International Tax Watch

Treasury Finalizes Regulations Under Code Secs. 954 and 956

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I. Introduction

On November 2, 2016, Treasury and the IRS finalized the temporary and proposed regulations that had been published on September 2, 2015 (the *"Final Regulations"*). Temporary regulations were published under Code Sec. 954 and under Code Sec. 956 (the *"Temporary Regulations"*) and proposed regulations were published under Code Sec. 956 (the *"Proposed Regulations"*). Code Sec. 954 deals with the various categories of subpart F income, which is income that is subject to current U.S. taxation when earned by a controlled foreign corporation (a *"CFC"*).[1] One category of subpart F income is "foreign personal holding company income" (*"FPHCI"*), which generally includes passive-type income, such as rents and royalties.[2] However, rents and royalties that are derived from unrelated parties in connection with the active conduct of a trade or business are not FPHCI.[3] The Temporary Regulations under Code Sec. 954 concerned this exception from FPHCI. Code Sec. 956 subjects a U.S. shareholder to current taxation when a CFC invests its earnings in U.S. property. Treasury regulations in effect prior to the Temporary and Proposed Regulations implemented: (i) anti-abuse rules designed to prevent transactions that Treasury felt violated the purpose of Code Sec. 956 and (ii) very limited guidelines for the treatment of partnerships under Code Sec. 956. The main focus of the Temporary and Proposed Regulations was to broaden and add to the anti-abuse rules and to set forth a regime for the treatment of partnerships. We published two columns describing and analyzing the Temporary and Proposed Regulations and this column will focus on the changes made under the Final Regulations.[4]

II. Summary of the Temporary, Proposed and Final Regulations

The Final Regulations generally follow the Temporary and Proposed Regulations. Any differences are in the details that are explored in the next section. The following general summary, therefore, encompasses the Temporary, Proposed and Final Regulations.

A. Temporary Regulations Under Code Sec. 954

Under final regulations promulgated in 1995, the exception to FPHCI for active rents and royalties came in two flavors. There was a development exception and a marketing exception.[5] Generally, the development exception applied when a CFC: (i) developed, manufactured or added substantial value to leased or licensed property and (ii) when the CFC was regularly engaged in such activity. The marketing exception applied only when officers and employees of the CFC were regularly engaged in marketing activities (an *"Officer/Employee Requirement"*), marketing leases or licenses, and when the marketing function was substantial compared to the rent or royalty income earned by the CFC. The Temporary Regulations under Code Sec. 954 made two major changes. First, they imposed an Officer/Employee Requirement on the development exception[6] and, second, they clarified that in determining whether marketing activities were substantial, the CFC's activities across multiple jurisdictions were counted.[7] The Temporary Regulations further articulated that making payments under a cost sharing arrangement would not automatically qualify the payor as an active developer or marketer of leased or licensed property.[8]

The Final Regulations finalized the Temporary Regulations under Code Sec. 954 without material alteration and finalize the Temporary and Proposed Regulations under Code Sec. 956 with some meaningful changes.

B. Temporary Regulations Under Code Sec. 956

Prior to the Temporary Regulations, the regulations under Code Sec. 956 provided an anti-abuse rule under which a CFC was treated as owning U.S. property when the property was owned on the CFC's behalf by a trustee or nominee or by another foreign corporation controlled by the CFC "if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) the other foreign corporation [was] to avoid the application of section 956" (the *"Section 956 Anti-Abuse Rule"*).[9] The Section 956 Temporary Regulations made modifications to the Section 956 Anti-Abuse Rule and added another anti-abuse rule.

Modifying the Section 956 Anti-Abuse Rule, the Temporary Regulations added that creating, organizing or funding a foreign partnership would also trigger the rule. The Temporary Regulations also expanded the Section 956 Anti-Abuse Rule to apply more broadly to transactions with "a" principal purpose (rather than "the" principal purpose) to avoid Code Sec. 956 and to include a funding "by any means."[10] Finally, the Temporary Regulations added an example illustrating that a taxpayer can have a purpose to avoid Code Sec. 956 with respect to the CFC doing the funding even when there would be a full Code Sec. 956 inclusion with respect to the funded CFC.[11] For example, the Section 956 Anti-Abuse Rule applies when a low-tax CFC funds a high tax CFC, and that high-tax CFC then makes an investment in U.S. property. Without the Section 956 Anti-Abuse Rule, there would be a Code Sec. 956 inclusion with respect to the CFC with high-tax E & P, but there would be foreign tax credits to offset tax on the inclusion. The Temporary Regulations made it clear that such a transaction is caught by the Section 956 Anti-Abuse Rule.

The Temporary Regulations also added an anti-abuse rule that applies when: (1) a foreign partnership makes a distribution to a U.S. partner; (2) the distribution would not have been made but-for the funding of the partnership through an obligation held by a CFC; and (3) the CFC and the U.S. partner are related within the meaning of Code Sec. 954(d)(3) (the *"But-For Distribution Rule"*).[12] When the But-For Distribution Rule applies, the partnership's obligation held by the CFC is treated as U.S. property.

C. Proposed Regulations

The Proposed Regulations proposed rules of general application that apply to determine: (i) the amount of U.S. property held by a foreign partnership that is attributable to a CFC partner and (ii) the amount of a foreign partnership's liability obligations to CFCs that are treated as obligations of their U.S. owners. The rules apply an "aggregate" concept to partnerships (as opposed to an "entity" concept), treating partners as holders of the assets of the partnership and as obligors with respect to the partnership's liabilities. The Proposed Regulations treat a CFC partner in a partnership as holding its attributable share of U.S. property held by the partnership, determining such attributable share in accordance with the CFC partner's "liquidation value percentage" (*"LVP"* used for *"LVP Attribution"*).[13] A partner's LVP is determined by hypothesizing a constructive liquidation of the partnership and determining the percentage of all liquidating distributions that would go to each partner. An exception to this rule applies when the foreign partnership makes special allocations with respect to its U.S. property, as long as such allocations were not made with a principal purpose of avoiding Code Sec. 956 (the *"Special Allocation Rule"*). Under the Special Allocation rule, ownership attribution follows the special allocation, not LVP Attribution.

The Proposed Regulations also provided that an obligation of a foreign partnership is treated as separate obligations of each of its partners to the extent of each partner's share of the obligation.[14] Thus, for example, if a CFC made a loan to a partnership, the loan would be treated as U.S. property to the extent of any U.S. partner's share of the partnership's liability. An exception applies, however, when the partner is not a CFC or a person related to a CFC (under Code Sec. 954(d)(3)) to which Code Sec. 956 would have applied by virtue of such attribution. In such case, the obligations of a foreign partnership are not attributed to a partner.

III. Analysis of the Final Regulations

The Final Regulations do not make material changes to the Section 954 Temporary Regulations.[15] However, the Final Regulations do make significant changes to the Section 956 Temporary and Proposed Regulations. Those changes are analyzed below.

A. What Constitutes a "Funding"?

The Temporary Regulations expanded the Section 956 Anti-Abuse Rule's concept of "funding" to include a funding "by any means." Such a standard introduced substantial ambiguity as to which kinds of transactions may constitute a funding. Instead of dealing with this ambiguity by better defining the concept in the regulations, Treasury added three examples under Reg. §1.956-1(b)(4), Examples 4, 5 and 6.

In Example 4, a CFC's deposit with a third-party bank is considered a funding when the bank made a loan to a related CFC and the bank would not have made the loan but-for the deposit. This example follows the holding of Rev. Rul. 87-89[16] but takes the holding a step further. The revenue ruling contemplates a situation where a CFC deposits funds with a third-party bank and the bank makes a loan to the CFC's U.S. parent. The loan would not have been made but-for the CFC's deposit. The revenue ruling held that the loan is treated as a direct loan from the CFC to its U.S. parent. By ignoring the CFC's loan to its parent, the ruling creates additional questions of interpretation. Example 4 of the Final Regulations is a bit different, but the logic is the same. In Example 4, the depositing CFC is treated as making a loan to the borrowing CFC

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and the depositing CFC is treated as making a loan to its U.S. parent. As a result, in Example 4, the depositing CFC is treated as funding the borrowing CFC. It is important to note, however, that even if a deposit at a bank is a funding, it does not trigger the Section 956 Anti-Abuse Rule unless the deposit has a principal purpose to avoid Code Sec. 956.

In Example 5, a CFC's inventory sales to another CFC that are made in the ordinary course of business, on arm's-length terms, are not treated as a funding. In Example 6, a CFC's repayment of a loan borrowed from another CFC (on arm's-length terms) is not treated as a funding of the lending CFC by the borrowing CFC. The Treasury's examples conspicuously leave out dividend distributions. As we pointed out in a prior column, in our view, the term "funding" should not be read to include dividends.[17] However, it is unfortunate that Treasury decided not to provide its position on dividends in a clarifying example.

B. But-For Distribution Rule

As discussed above, the Temporary Regulations added a new anti-abuse rule, the But-For Distribution Rule. Generally speaking, this rule applies when a foreign partnership's obligation to a CFC is the "but-for" cause of the partnership's distribution to a U.S. partner that is related to the CFC. The "but-for" test is an extraordinarily ambiguous test. The Final Regulations recognize this ambiguity, adding a clarifying provision that only helps Treasury and the IRS.

Specifically, the Final Regulations add that if a partnership distributes "liquid assets" to a U.S. partner and, immediately prior to the distribution, the partnership would not have had sufficient liquid assets to make the distribution without taking into account an obligation held by a CFC, then the partnership's obligation to the CFC is deemed to be the but-for cause of the partnership's distribution (the *"Deemed But-For Cause Rule"*).[18] For example, if a foreign partnership does not have sufficient cash on hand to make a distribution and it borrows money from a CFC to make a distribution, the CFC loan is deemed to be the but-for cause of the distribution, even if the partnership was sufficiently credit worthy to have borrowed the funds from an unrelated third-party. When a foreign partnership has multiple obligations to a CFC, the Deemed But-For Cause Rule applies in reverse chronological order, beginning with the obligation closest in time to the distribution.[19] For the purpose of the Deemed But-For Cause Rule, liquid assets are: (1) cash; (2) cash equivalents; (3) marketable securities; (4) and obligations owed to a related person (where relatedness is determined under Code Sec. 954(d)(3)).[20]

The most important aspect of the Final Regulations, however, is that they bring into effect the rules for attributing a partnership's U.S. property to CFC partners and for treating partnership liabilities owed to CFCs as liabilities of the partnership's U.S. partners.

Unfortunately, the Deemed But-For Cause Rule does nothing to clarify the general ambiguity of the "but-for" test and such ambiguity remains as a significant issue. It was an issue commentators noted and that Treasury has not adequately addressed in the final regulations.

C. Rev. Rul. 90-112 Obsoleted

The progenitor of the rules for determining a CFC's indirect ownership of U.S. property through a partnership is Rev. Rul. 90-112.[21] The ruling largely took an aggregate approach, treating a CFC that was a 25-percent partner in a partnership as the 25-percent owner of the U.S. property held by the partnership. The ruling added one limitation, however, that was not constant with the aggregate approach. Specifically, in determining the portion of the U.S. property's basis attributable to the CFC partner (for Section 956 purposes), the amount of basis attributable to the CFC was not to exceed the CFC's basis in its partnership interest (the *"Outside Basis Limitation"*). Final regulations promulgated in 2002 had generally codified the holding of Rev. Rul. 90-112, but they did not mention the Outside Basis Limitation. Rev. Rul. 90-112 was not obsoleted, so the presumption was that the Outside Basis Limitation continued to apply. The Final Regulations formally obsolete Rev. Rul. 90-112 and explicitly reject the Outside Basis Limitation.[22]

D. Timing for Determination of LVP

The Final Regulations follow the Proposed Regulations in treating a CFC partner in a partnership as holding its attributable share of U.S. property held by the partnership, determining such CFC partner's attributable share in accordance with such partner's LVP. The manner for determining a partner's LVP is the same in both the Proposed and Final Regulations. The major change in the Final Regulations concerns the timing of the constructive liquidation that is used to determine a partner's LVP. Under the Proposed Regulations, the constructive liquidation was deemed to occur immediately after the partnership's most recent "revaluation event" (*e.g.*, a non-*de minimis* contribution, a partial/complete liquidation of a partner's interest and other specified events that impact the relative interest of the partners).[23] If the partnership never had a revaluation event, the constructive liquidation was deemed to have occurred immediately after the formation of the partnership. Thus, under the Proposed Regulations, a partner's share of a liquidating distribution may change; however, such partner's LVP would not change absent a revaluation event. A common situation where this may have been problematic is where a partnership agreement sets forth one sharing ratio for the partners at the outset that subsequently changes after a period of time. In such a circumstance, the change in sharing percentages is not a revaluation event, but it certainly affects the partners' share of the proceeds from a liquidation. To account for this, the Final Regulations add that if the most recently determined LVP for any partner differs from the partner's LVP on the first day of the current tax year by

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controversial. Another health care reform effort may have to wait until 2018, as many are projecting that tax reform efforts will use up the remainder of 2017.

ENDNOTE

1 H.R. 1628.

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more than 10 percentage points, then all of the partner's LVPs must be redetermined as of the first day of the current tax year.[24]

E. Special Allocation Rule

The Special Allocation Rule under the Proposed Regulations had provided that whenever an allocation of income or gain did not accord with a partners LVP, the rule for Special Allocations would apply instead of LVP Attribution.[25] The trouble with that formulation is that it would have caused the Special Allocation Rule to apply even when there were, conventionally speaking, no special allocations. For example, if one partner was entitled to a preferred return and a preference in liquidation, but the partners otherwise shared profits and losses based on a fixed percentage, the allocations made based on the fixed percentage would have been treated as a special allocation because they would not have been allocations in accordance with the partners' LVPs. However, the Final Regulations clarify that the Special Allocation Rule only applies "if a partnership agreement provides for the allocation of book income (or, where appropriate, book gain) from a subset of property of the partnership to a partner" that is not in accordance with the partner's LVP.[26] In other words, the rule only applies when there are special allocations. If income from all property is allocated in a manner that does not accord with LVP, then LVP Attribution applies, not the Special Allocation Rule.

The change in the Final Regulations is not a perfect fix because it leaves open questions how allocations work when there is a special allocation. For example, the Special Allocation Rule provides how it applies to property subject to the special allocation, but it does not explain how the remainder of the partnership's property is dealt with. It does not explain, for example, whether or not LVP is modified to remove the special allocation property from the LVP calculation. Moreover, arguably, if there are special allocations with respect to one property, the remaining partnership property is a "subset" of property which is not allocated according to LVP. In that case, if a partnership makes any special allocations, arguably, all partnership property is subject to the Special Allocation Rule. In sum, the Final Regulations reduce but do not eliminate the ambiguity concerning the interaction between the general rule that is based on LVP and the Special Allocation Rule.

Another important note regarding the Special Allocation Rule is that the Final Regulations are accompanied by additional proposed regulations. Under the Proposed Regulations, the Special Allocation Rule would not apply to partnerships where the partners are commonly controlled through chains of 80 percent or greater common ownership.[27] The Treasury's reasoning for the proposal is its belief that in such a context, it is unlikely that special allocations will have true economic significance and that it is more likely that such special allocations' only purpose is inappropriate tax planning.[28]

F. Allocation of Partnership Liabilities Between Partners

As discussed above, the Proposed Regulations proposed rules under which an obligation of a foreign partnership is treated as separate obligations of each of its partners to the extent of each partner's share of the obligation. For the purpose of this rule, under the Proposed Regulations, a partner's share of the partnership's obligation was not determined using LVP. Rather, the partner's share of the obligation was determined in accordance with the partner's interest in partnership profits, taking into account all facts and circumstances relating to the economic arrangement of the partners.[29] As we noted in our prior column, it seemed very odd for LVP to be used to attribute partnership assets to partners, but not to be used to allocate partnership liabilities between partners.[30] The Treasury agreed with this critique and, accordingly, for Code Sec. 956 purposes, the Final Regulations allocate partnership liabilities between partners based on LVP.[31]

IV. Conclusion

The Final Regulations finalized the Temporary Regulations under Code Sec. 954 without material alteration and finalized the Temporary and Proposed Regulations under Code Sec. 956 with some meaningful changes. Many of the changes clarify and streamline the Final Regulations. However, ambiguities remain, especially with respect to the anti-abuse provisions introduced in the Temporary Regulations. Specifically, Treasury declined to clarify the guidelines for what constitutes a "funding" for the purpose of the Section 956 Anti-Abuse Rule or what constitutes a "but-for" cause for the purpose of the But-For Distribution Rule. The most important aspect of the Final Regulations, however, is that they bring into effect the rules for attributing a partnership's U.S. property to CFC partners and for treating partnership liabilities owed to CFCs as liabilities of the partnership's U.S. partners.

ENDNOTES

1 *See* Code Secs. 951(a); 952(a)(2); 954(a)(1).
2 Code Sec. 954(c)(1).
3 Code Sec. 954(c)(2).
4 John D. McDonald, et al., *IRS Modifies Active Lease and Licensing Regulations*, TAXES, November 2015, at 7 (hereinafter the "954 Article"); John D. McDonald, et al., *The IRS Issues New Code Sec. 956 Regulations*, TAXES, January 2016, at 7 (hereinafter the "956 Article").
5 Reg. §1.954-2(c) and (d) (1995).
6 Temporary Reg. §1.954-2(c) and (d) (1995); *see also* T.D. 9733 (Sept. 1, 2015).
7 *See supra* note 7.
8 *See supra* note 7.
9 Temporary Reg. §1.956-1T(b)(4)(i)(B) (2015).
10 *Id.*
11 *See* T.D. 9733 (Sept. 1, 2015); Temporary Reg. §1.956-1T(b)(4)(3), Ex. 3 (2015).
12 Temporary Reg. §1.956-1T(b)(5) (2015).
13 Proposed Reg. §1.956-4(b) (2015).
14 Proposed Reg. §1.956-4(c) (2015).
15 *See* Reg. §1.954-2(c) and (d); *see also* T.D. 9792 (Nov. 2, 2016).
16 Rev. Rul. 87-89, 1987-2 CB 195.
17 *See* 956 Article at 10.
18 Reg. §1.956-4(c)(3)(ii)(A).
19 Reg. §1.956-4(c)(3)(ii)(B).
20 Reg. §1.956-4(c)(3)(ii)(D).
21 Rev. Rul. 90-112, 1990-2 CB 186.
22 *See* T.D. 9702 (Nov. 2, 2016).
23 Proposed Reg. §1.956-4(b) (2015); *see also* Reg. §§1.704-1(b)(2)(iv)(f)(5) and 1.704-1(b)(2)(iv)(s)(1) (describing what constitutes a revaluation event).
24 Reg. §1.956-4(b)(2)(i)(B).
25 Proposed Reg. §1.956-4(b)(2)(ii) (2015).
26 Reg. §1.956-4(b)(2)(ii).
27 Proposed Reg. §1.956-4(b)(2).
28 T.D. 9702 (Nov. 2, 2016).
29 Proposed Reg. §1.956-4(c)(1).
30 956 Article at 14.
31 Reg. §1.956-4(c)(1).

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8379 was not filed with the original tax return, the IRS instructs a taxpayer to submit a paper Form 8379 to any one of the 10 IRS campuses based on where the taxpayer filed the original return.[34]

Limitations can be a factor. Code Sec. 6511(a) limits the time in which a taxpayer can file a claim for refund and provides:

> Claim for credit or refund of an overpayment of any tax imposed by this title in respect of which tax the taxpayer is required to file a return shall be filed by the taxpayer within 3 years from the time the return was filed or 2 years from the time the tax was paid, whichever of such periods expires the later, or if no return was filed by the taxpayer, within 2 years from the time the tax was paid.[35]

In *Kathleen Hall–Ditchfield*,[36] the wife-plaintiff sued the United States alleging injured spouse relief when the IRS withheld tax refunds that would have otherwise been refunded to the couple and applied it to back Federal taxes that the husband, but not the wife, owed for the applicable tax years.[37] The IRS withheld refunds for three tax years, 1999, 2000 and 2001, and applied it to the husband's back taxes. The wife-plaintiff alleged she was entitled to injured spouse relief because the tax years for which the IRS withheld the refund, she was the sole source of marital income. In April 2005, the wife-plaintiff filed three copies of Form 8379, one for each applicable tax year, and requested return of overpaid tax. In response, the IRS stated that the plaintiff failed to file the forms within the three-year statute of limitations period and denied her claim as to those tax years. Applying Code Sec. 6511(a) to determine whether her claim was timely, the court explained:

> The plaintiff alleges that she filed her Forms 8379 with the IRS on April 23, 2005, and she attaches those forms. A claim filed on that date would be timely if the tax return at issue [was] filed any time on or after April 23, 2002, or the tax [was] paid any time on or after April 23, 2003.[38]

The court held that because plaintiff filed her tax returns outside of the time required by Code Sec. 6511(a), she was time barred from bringing an injured spouse claim and dismissed her claim with prejudice.[39]

Conclusion

The IRS has a potent tax collection tool in the refund offset and uses it extensively. The refund offset is distinguished from a levy, though the IRS often uses a notice of levy as a form of communication to other agencies, thus confusing the distinction. The courts have, for the most part, not allowed the due process system attributable to levies to be invoked even when the form of levy is used as the refund offset communication. A common situation involving a refund offset is a husband-wife, current or former and one of the spouses is innocent. The IRS has attempted to provide procedures to deal with these reasonably complicated situations by delineating when the innocent spouse can escape the clutches of the refund offset.