, rather than the CFC's proportionate share of the United States property.[69] We understand why an approach that results in a disproportionate inclusion may be appropriate in the case of a subsidiary foreign corporation. For example, the additional deterrence that a disproportionate inclusion rule provides may be appropriate because of the possibility that a CFC might completely avoid a Section 956 inclusion by funding a subsidiary without earnings and profits. However, in light of the existing proportionate look-through mechanism that applies with respect to partner-

[68] Temp. Treas. Regs. § 1.956-1T(b)(4)(iv), Ex. 3. Since this example appears to apply the Temporary Regulations in circumstances where the funding does not result in a different Section 956 inclusion (the difference is that a Section 902 tax credit is available under Section 960 with respect to the acquisition of property by the sister CFC), the IRS and Treasury may wish to clarify in the Treasury Regulations that avoiding the application of Section 956 includes a reduction of taxes payable in respect of Section 956 inclusions through use of foreign tax credits under Section 960**.** *See also* CCA 201446020 (July 29, 2014).

[69] *See* Temp. Treas. Regs. § 1.956-1T(b)(4)(iv), Ex, 4 (with a principal purpose of avoiding Section 956, CFC makes a contribution to acquire United States property to a foreign partnership that is owned 60% by CFC and 40% by CFC's US parent; CFC treated as owning 100% of United States property rather than 60% under the property rule).

ships, we do not believe that an additional anti-abuse rule is required in relation to controlled partnerships in these circumstances.

The controlled partnership anti-avoidance rule in the Temporary Regulations also would apply to funding that is provided by a CFC to a partnership that is owned by one or more foreign corporations that are controlled by the CFC, if the partnership acquires property that would be United States property in the hands of the CFC and a principal purpose of the funding is to avoid the application of Section 956 with respect to the CFC. For example, if U.S. Parent owns 100% of each of CFC1, CFC2 and CFC3, and CFC1 has earnings and profits but CFC2 and CFC3 do not have earnings and profits, absent the partnership anti-avoidance rule, CFC1 could make a loan to a foreign partnership that is owned by CFC2 and CFC3, and the foreign partnership could use the proceeds to invest in United States property without a corresponding Section 956 inclusion (under the Obligation Rule, CFC 1 would be treated as holding obligations of CFC2 and CFC3, but those obligations would not be treated as United States property). In these circumstances, we believe that the partnership anti-avoidance rule appropriately backstops the anti-avoidance rule for foreign corporations that are controlled by a CFC. For these reasons, we recommend limiting the partnership anti-avoidance rule so that it applies only with respect to property indirectly held through a partnership that is owned by one or more foreign corporations that are controlled by the funding CFC.