NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE APPLICATION OF SECTION 956 TO PARTNERSHIP TRANSACTIONS

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New York State Bar Association Tax Section

Report on the Application of Section 956 to Partnership Transactions[1]

This report of the New York State Bar Association Tax Section addresses the application of Section 956 to certain transactions involving foreign partnerships.[2] More specifically, the preamble to the recently proposed regulations under Section 954(i) requested comments regarding the application of Section 956 in the case of a loan by a controlled foreign corporation ("CFC") to a foreign partnership in which one or more partners are U.S. shareholders of the CFC. This report is not intended to constitute a comprehensive discussion of all U.S. federal income tax issues relating to the interaction of Section 956 and partnerships but rather is generally limited to the specific matters in respect of which the IRS requested comments in the preamble to the proposed Section 954(i) regulations.

As discussed below, we believe that a loan by a CFC to a related foreign partnership should generally not be treated as an investment in U.S. 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 U.S. property or otherwise distributed to any U.S. partners in the partnership.

This report is divided into four parts. Part I contains a general summary of the recommendations set forth in this report. Part II contains a general summary of Section 956 and the relevant administrative and judicial guidance with respect to the

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1 This report was drafted by Jeffrey D. Hochberg. Helpful comments were received from Kimberly S. Blanchard, Peter H. Blessing, Andrew H. Braiterman, Saul Brander, William L. McRae, David S. Miller, Andrew W. Needham, Erika W. Nijenhuis, Andrew L. Oringer, Michael L. Schler, David P. Sicular, Willard Taylor, Diana L. Wollman and Andrew Walker.

2 Unless otherwise indicated, all Section references in this report are to the Internal Revenue Code of 1986, as amended.

issues that are addressed in this report. Part III contains a summary of the request for comments in the preamble to the Section 954(i) regulations. Part IV contains a detailed discussion of our recommendations.

I. Summary of Recommendations

- A loan by a CFC to a related domestic partnership should continue to be treated as an investment in U.S. property for Section 956 purposes irrespective of whether the partners in the partnership are U.S. or foreign persons.

- Subject to the exception described below, a loan by a CFC to a related foreign partnership should not be treated as an investment to U.S. 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 U.S. property or otherwise distributed to any U.S. partners in the partnership.

- A loan by CFC to a foreign partnership should be treated as an investment in U.S. property for Section 956 purposes if the loan would be treated under general U.S. federal income tax principles (such as the "Plantation Patterns" doctrine) as made to a U.S. partner of the foreign partnership that is a "U.S. shareholder" of the CFC.

- Treasury Regulations Section 1.956-IT should be amended so that it also applies to loans made by a CFC to a related foreign partnership if 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.

- A loan by a CFC to a foreign partnership should be treated as an investment in U.S. property for Section 956 purposes if (i) the loan proceeds are distributed to a U.S. partner of the foreign partnership that is a "U.S. shareholder" of the CFC and (ii) 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.

II. Overview of Section 956 Rules

Section 951 requires each U.S. shareholder of a CFC to include in gross income any increase in the amount of the CFC's earning that was invested in "U.S. property" in a particular quarter, but only to the extent such earnings have not been previously included in a U.S. shareholder's income under Section 951.[3] For this purpose, U.S. property generally includes (subject to certain exceptions) (i) tangible property located in the U.S., (ii) stock of a domestic corporation, (iii) obligations of a U.S. person that is related to the CFC (including certain pledges or guarantees of such obligations) and (iv) any right to the use in the U.S. of a patent or copyright, an invention, model or design, a secret formula or process, or any other similar property right.[4]

The regulations and rulings under Section 956 and the judicial cases that have interpreted Section 956 have broadly applied the substance over form doctrine in order to prevent a CFC from inappropriately avoiding the application of Section 956 by making indirect investments in U.S. property. This approach is supported by the statutory language of Section 956 as well as the legislative history to Section 956. Specifically, Section 951(a)(1)(A) provides that the calculation of a CFC's earnings invested in U.S. property at the end of a particular quarter is to be made with respect to any such property that is held "directly or indirectly" by the CFC. Furthermore, the Committee Reports to the 1976 amendments to Section 956 states that "if the facts indicate that the controlled foreign subsidiary facilitated a loan to, or borrowing by, a U.S. shareholder, the controlled foreign corporation is considered to have made a loan to (or acquired an obligation of) the U.S. shareholder."[5] An accompanying example provides that a CFC will be treated as having made an investment in U.S. property for

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3 IRC Section 951(a)(1)(B).

4 IRC Section 956(c).

5 H.R. Rep. No. 94-658, 94th Cong., 2d Sess., pp. 216-18 (1976), 1976-3 C.B. 217, fn. 22.

Section 956 purposes if the CFC makes a deposit in a U.S. bank and the deposit is either followed or preceded by the loan of a similar amount to a U.S. shareholder of the CFC by the bank.

Treasury Regulations Section 1.956-1T includes an anti-abuse rule under which a CFC is considered to hold, at the discretion of the District Director, investments in "U.S. property" that are acquired by any other foreign corporation that is controlled by the CFC (after the application of certain attribution rules), if one of the principal purposes for creating, organizing or funding such other foreign corporation is to avoid the application of Section 956 with respect to the CFC.

The Tax Court has applied Treasury Regulations Section 1.956-1T in order to treat certificates of deposit that were purchased by a CFC that had no earnings and profits as owned for Section 956 purposes by its parent CFC which funded the acquisition.[6]

In addition, the IRS has issued two revenue rulings that apply the principles set forth in the legislative history cited above and in Treasury Regulations Section 1.956-1T in order to prevent a CFC from avoiding the application of Section 956 through indirect investments in U.S. property. First, in Rev. Rul. 76-192,[7] the IRS addressed a transaction in which a CFC made a loan to its sister CFC indirectly through the medium of a deposit by the first CFC in a foreign bank and the loan of equivalent funds by the bank to the sister CFC. The sister CFC then loaned the funds to the common parent of both CFCs. The IRS ignored the participation of the sister CFC and the bank in the transaction and treated the first CFC as having made the loan to its U.S. parent for Section 956 purposes. Second, in Example 3 of Rev. Rul. 87-89,[8] a CFC deposited money with a bank that subsequently lent such money back to the CFC's

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

7 1976-1 C.B. 205.

8 1987-2 C.B. 195.

United States parent at a higher interest rate. The IRS ruled that the CFC's deposit with the bank was an investment in "U.S. property" for Section 956 purposes, because the facts indicated that the bank would not have made the loan to the United States parent on the same terms in the absence of the deposit by the CFC.

Similarly, a field service advice issued by the IRS advice addressed a transaction in which a domestic corporation entered into an interest rate swap with an unrelated foreign bank and then transferred its right to receive income under the swap to several of its foreign subsidiaries in exchange for an upfront cash payment. The IRS recharacterized the transaction as a set of loans from the foreign subsidiaries to the U.S. parent for Section 956 purposes.[9]

Although, as discussed below, the IRS has not issued any guidance in respect of loans that are indirectly made by a CFC to a U.S. shareholder through the use of a related foreign partnership, the IRS has issued a published ruling[10] and regulation[11] under which a CFC that is a partner in a partnership will be treated as owning its pro rata share of the assets held by the partnership for purposes of determining whether the CFC holds "U.S. property" for Section 956 purposes.

III. Request for Comments in Preamble to Section 954(i) Regulations

The preamble to the recently proposed regulations under Section 954(i) requested comments regarding the application of Section 956 in the case of a loan by a CFC to a foreign partnership in which one or more partners are U.S. shareholders of the CFC. The preamble specifically requested comments regarding the circumstances, if any, under which the loan to the foreign partnership should be considered to be the obligations of such partners and thus U.S. property for Section 956 purposes. The preamble then states that the IRS and Treasury Department are particularly interested in the relevance of (i) the consistent application of Section 956 to CFC loans to foreign partnerships,

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9 FSA 200031023.

10 Rev. Rul. 90-112, 1990-2 C.B. 186.

11 Treasury Regulations Section 1.956-2(a)(3).

domestic partnerships, foreign branches, and disregarded entities of U.S. shareholders, (ii) the foreign partnership's status as a foreign person, (iii) the partners' liability for the partnership's debt under local law, (iv) the use of the loan proceeds in business activities located inside or outside of the United States and (v) the fact that the CFC earnings loaned to the partnership would not have been deferred had they been earned by the partnership.[12]

IV. Discussion of Recommendations

The following discussion of our recommendations regarding the application of Section 956 to transactions between a CFC and a related foreign partnership is divided into four parts. The first part addresses the application of Section 956 to loans that are made by a CFC to a related domestic partnership. The second part addresses the application of Section 956 to loans that are made by a CFC to a related foreign partnership when the loan proceeds are not invested in U.S. property or otherwise distributed to any U.S. partners in the partnership. The third part addresses the application of Section 956 to loans that are made by a CFC to a related foreign partnership when the loan proceeds are subsequently loaned by the foreign partnership to a U.S. shareholder of the CFC or is otherwise invested in U.S. property. The fourth part addresses the application of Section 956 to loans that are made to a related foreign partnership where the foreign partnership subsequently distributes all or a portion of the loan proceeds to a U.S. partner that is a U.S. shareholder of the CFC.

A. Loans to a Related Domestic Partnership

A note held by a CFC is only treated as U.S. property for Section 956 purposes if the note is issued by a "U.S. person" as defined under Section 7701 of the Code.[13] The term "U.S. person" under Section 7701 includes a domestic partnership.[14] The statutory language of Section 956 thus treats an obligation of a domestic partnership

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[12] 71 F.R. 2496-2497.

[13] IRC Section 957(c). See also Treasury Regulations Section 1.956-2(a)(1)(iii).

[14] IRC Section 7701(a)(30).

as "U.S. property" for Section 956 purposes irrespective of whether the partners in the U.S. partnership are foreign or U.S. persons and irrespective of whether the domestic partnership holds assets in the U.S. or is engaged in a U.S. trade or business.[15] Thus, although the policy reasons for treating a loan to a domestic partnership with no U.S. partners or U.S. assets or business as "U.S. property" for Section 956 purposes are not entirely clear, the statutory language does not allow for any exceptions that would apply to such a case. We therefore recommend that no changes be made to the existing rule under which obligations of a domestic partnership are treated as "U.S. property" for Section 956 purposes.

We similarly think that a loan to a foreign entity that is treated as a branch of a domestic partnership should continue to be treated as "U.S. property" for Section 956 purposes because the branch is classified as a "U.S. person" under general U.S. tax principles.[16] Although such a loan is covered by the statutory language of Section 956, we think that it would be helpful if any guidance that is issued in respect of the application of Section 956 to foreign partnerships also acknowledges this result notwithstanding that the loan is issued by a foreign entity that is classified as a corporation for local law purposes.

B. Loans to a Related Foreign Partnership

The tax treatment of a loan from a CFC to a related foreign partnership depends in part upon whether the partnership should be treated as an aggregate of its

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15 There is no indication in the legislative history, however, that Congress contemplated whether a partnership should be treated as an entity or as an aggregate of its partners for Section 956 purposes.

16 While we are somewhat troubled by the distinction for Section 956 purposes between a foreign entity that is classified as a corporation or partnership for U.S. tax purposes and a foreign entity that is classified as a branch for U.S. tax purposes, this distinction applies without an apparent policy justification in numerous other areas of the Code (including the source rules discussed below). We therefore think that the Section 956 rules should generally follow the U.S. tax rules governing the classification of foreign entities in determining whether a CFC holds an obligation of a U.S. person for Section 956 purposes.

partners or as an entity for Section 956 purposes. We think that the statutory language of Section 956 implicitly provides that, subject to certain exceptions described below, a foreign partnership should be treated as an entity for Section 956 purposes and that accordingly a loan to a foreign partnership should not be treated as an obligation of a U.S. person even if the partners in the partnership are U.S. persons. More specifically, as noted above, the term U.S. person for Section 956 purposes is defined by reference to Section 7701 which treats a domestic partnership as a U.S. person notwithstanding that the domestic partnership may have no U.S. partners and no U.S. activities. Section 956 thus treats a partnership as an entity for this purpose rather than as an aggregate of its partners. It would arguably be inconsistent to treat a domestic partnership as an entity for Section 956 purposes and to treat a foreign partnership as an aggregate of its partners for purposes of the same statutory provision.[17]

Furthermore, we think that generally treating a foreign partnership as an entity for Section 956 purposes (subject to the exceptions described below) is consistent with the policy objectives of Section 956 and subchapter K. More specifically, the legislative history to subchapter K states that, for purposes of interpreting provisions that are outside of subchapter K, a partnership may be either 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 particular Code section that is under consideration.[18] Section 956 is designed to prevent a CFC from achieving the economic effect of a dividend to a U.S. shareholder through an investment in U.S. property such as via a loan to a U.S.

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17 We note in this regard that the recently issued proposed regulations under Section 1248 treat a foreign partnership as an aggregate of its partners notwithstanding that a domestic partnership is classified as an entity for Section 1248 purposes. The preamble to the regulations, however, provides that the inconsistency was necessary because treating a foreign partnership with U.S. partners as an entity for Section 1248 purposes would frustrate the legislative intent of Section 1248. By contrast, as discussed below, we think that treating a foreign partnership as an entity for Section 956 purposes would be consistent with the legislative intent of Section 956.

18 H.R. Conf. Rep. No. 2543, 83rd Cong. 2d. Sess. 59 (1954).

shareholder of the CFC.[19] Based on this legislative purpose, we can see no policy reason why a loan by a CFC to a foreign partnership should be treated as an investment in U.S. property if the foreign partnership does not invest the loan proceeds in U.S. property and does not distribute any of the loan proceeds to any U.S. partners, particularly when the loan is part of an ordinary course transaction between related foreign entities.

Furthermore, the policy underlying Section 956 was developed long before the issuance of the check-the-box regulations, when partnerships were rarely implicated in cross-border lending. The check-the-box regulations enabled many foreign entities to be treated as partnerships for U.S. federal income tax purposes notwithstanding that such entities are otherwise treated as corporate entities under local law. We do not think that there is any policy reason to treat a loan by a CFC to a related corporate entity as a deemed dividend simply because its parent makes an election to treat the related corporate entity as a partnership for U.S. federal income tax purposes.

Finally, we note that the treatment of a partnership as an entity for Section 956 purposes is generally consistent with the general tax treatment of loans that are issued by a foreign partnership or a domestic partnership. More specifically, interest that is paid by a foreign partnership is generally treated as foreign source income that is not subject to U.S. withholding tax even if the partners in the partnership are U.S. persons.[20] Conversely, interest that is paid by a domestic partnership is generally treated as U.S. source income that is subject to U.S. withholding tax even if the partners in the partnership are foreign persons.[21]

Based on the discussion above, it appears that the only possible reason to treat a foreign partnership as an aggregate of its partners for Section 956 purposes would

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[19] H.R. Rep. No. 94-658, 94th Cong., 2d Sess., 1976-3 C.B. 217, fn. 22.

[20] IRC Section 861(a)(1). Although interest that is paid by a foreign partnership is generally treated as U.S. source income if the foreign partnership is engaged in a U.S. trade or business, the partnership is in all circumstances treated as an entity for source purposes rather than as an aggregate of its partners.

[21] IRC Section 862(a).

be to prevent taxpayers from engaging in the abusive transactions described below in which a CFC effectively repatriates assets to a U.S. shareholder through a foreign partnership and then takes the position that Section 956 does not apply to the transaction. We note in this regard that simply treating a foreign partnership as an aggregate of its partners for Section 956 purposes is not likely, by itself, to eliminate the possibility that taxpayers will engage in similar abusive transactions unless the IRS also issues rules similar to the rules described below that would trace the distribution of the loan proceeds to its U.S. partners. This could be illustrated by an example in which a CFC lends $100 to a foreign partnership in which a U.S. shareholder of the CFC holds a 50% interest. If a the foreign partnership is treated as an aggregate of its partners for Section 956 purposes, then the U.S. shareholder would have a Section 956 inclusion of $50 in connection with the loan irrespective of the portion of the loan proceeds that is distributed to the U.S. shareholder. The CFC could then distribute the full $100 to the U.S. shareholder, thereby repatriating $100 to the U.S. shareholder with a $50 Section 956 inclusion. Thus, while treating a foreign partnership as an aggregate of its partners may seem like a simple way to address abusive Section 956 transactions, we think that any such rule would in any case need to incorporate some of the complexity of our proposed anti-abuse rule that is described below.

We note, however, that general U.S. tax principles should apply in determining whether a loan to a foreign partnership should be respected as a loan to the partnership rather than as a loan to the partners in the partnership. Specifically, under the "Plantation Patterns" doctrine, a loan to a partnership would likely be treated as a loan to a partner in the partnership if (i) the partner is ultimately liable for the loan if the partnership defaults (e.g., if there is a partner guarantee of the loan or if a partner is liable for obligations of the partnership) and (ii) the partner's responsibility for the obligation of the partnership was the "obligation primary in nature" and was the "real undergirding for the deal".[22] Accordingly, a loan by a CFC to a related foreign partnership could be

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22 In Plantation Patterns, 462 F.2d 712 (5th Cir. 1972), a thinly capitalized corporation issued debt that was guaranteed by its shareholder. The court held that the debt should be treated for tax purposes as issued by the shareholder-

treated as a loan to a partner in the partnership for tax purposes -- including Section 956 purposes -- if the partner is liable for the obligations of the partnership and the partnership is thinly capitalized.[23]

C. Loans to a Related Foreign Partnership That Invests Loan Proceeds in U.S. Property

As discussed above, Section 1.956-1T includes an anti-abuse rule under which a CFC is considered to hold, at the discretion of the District Director, investments in "U.S. property" that are acquired by any other foreign corporation that is controlled by the CFC (after the application of certain attribution rules), if one of the principal purposes for creating, organizing or funding such other foreign corporation is to avoid the application of Section 956 with respect to the CFC. This regulation does not, however, apply to a loan by a CFC to a related foreign partnership that invests the loan proceeds in

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guarantor, and that the shareholder-guarantor should be treated as having made a capital contribution to the corporation of the cash it was deemed to have received from its deemed issuance of the debt. The court's holding was based upon its finding that (i) the shareholder guarantee was the "real undergirding for the deal" because the creditor would not otherwise have lent money to the corporation (in part because the corporation was thinly capitalized), (ii) the guarantee was, as a substantive matter, "an obligation primary in nature", (iii) the corporation's business prospects were "questionable" without the shareholder guarantee and (iv) a substantial portion of the guaranteed debt was used to acquire capital assets of the corporation. Similarly, in Selfe v. United States, 778 F. 2d 769 (11th Cir. 1985), the court stated that "under the principles of Plantation Patterns, a shareholder guarantee of a loan may be treated as an equity investment in the corporation where the lender looks to the shareholder as the primary obligor." See also Lane v. United States, 742 F.2d 1311 (11th Cir. 1984); Casco Bank and Trust Co. v. United States, 554 F.2d 528 (1st Cir. 1976); Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967) and Santa Anita Consolidated, Inc. v. Commissioner, 50 T.C. 536 (1968).

23 We note that the Service ruled in PLR 8101012 that general tax principles should apply in determining the identity of an obligor under a note for Section 956 purposes. More specifically, the IRS ruled that a guarantee by a United States parent of an obligation issued by a foreign entity will not be treated as an obligation of a United States person for Section 956 purposes as long as the United States parent is respected for tax purposes as the guarantor, and not the obligor, with respect to the underlying obligation.

U.S. property.[24] Thus, a taxpayer could assert that Section 956 should not apply to a transaction in which a CFC makes a loan to a related foreign partnership even if the foreign partnership then uses the loan proceeds to make a loan to a U.S. partner in the partnership that is a U.S. shareholder of the CFC.[25] We think that there is no policy reason as to why a loan to a related foreign partnership that invests in U.S. property should be treated any differently than a loan to a related corporation or trust that invests in U.S. property. Furthermore, we are concerned that the fact that the anti-abuse rule applies only at the discretion of the District Director might be interpreted by certain taxpayers as allowing them to play the "audit lottery" and thus to engage in transactions that are described in Treasury Regulations Section 1.956-1T on the theory that the taxpayer's transaction has not yet been identified by the District Director.

In light of the issues discussed above, we recommend that Treasury Regulations Section 1.956-1T be amended so that it (i) applies automatically (assuming the transaction satisfies the "principal purpose" test) even if not specifically identified by the IRS and (ii) also applies to a loan that is made by a CFC to a related foreign partnership if 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.

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24 This regulation would not be necessary in the case of a CFC that makes an equity contribution to a foreign partnership because, as discussed above, the Section 956 regulations provide that a CFC that is a partner in a partnership is treated as owning its pro rata share of the assets held by the partnership for purposes of determining whether the CFC holds "U.S. property" for Section 956 purposes.

25 It might be possible under current law to collapse the loans even in the absence of such regulations based on the cases and rulings described above which used the "directly or indirectly" language in Section 951 to collapse back-to-back loan arrangements into a single loan held by the CFC for Section 956 purposes. Alternatively, it might be possible for the Service to apply the partnership anti-abuse rule under Treasury Regulations Section 1.701-2 in order to treat the loan to the related foreign partnership as a direct loan to the U.S. partners in the partnership. However, the omission of related partnerships in Treasury Regulations Section 1.956-1T might be viewed as implying that the IRS could not collapse back-to-back loans that involve a CFC and a related foreign partnership.

D. Loans to a Related Foreign Partnership That Distributes the Loan Proceeds to its U.S. Partners

This section addresses the application of Section 956 to transactions in which a CFC lends money to a related foreign partnership which then distributes all or a portion of the loan proceeds to its U.S. partners.

1. Illustration of Problem

The potential Section 956 abuse in respect of loans that are made by a CFC to a related foreign partnership could be illustrated by the following example. Assume that a CFC which is owned by "U.S. Shareholder" has $100 of earnings that it wants to repatriate to U.S. Shareholder. U.S. Shareholder owns 99% of a foreign partnership in which it has a zero tax basis. CFC lends the $100 to the foreign partnership and the foreign partnership allocates $99 of the debt to U.S. Shareholder under Section 752, thereby increasing U.S. Shareholder's tax basis in foreign partnership to $99. The foreign partnership then distributes $99 to U.S. Shareholder which is not subject to tax under Section 731 because the amount of the distribution does not exceed U.S. Shareholder's tax basis in the foreign partnership.[26] U.S. Shareholder takes the position that Section 956 should not apply to the loan to the foreign partnership because, as discussed above, a foreign partnership is not a U.S. person under Section 7701 and thus an obligation of a foreign partnership does not constitute U.S. property for Section 956 purposes. U.S. Shareholder also takes the position that Treasury Regulations Section 1.956-1T discussed above should not apply to this transaction (even if such regulations are amended to include loans to related foreign partnerships) because the regulations only address transactions in which the related foreign entity makes a loan to a U.S. shareholder of the CFC and they do not address transactions in which the related foreign entity makes a distribution to a U.S. shareholder. Finally, U.S. Shareholder takes the position that the cases and rulings described above in which a multiparty financing arrangement was collapsed into a single loan for Section 956 purposes should not apply to this transaction

26 IRC Section 731(a)(1). The U.S. shareholder would eventually have to include the $99 in income when the loan is repaid, thereby triggering a deemed distribution of $99 by the foreign partnership to the U.S. shareholder.

because the facts in the rulings and cases all involved situations in which the U.S. person that ultimately received the cash that was advanced by the CFC issued a debt instrument that would have been treated as U.S. property if it had been issued directly to the CFC.[27]

The strategy that is illustrated by the example in the preceding paragraph transaction cannot be as easily employed in the context of a loan to a related foreign corporation for two reasons. First, a shareholder's tax basis in a foreign corporation is not increased as a result of the loan. Thus, if the related foreign partnership in the preceding example was a related foreign corporation, the related foreign corporation could only distribute the loan proceeds to U.S. Shareholder in a tax-free manner if U.S. Shareholder had a pre-existing $99 tax basis in the stock of the foreign corporation. Second, a distribution by a related foreign corporation would be treated as a taxable dividend to the extent that the corporation had any current or accumulated earnings and profits. Thus, the repatriation strategy illustrated above with respect to foreign partnerships could not be easily replicated through the use of a related foreign corporation.

2. <u>Proposed Conduit Rule</u>

We think that it would be inappropriate to allow a CFC to repatriate its earnings to a U.S. shareholder through a related foreign partnership in the manner described above. We think that the most appropriate way for the IRS to address this issue would be for it to issue regulations under the anti-conduit provisions set forth in Section 7701(l) of the Code. More specifically, Section 7701(l) of the Code provides that the IRS may issue regulations that would recharacterize any multiparty financing transaction as a transaction directly among any two or more of such parties where the IRS determines that such recharacterization is appropriate to prevent the avoidance of U.S. federal

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27 We do not intend to imply that the position that Section 956 should not apply to the transaction described above would necessarily be sustained under current law. In particular, it might be possible for the IRS to apply the partnership anti-abuse rule under Treasury Regulations Section 1.701-2 in order to treat the loan to the related foreign partnership as a direct loan to the U.S. partners in the partnership.

income tax.[28] We recommend that the IRS issue regulations or other administrative guidance pursuant to its authority under Section 7701(l) that would provide that a loan that is directly or indirectly made by a CFC to a foreign partnership will be treated as loan by the CFC to a U.S. partner in the partnership for Section 956 purposes if (i) the partnership distributes the loan proceeds to the U.S. partner and (ii) 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.[29]

Because cash is fungible, it would be difficult, if not impossible, to track the distribution of the loan proceeds to any particular partner.[30] We therefore recommend that the anti-abuse rule described in the preceding paragraph should treat all cash that is distributed by the foreign partnership to its partners as a distribution of the loan proceeds to the extent that (i) the cash is distributed at any time after the loan is made or (ii) the cash is distributed before the loan was made if such distribution was made in contemplation or anticipation of a loan from the CFC (or a related entity).[31] However, the portion of the loan proceeds that is treated as distributed to a partner in the partnership

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28 The IRS has already issued regulations under Section 881 that would treat certain multiparty financings as a single financing transaction in order to prevent the avoidance of U.S. withholding tax on U.S. source FDAP payments. See Treasury Regulations Section 1.881-3.

29 Although we would generally prefer to avoid the subjective nature of a "principal purpose" test, we note that there are numerous anti-abuse rules in the Code and regulations that rely on a "principal purpose" determination and, as discussed above, the Treasury Regulations Section 1.956-T anti-abuse rule already employs such a standard. Moreover, the proposed anti-abuse rule as well as the current anti-abuse rule in Treasury Regulations Section 1.956-1T would only require that the avoidance of Section 956 is "a" principal purpose rather than being "the" principal purpose of a transaction.

30 The discussion above refers to cash loans and distributions for purposes of simplicity. The rule described below should, however, also apply to non-cash loans and distributions.

31 It may be advisable to include a time limitation under which a distribution by the foreign partnership would be subject to this rule only if it is made within a specified time period after the loan to the foreign partnership.

that is not a U.S. shareholder of the CFC should never exceed such partner's percentage interest in the partnership.[32]

The anti-abuse rule described above should apply to loans that are directly or indirectly made by a CFC to a related foreign partnership. The phrase "directly or indirectly" is intended to address loans that are made through the use of multiple tiers of entities. We recommend that the anti-abuse rule that is described in this section provide that the cash tracing rules described above will also apply to cash that is funded through multiple entities. A CFC could thus not avoid the application of the anti-abuse rule by making a loan to a related CFC that then makes a loan to a related foreign partnership that distributes the cash to its partners.

3. <u>Subchapter K Adjustments</u>

If the recommendation described above is adopted, corresponding changes would need to be made to the subchapter K rules so that a partner that is required to treat its share of a loan by a CFC to a partnership as a deemed Section 956 dividend under the rules described above does not include the amount of the loan in income a second time in connection with the distribution that it is deemed to receive from the partnership when the loan is repaid. The need for such a corresponding change can be illustrated by the following example. Assume that a U.S. shareholder of a CFC owns 99% of a related foreign partnership in which it has a zero tax basis and in respect of which it is allocated 99% of the partnership's profits, losses and liabilities under the allocation rules of subchapter K. Assume further that the CFC makes a loan of $100 to the related foreign partnership and the foreign partnership then distributes $99 of the loan proceeds to the U.S. shareholder in a transaction that triggers a $99 Section 956 inclusion to the U.S. shareholder under the rules described above. Absent a special rule that is designed to address this type of case, the U.S. shareholder's basis in the foreign partnership would first be increased by $99 under Section 752 of the Code as a result of the allocation of

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32 This rule is designed to prevent the related foreign partnership from first distributing all of the loan proceeds to a partner that would not be subject to Section 956 in respect of the distribution and then distributing other cash to a partner that is a U.S. shareholder of the CFC.

$99 of the debt to the U.S. shareholder and would then be decreased by $99 under section 731 of the Code when the $99 is distributed to the U.S. shareholder. The U.S. shareholder would thus recognize $99 of income under Section 956 in respect of the loan and distribution and it would still have a tax basis of zero after the distribution. The U.S. shareholder, however, would recognize $99 of income when the loan is repaid (assuming that the U.S. shareholder still has tax basis of zero at the time of the repayment) because it would be deemed to have received a $99 distribution from the foreign partnership under Section 752 of the Code upon the repayment of the loan. The U.S. shareholder would therefore have inappropriately recognized $198 of income in respect of a single $99 distribution.

There are three possible ways that the regulations can address this issue. First, the regulations could provide that a loan to a foreign partnership that triggers a Section 956 inclusion to a partner that receives a distribution of the loan proceeds will not be subject to the general rules of subchapter K to the extent of the Section 956 inclusion. Thus, in the example described in the preceding paragraph, the U.S. shareholder would simply include $99 of income under Section 956 and it would not recognize any income or make any basis adjustments in respect of the loan to the foreign partnership, the distribution of the loan proceeds to the U.S. partner or the repayment of the loan. Under this approach, the portion of the loan that triggers a Section 956 inclusion would effectively be treated as if made directly to the U.S. shareholder and the subchapter K rules would accordingly not apply to that portion of the loan. While this approach seems to be the most conceptually correct approach, it would create administrative difficulties if the Section 956 inclusion occurs in a year that is after the year in which the loan from the CFC is made (e.g., if the cash is not distributed to the U.S. shareholder in the year in which the loan is made) because the subchapter K rules would account for the loan in the year in which the loan is made. This could be addressed through corrective allocations that could be made in the year in which the Section 956 inclusion is recognized, thereby avoiding the double inclusion problem that is described above.

Second, the regulations could provide that a partner's basis in a partnership would not be decreased upon a Section 731 distribution by a foreign

partnership to a partner to the extent of the portion of the distribution that is treated as a deemed dividend by such partner under Section 956.

Third, the regulations could provide that a partner's basis in a partnership would not be decreased upon the repayment of a borrowing by the partnership to the extent of the portion of the distribution that is treated as a deemed dividend by such partner under Section 956.

4. Pledges and Guarantees

We also recommend that any guidance that is issued in this regard also clarity that the principles of Section 956(d) will apply where appropriate in order to treat a loan made by a third party to a foreign partnership in the same manner as if the CFC had made a loan to the foreign partnership. More specifically, Section 956(d) provides that a CFC will be treated as having made a loan to a U.S. person for Section 956 purposes to the extent that CFC guarantees the loan or otherwise provides credit support for the loan. Similarly, we think that a loan by a third party to a foreign partnership should be treated as a loan from the CFC to the foreign partnership for purposes of the conduit rules described above if the CFC guarantees the loan or otherwise provides credit support for the loan.[33]

5. Application of Other Anti-Abuse Rules

Finally, we acknowledge the possibility that a taxpayer might be able to craft a transaction in which a CFC effectively repatriates cash to a U.S. shareholder through a foreign partnership not technically subject to Section 956 under the proposed anti-abuse rule described above. We therefore recommend that the IRS clarify in any guidance that it issues regarding the application of Section 956 to foreign partnerships (such as in the preamble to any regulations that are issued) that it retains the right to challenge transactions that frustrate the legislative intent behind Section 956 even if the transaction is not technically subject to the specific anti-abuse rules in the Section 956

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33 The loan should, however, only be treated as a deemed loan by the CFC to a U.S. partner if one of the principal purposes for structuring the loan in this manner was to avoid the application of Section 956.

regulations. For example, the IRS could apply the Section 956 judicial and administrative guidance with respect to the phrase "directly or indirectly" in Section 951 that is described above or it could use its general authority under the partnership anti-abuse rules to challenge transactions in which a partnership is used in a manner that is inconsistent with the intent of subchapter K.[34]

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34 Treasury Regulations Section 1.701-2.