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Temporary Subpart F Regulations Change the Rules under Section 956 and the Active Rents and Royalties Exception; Proposed Section 956 Regulations Also Released

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On September 1, 2015, temporary subpart F regulations *with immediate effect* were released[1] that—

- Changed the "active rents and royalties exception" regulations on subpart F income.
- Changed the section 956 "anti-abuse" rule in Treas. Reg. §1.956-1T(b)(4).
- Added section 956 regulations that apply to a debt obligation held by a controlled foreign corporation (CFC) where the obligor is a foreign partnership, and the partnership has a U.S. partner.

Each of these provisions applies to taxable years of CFCs ending on or after September 1, 2015—i.e., to the current, as well as future, taxable years of CFCs now in existence.

Proposed section 956 regulations also released on September 1[2] cover other topics. Insofar as the Proposed Regulations would revise the determination, under current Treas. Reg. §1.956-2(a)(3), of a CFC partner's share of U.S. property owned indirectly through a partnership, they can be relied upon by taxpayers immediately.

As for matters covered by the proposed section 956 regulations and not the Temporary Regulations, when and if they become final they are not proposed to take effect until tax years of CFCs ending on or after the date final regulations are published in the Federal Register. Once they are final and in effect, in some cases they would apply only to property acquired, or pledges or guarantees entered into, after they are finalized, but in other cases would apply to property acquired or pledges or guarantees entered into, *on or after September 1, 2015.*

[1] T.D. 9733, 80 Fed. Reg. 52976 (Sept. 2, 2015) (the "temporary subpart F regulations" or "Temporary Regulations").

[2] REG-155164-09, 80 Fed. Reg. 53058 (Sept. 2, 2015) (the "proposed section 956 regulations" or "Proposed Regulations").

This alert is intended to provide an overview of key aspects of the temporary subpart F regulations, and the proposed section 956 regulations.

I. Temporary Subpart F Regulations

A. Active Rents and Royalties

The Temporary Regulations modify the so-called "developer exceptions" and "active marketing exceptions" in Treas. Reg. §1.954-2(c)(1)(i) and (iv) (for rents) and Treas. Reg. §1.954-2(d)(1)(i) and (ii) (for royalties) from the definition of foreign personal holding company income ("FPHCI").

1. Developer Exceptions

Prior to September 1, paragraphs (c)(1)(i) and (d)(1)(i) of Treas. Reg. §1.954-2 provided that rental and royalty income of a CFC were excluded from FPHCI if they were derived by the CFC from leasing or licensing property that the CFC has manufactured (in the case of leased property) or developed or created (in the case of licensed property), or produced, or has acquired and added substantial value to, but only if the CFC is regularly engaged in the manufacture (in the case of leased property) or development or creation (in the case of licensed property), or production of, or in the acquisition and addition of substantial value to, property of such kind.

In an effort to more clearly distinguish between passive investment income and active business income, the Temporary Regulations insert the words "through its own officers or staff of employees" three times in each of the paragraphs above. Thus, the new developer exceptions refer to property that the CFC*, through its own officers or staff of employees,* has manufactured or developed or created or produced, or has acquired and*, through its own officers or staff of employees,* added substantial value to, but only if the CFC*, through its own officers or staff of employees,* is regularly engaged in the manufacture or development or creation or production of, or in the acquisition of and addition of substantial value to, property of such kind.

In addition to adding these references, the Temporary Regulations provide that "CST Payments" (cost sharing transaction payments) and "PCT Payments" (platform contribution transaction payments) made by a CFC to another controlled participant in a cost sharing arrangement do not cause the activities undertaken by the other controlled participant to be considered to be undertaken by the CFC's own officers or staff of employees.[3]

These provisions are applicable to rents and royalties received or accrued during the taxable year of a CFC *ending* on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which such tax years end, but only with respect to property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after September 1, 2015.[4]

2. Active Marketing Exceptions

[3] Treas. Reg. §1.954-2T(c)(2)(viii).

[4] Treas. Reg. §1.954-2T(j).

a. Operations in multiple foreign countries

Prior to September 1, paragraphs (c)(1)(iv) and (d)(1)(ii) of Treas. Reg. §1.954-2 provided that rental and royalty income of a CFC were excluded from FPHCI if they were derived by the CFC from leasing or licensing property that is leased or licensed as a result of the performance of marketing functions by the CFC if the CFC, through its own officers or staff of employees located in *a foreign country*, maintains and operates an organization in *such country* that is regularly engaged in the business of marketing, or of marketing and servicing, the leased or licensed property and that is substantial in relation to the amount of rents or royalties derived from the leasing or licensing of such property.[5]

In an effort not to discriminate between rental or royalty streams based on whether or not the CFC operates in more than one foreign country, the Temporary Regulations insert references to multiple foreign countries in these paragraphs so that the active marketing exceptions apply if the CFC, through its own officers or staff of employees located in a foreign country *"or countries,"* maintains and operates a sufficiently substantial organization "*either"* in such (foreign) country "*or in such [foreign] countries (collectively), as applicable"* (emphasis added).

b. Substantiality safe harbor

Under prior and current regulations, the substantiality tests in the active marketing exceptions can be met either by facts and circumstances, or via a safe-harbor test. The safe harbor tests are met if "active leasing expenses" or "active licensing expenses" exceed a fixed percentage of "adjusted leasing profit" or "adjusted licensing profit." Consistent with the rule that CST Payments and PCT Payments do not cause the activities undertaken by another controlled participant in a cost sharing arrangement to be treated as undertaken by the CFC's own officers or staff of employees, the Temporary Regulations exclude deductions for CST Payments and PCT Payments in computing "active leasing expenses" and "active licensing expenses."

c. Effective date

These provisions are applicable to rents or royalties received or accrued during the taxable year of a CFC *ending* on or after September 1, 2015, and to taxable years of U.S. shareholders in which or with which such tax years end, but only to the extent that such rents or royalties are received or accrued on or after September 1, 2015.[6]

B. Section 956

Section 956 determines the amount that a U.S. shareholder includes in gross income with respect to a CFC under section 951(a)(1)(B). This amount is determined, in part, based on the amounts of United States property ("U.S. property") held by the CFC.

1. Changes to the Current Anti-Abuse Rule

[5] The effect, under Temporary Regulations, that a cost sharing arrangement has on the scope of the activities treated as undertaken by a CFC's own officers or staff of employees in the developer exception context applies equally in the active marketing exception context.

[6] Treas. Reg. §1.954-2T(j).

Prior to September 1, Treas. Reg. 1.956-1T(b)(4)(i)(B) provided that a CFC will be considered to hold indirectly, at the discretion of the District Director, investments in U.S. property acquired by any other *foreign corporation* that the CFC controls, "if one of the principal purposes of creating, organizing, or *funding (through capital contributions or debt)* such other *foreign corporation"* (emphasis added) is to avoid the application of section 956 with regard to the CFC.

The Temporary Regulations expand the scope of this rule in several ways—

- The rule now also applies if the U.S. property is acquired by a partnership controlled[7] by the CFC, rather than only if the property is acquired by a foreign corporation controlled by the CFC.[8]
- The rule now extends to cases where the funding that was done for section 956-avoidance purposes was funding "*by any means (including* through capital contributions or debt)" (emphasis added) (i.e., funding through a means *other than* capital contributions or debt).[9]
- The rule is now self-executing (i.e., it does not require an exercise of discretion by the District Director).[10]

In addition to these changes, subtle changes were made by the Temporary Regulations to the examples under Treas. Reg. §1.956-1T(b)(4), and two examples were added.[11]

These provisions are applicable to taxable years of a CFC ending on or after September 1, 2015, and to taxable years of U.S. shareholders in which such taxable years end, with respect to property acquired on or after September 1, 2015.[12] For purposes of this effective date, a deemed exchange of property pursuant to section 1001 on or after September 1, 2015 constitutes an acquisition of property on or after such date.[13] Thus, a modification to an existing debt can subject a debt owned prior to September 1, 2015 to these new Temporary Regulations.

2. Loans to Foreign Partnerships

[7] The Temporary Regulations modify the definition of "control" that appears in the prior version of the anti-abuse rule. It appears that there may be one or more typographical errors in this definition. If so, we would anticipate further clarification of the new definition upon correction.

[8] Under Treas. Reg. §1.956-2(a)(3), if a CFC is a partner in a partnership that owns property that would be treated as an investment in U.S. property if held directly by the CFC, then the CFC partner is treated as holding an interest in such property to the extent of its interest in the partnership. Under the Temporary Regulations, where a CFC controls a partnership and a principal purpose of creating, organizing or funding the partnership is to avoid section 956, and the partnership utilizes those funds to invest in U.S. property, the CFC partner is treated as indirectly owning *all* of such U.S. property held by the partnership, and not just a proportionate share.

[9] Treas. Reg. §1.956-1T(b)(4)(i)(B).

[10] Id.

[11] One added example illustrates that the funding and funded CFCs' *tax attributes* are taken into account when determining whether a principal purpose of the funding is to avoid the application of section 956 with regard to the funding CFC, and not just the relative amounts of applicable earnings at the CFCs.

[12] Treas. Reg. §1.956-1T(g)(1).

[13] Id.

One general category of "U.S. property" for section 956 purposes is "an obligation [i.e., a debt obligation] of a United States person."[14] A foreign partnership is not a United States person. The Temporary Regulations provide a new anti-abuse rule (Treas. Reg. §1.956-1T(b)(5)) that treats a CFC-owned obligation of a foreign partnership in some cases as an obligation of the partnership's partner (e.g., a partner that is a United States person).[15] Thus, to the extent that new Treas. Reg. §1.956-1T(b)(5) applies to the CFC-owned debt of a foreign partnership with a partner that is a U.S. shareholder in the CFC, the debt would generally constitute, at least in part, U.S. property owned by the CFC.

Under the Temporary Regulations a foreign partnership's obligation is treated as an obligation of a partner when (1) the foreign partnership makes a distribution to the partner; (2) "[t]he foreign partnership would not have made the distribution but for a funding of the partnership through the obligation;" and (3) the partner is related to the CFC under section 954(d)(3).[16] The obligation of the foreign partnership is treated as an obligation of a partner only to the extent of the lesser of the obligation held by the CFC *or* the amount of the distribution that would not have been made but for the partnership funding.[17]

This provision is applicable to taxable years of a CFC *ending* on or after September 1, 2015, and to taxable years of U.S. shareholders in which such taxable years end, in the case of distributions made on or after September 1, 2015.[18] Thus, to the extent a CFC owns the debt of a foreign partnership which made distributions to a partner prior to September 1, 2015, those prior distributions are not subject to the Temporary Regulations. However, distributions occurring on or after September 1, 2015 are subject to the Temporary Regulations, even if the CFC acquired the partnership's debt prior to September 1, 2015.

II. The Proposed Section 956 Regulations

Where a CFC holds the debt of a foreign partnership, the Proposed Regulations, if finalized, would result in an income inclusion in many more cases than under the new anti-abuse rule of Treas. Reg. §1.956-1T(b)(5). The Proposed Regulations would also significantly clarify and modify the current rule for determining the extent to which U.S. property held by a partnership results in a CFC partner in the partnership being treated as holding U.S. property. In addition, the Proposed Regulations provide rules with respect to pledges and guarantees of debts by partnerships, and obligations of disregarded entities.

A. Obligations of a Foreign Partnership

The Proposed Regulations contain rules which, if enacted, would replace the rule in the Temporary Regulations for determining when a CFC-held obligation of a foreign partnership results in the CFC being treated as holding U.S. property. Under the Proposed Regulations, an obligation of a foreign partnership would be

[14] See sections 956(c)(1)(C) and 7701(a)(30).

[15] Treas. Reg. §1.956-1T(b)(5).

[16] Id.

[17] Treas. Reg. §1.956-1T(b)(5)(ii).

[18] Treas. Reg. §1.956-1T(g).

treated as owed proportionally by the partners *regardless* of whether the partnership made any distributions to the partners (although partnership distributions may result in additional amounts of such obligations being treated as owed by the distributee partner).[19] A partner's share of a foreign partnership's obligation would be determined by reference to the partner's relative interest in the *profits* of the partnership.[20] Thus, in general, CFC-owned debt of a foreign partnership with only U.S. partners would be treated as CFC-owned debt of the U.S. partners.

An exception would apply where neither the CFC that holds the obligation nor any person related to the CFC is a partner in the obligor foreign partnership within the meaning of section 954(d)(3). In that case, the obligation will *not* be treated as an obligation of the partners.[21]

B. Section 956 Property Held through a Domestic or Foreign Partnership

Under the *Brown Group* regulations, if a CFC is a partner in a partnership that owns property that would be U.S. property if owned directly by the CFC, the CFC will be treated as holding an interest in the property equal to its interest in the partnership, and such interest will be treated as an investment in U.S. property.[22] The *Brown Group* regulations do not provide guidance for determining how to calculate a partner's interest in the partnership. The Proposed Regulations expand this one-sentence rule into a very detailed regulation, including examples, for determining a CFC-partner's interest in the partnership's U.S. property. The preamble to the Proposed Regulations provides that "*it generally would be reasonable to use the method set forth [in the Proposed Regulations] to determine a partner's interest in property acquired prior to finalization*."[23] Thus, the approach provided by the Proposed Regulations may immediately be relied upon by taxpayers as a reasonable method for determining a partner's indirect interest in a partnership's U.S. property.

Under the proposed regulations, the amount of a CFC partner's share of the partnership's U.S. property is determined by allocating the partnership's adjusted basis in the property among its partners. Basis is generally allocated to each partner based on its "liquidation value percentage."[24] In general, this percentage is based on a partner's relative rights to cash upon a hypothetical partnership liquidation. To the extent a partnership specially allocates income from partnership property, a partner's attributable share is determined solely by reference to the partner's special allocation with respect to the property, provided that the special allocation does not have a principal purpose of avoiding the purposes of section 956.[25]

The Proposed Regulations would also apply the foregoing rules to the question of when, under section 956(c)(3), a trade or service receivable acquired by a

[19] Prop. Reg. §1.956-4(c).

[20] Prop. Reg. §1.956-4(c)(1).

[21] Prop. Reg. §1.956-4(c)(2).

[22] Treas. Reg. §1.956-2(a)(3).

[23] 80 Fed. Reg. at 53063 (emphasis added).

[24] Prop. Reg. §1.956-4(b)(2)(i).

[25] Prop. Reg. §1.956-4(b)(2)(ii).

partnership in which a CFC is a partner will be treated as having been acquired by the CFC in a factoring transaction from a related United States person.[26]

C. Guarantees, Partnerships, and Disregarded Entities

The Proposed Regulations would revise the final regulations on the extent to which a pledge or guarantee of the obligation of a United States person would cause the obligation to be treated as held by a CFC.[27] Under the Proposed Regulations—

- A partnership would be treated as holding the obligation of a United States person if the partnership is a pledgor or guarantor of the obligation.

- A CFC would not be treated as the pledgor or guarantor of an *obligation* of a foreign partnership that is attributed to a U.S. partner simply because a portion of the partnership's *assets* are attributed to the CFC.

The preamble to the Proposed Regulations indicates that the Treasury and IRS are considering whether and how to address by regulations such cases in which multiple pledges and guarantees result in double-counting of the CFC holders of an obligation of a United States person, and invite comments on the issue.

Finally, the Proposed Regulations make explicit that an obligation of a disregarded entity is treated as an obligation of the owner of the disregarded entity.[28]

D. Effective Date

The Proposed Regulations are proposed to be effective for taxable years of CFCs ending on or after the date of publication of the final regulations, and taxable years of U.S. shareholders in which or with which such taxable year end.[29] However, most of the rules would apply to property acquired or pledges or guarantees entered into or after September 1, 2015.[30] For purposes of the effective date, a significant modification, within the meaning of Treas. Reg. §1.1001-3(e), of an obligation on or after September 1, 2015 is treated as an acquisition of such obligation on or after the effective date. Thus, taxpayers wishing to confirm that their organizational structures and loans to a partnership are not subject to the Proposed Regulations upon finalization should consider these Proposed Regulations and the provisions of Treas. Reg. §1.1001-3(e) before significantly modifying any existing debt of a partnership.

[26] Prop. Reg. §1.956-3(a)(ii).

[27] Prop. Reg. §1.956-2(c); Prop. Reg. §1.956-4(d).

[28] Prop. Reg. §1.956-2(a)(3).

[29] Prop. Reg. §1.956-4(f)(2).

[30] Id.