

I.R.S. PROPOSES NEW PARTNERSHIP RULES UNDER CODE §956

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The I.R.S. recently released temporary and proposed regulations to limit the use of foreign partnerships to avoid income inclusions under Code §956.

BACKGROUND

A U.S. shareholder who owns 10% or more of the voting shares of a controlled foreign corporation (“C.F.C.”) must include in gross income the amount of the C.F.C.’s earnings invested in U.S. property to the extent such earnings have not already been included in the shareholder’s income.¹

U.S. property generally includes obligations of related U.S. persons. For the purposes of Code §956, an “obligation” may be a bond, note, debenture, certificate, bill receivable, account receivable, note receivable, open account, or other indebtedness, whether or not issued at a discount and whether or not bearing interest.² Consequently, if a C.F.C. loans funds to a related U.S. person, the U.S. shareholder of the C.F.C. must include the amount of the loan in income to the extent it has not already done so in prior years. If the amount of the loan increases during the year, the increase in the loan is the amount included in the income of the U.S. shareholder.

The amount of the inclusion is limited to the earnings of the C.F.C.³ However, under an anti-abuse rule (the “Principal Purpose Rule”), one C.F.C. can be considered to hold U.S. property acquired by another C.F.C. if one of the principal purposes is to avoid Code §956.⁴ Therefore, an inclusion cannot be avoided by funneling the investment in the U.S. property through an entity that has little or no earnings.

EXISTING RULES FOR PARTNERSHIPS

If a C.F.C. is a partner in a partnership that owns property that would be U.S. property if owned directly by the C.F.C., the C.F.C. is treated as holding a proportionate interest in the property equal to its interest in the partnership (the “Proportionate Interest Rule”).⁵

¹ Code §§951 and 956.

² Treas. Reg. §1.956-2T(d)(2).

³ Code §§956(a)(2) and (b)(1).

⁴ Treas. Reg. §1.956-1T(b)(4).

⁵ Treas. Reg. §1.956-2(a)(3).

TEMPORARY REGULATIONS

The Temporary Regulations⁶ provide a number of new rules that are not limited to the application of Code §956 for partnerships.⁷ However, in this article we limit our discussion to the new rules for partnerships under Code §956.

The Principal Purpose Rule discussed above only applied to C.F.C.'s and not to partnerships. The Temporary Regulations expand the Principal Purpose Rule to partnerships that are controlled by C.F.C.'s. Thus, if a principal purpose of acquiring U.S. property through a partnership that is controlled by a C.F.C. is to avoid Code §956, the C.F.C. will be treated as holding the U.S. property.

However, because the C.F.C. may already be treated as holding a portion of the U.S. property owned by the partnership under the Proportionate Interest Rule discussed above, a coordination rule is provided so that the Principal Purpose Rule applied to the partnership will only cause the C.F.C. to hold the U.S. property to the extent it exceeds the amount already treated as held under the Proportionate Interest Rule.

The Temporary Regulations also provide a new rule for foreign partnerships funded by C.F.C.'s. Where a C.F.C. funds a foreign partnership (or guarantees a borrowing by a foreign partnership) and the foreign partnership makes a distribution to a U.S. partner that is related to the C.F.C., the partnership obligation is treated as an obligation of the distributee U.S. partner (the "Temporary Regulation Fund & Distribution Rule"). Consequently, even though the C.F.C. does not directly or indirectly hold an obligation of a related U.S. person, the funding/distribution is treated as though the C.F.C. acquired an obligation of a related U.S. person. This rule is subject to some limitations, and it will be removed when the Proposed Regulations (discussed next) are finalized.

The Temporary Regulations generally apply to taxable years of C.F.C.'s ending on or after September 2, 2015.

PROPOSED REGULATIONS

The Proposed Regulations have a number of new rules, including:

- The Foreign Partnership Obligation Look-Through to Partners Rule,⁸
- The Partnership Guarantee of an Obligation of a U.S. Person Rule,⁹

⁶ Treasury Decision 9733.

⁷ See, for example, our article in this issue of *Insights*, "[Temporary Regulations Alter C.F.C.'s Active Rents and Royalties Exception to Subpart F.](#)" discussing new rules for the active rents and royalties exception to foreign personal holding company income.

⁸ Prop. Reg. §1.956-4(c)(1).

⁹ Prop. Reg. §1.956-2(c)(1).



- The Foreign Partnership Fund & Distribution Rule,¹⁰ and
- The C.F.C. Partner’s Liquidation Value Percentage Rule.¹¹

The Foreign Partnership Obligation Look-Through to Partners Rule

Under the Foreign Partnership Obligation Look-Through to Partners Rule, an obligation of a foreign partnership is treated as an obligation of the partners to the extent of each partner’s share of the obligation as determined in accordance with the partner’s interest in partnership profits. For example, if a C.F.C. loans \$100 to a foreign partnership and the U.S. shareholder of the C.F.C. owns 50% of the foreign partnership, the C.F.C.’s loan to the foreign partnership is treated as \$50 of U.S. property. The Foreign Partnership Obligation Look-Through to Partners Rule does not apply where neither the C.F.C. nor any person related to the C.F.C. is a partner in the partnership.¹²

The Partnership Guarantee of an Obligation of a U.S. Person Rule

The Partnership Guarantee of an Obligation of a U.S. Person Rule applies to both domestic and foreign partnerships. Under this rule, any obligation of a U.S. person with respect to which a partnership is a pledgor or guarantor will be considered to be held by the partnership.¹³ For example, assume a C.F.C. is a partner in a foreign or domestic partnership. If the partnership guarantees a loan for the U.S. parent, the C.F.C. will be treated as holding a share of the obligation.

This guarantee rule previously only applied to C.F.C.’s. The new rule continues to apply to C.F.C.’s, and under the Proposed Regulations would be extended to partnerships. The look-through to partners rule, combined with the guarantee rule, can create an investment in U.S. property where a C.F.C. guarantees the debt of a foreign partnership. For example, assume a foreign partnership borrows \$100 from a bank, and a C.F.C. (that may or may not be a partner in the partnership) guarantees the bank debt. If the U.S. shareholder of the C.F.C. owns 50% of the foreign partnership, the C.F.C.’s guarantee of the bank loan causes the C.F.C. to be treated as holding \$50 of U.S. property.

The Foreign Partnership Fund & Distribution Rule

The Foreign Partnership Fund & Distribution Rule is similar to, but not the same as, the Temporary Regulation Fund & Distribution Rule discussed above. The Foreign Partnership Fund & Distribution Rule increases the amount of a foreign partnership’s obligation that is treated as U.S. property when the following requirements are satisfied:

1. A C.F.C. lends funds (or guarantees a loan) to a foreign partnership whose obligation is U.S. property with respect to the C.F.C. pursuant to proposed §1.956-4(c)(1);

¹⁰ Prop. Reg. §1.956-4(c)(3).

¹¹ Prop. Reg. §1.956-4(b).

¹² Prop. Reg. §1.956-4(c)(2).

¹³ Prop. Reg. §1.956-2(c)(1).

“The look-through to partners rule, combined with the guarantee rule, can create an investment in U.S. property where a C.F.C. guarantees the debt of a foreign partnership.”

2. The partnership distributes the proceeds to a partner that is related to the C.F.C. and whose obligation would be U.S. property if held by the C.F.C.;
3. The foreign partnership would not have made the distribution but for a funding of the partnership through an obligation held (or treated as held) by the C.F.C.; and
4. The distribution exceeds the partner's share of the partnership obligation as determined in accordance with the partner's interest in partnership profits.

For example, assume a U.S. shareholder of a C.F.C. that is related to the C.F.C. has a 60% interest in the profits of a foreign partnership and the C.F.C. lends \$100 to the partnership. If the partnership, in turn, distributes \$100 to the U.S. shareholder in a distribution that would not have been made but for the funding by the C.F.C., the C.F.C. will be treated as holding U.S. property in the amount of \$100. As mentioned above, when this is finalized, the comparable rule in the Temporary Regulations will be removed.

The C.F.C. Partner's Liquidation Value Percentage Rule

Under the existing Proportionate Interest Rule¹⁴ (discussed above), the current regulations do not provide a method for how to measure the C.F.C.'s proportionate interest in the partnership. Under the Proposed Regulations, a C.F.C. partner will be treated as holding its share of partnership property determined in accordance with the C.F.C. partner's "liquidation value percentage." Very generally, the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if the partnership sold all of its assets for cash equal to the fair market value of such assets, satisfied all of its liabilities, and then liquidated.

The Proposed Regulations are proposed to generally become effective after final regulations are published.

CONCLUSION

The Temporary and Proposed Regulations are intended to target transactions that the I.R.S. believes are contrary to the policies under Code §956. The Temporary Regulations are more limited in their scope while the Proposed Regulations are quite broad. If finalized in the current form, the Proposed Regulations would cause most C.F.C. loans to partnerships with related U.S. partners to be investments in U.S. property.

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¹⁴ Treas. Reg. §1.956-2(a)(3).