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Treasury Issues Final Regulations Under Section 956

On November 3, 2016, the Treasury issued final regulations (T.D. 9792) that set forth guidance on when a controlled foreign corporation (CFC) has a deemed repatriation under Section 956 in connection with transactions involving partnerships. These final regulations largely adopt temporary and proposed regulations issued in September 2015. The changes made by the final regulations were generally not substantive but rather are primarily intended to address the clarity and administration of the rules.

Background

Under Section 956, certain amounts may be required to be included in the gross income of a U.S. shareholder (defined in Section 951(b)) of a CFC (defined in Section 957(a)), including their pro rata share of certain types of income of CFCs and certain investments of CFCs in U.S. property (whether direct or indirect). The temporary and proposed regulations issued in September 2015 addressed indirect investments in U.S. property through other corporations and foreign partnerships. In general, the effect of the now finalized regulations will be to increase the circumstances under which a CFC may be treated as holding U.S. property, which in turn increases the possibility that the U.S. shareholders of the CFC will have an income inclusion under Section 951. In particular, the rules in the proposed regulations that treat obligations of a foreign partnership as obligations of its partners represent a significant expansion of Section 956's reach. U.S. property includes loans to U.S. persons, so under these rules a loan by a foreign partnership with a CFC partner to a U.S. person could result in a deemed repatriation to the U.S. shareholders of the CFC.

Section 956(e) authorizes regulations necessary to carry out the purposes of Section 956, including to prevent the avoidance of that section. Under the anti-avoidance rule (Reg. § 1.956-1T(b)(4)), a CFC will be considered to indirectly hold investments in U.S. property acquired by any other foreign corporation that is controlled by the CFC if one of the principal purposes for creating, organizing or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of Section 956 to the CFC.

Anti-Avoidance Rule: Reg. 1.956-1(b)

The 2015 proposed regulations modified the temporary anti-avoidance rule under Section 956 so that it could apply when a foreign corporation controlled by a CFC is funded other than through capital contributions or debt. For instance, a CFC may be treated as holding U.S. property as a result of a deposit with an unrelated bank if the unrelated bank would not have made a loan to another person on the same terms without the CFC's deposit. Commentators expressed concern that this could result in common business transactions being subject to the anti-avoidance rule. Although the IRS did not change the rule in response to these comments, examples were added to the final regulations to clarify that certain common transactions, such as a repayment of an existing payable, would not be treated as a "funding" for purposes of the anti-avoidance rule.

In addition, the 2015 proposed regulations expanded the anti-avoidance rule to apply to transactions involving partnerships that are controlled by a CFC that provides funding to the partnership. A coordination rule protected a CFC from being treated as holding duplicative amounts of U.S. property as a result of a single partnership interest. The final regulations expand the coordination rule to prevent a CFC from being treated as holding duplicative amounts of U.S. property under the anti-avoidance rule as a result of a partnership obligation and provide an example to illustrate the application of the coordination rule.

Partnership Property Indirectly Held by a CFC Partner: Reg. 1.956-4(b)

Generally the amount of the Section 956 inclusion is the adjusted basis of the CFC in the U.S. property. Under the 2015 proposed regulations, a CFC partner in a partnership is treated as holding its attributable share of property held by the partnership and, for purposes of Section 956, a partner's adjusted basis in the property of the partnership equals the partner's attributable share of the partnership's adjusted basis in the property. In addition, a CFC partner's attributable share of partnership property is determined in accordance with the CFC partner's liquidation value percentage (LVP) of the partnership, unless the partnership agreement contains a special allocation of income (or, where appropriate, gain) to a particular item or items of partnership property that differs from the partner's LVP in a particular tax year. In that case, the partner's attributable share of the property is determined solely by reference to the partner's special allocation of the property, provided the special allocation does not have a principal purpose of avoiding Section 956.

Revenue Ruling 90-112's outside basis limitation

Revenue Ruling 90-112 also addresses the treatment under Section 956 of U.S. property held by a CFC indirectly through a partnership. However, the revenue ruling provides that the amount of U.S. property taken into account for purposes of Section 956 when a CFC partner indirectly owns property through a partnership is limited by the CFC's adjusted basis in the partnership. The IRS and Treasury concluded that the correct measurement of basis is the adjusted basis in the hands of the partnership and the outside basis limitation should not be included in the final (or proposed) regulations. Therefore, the revenue ruling is obsolete effective November 3, 2016. For tax years ending before that date, taxpayers may rely on the basis limitation provided in the revenue ruling.

Consistent use of the LVP method and time for determining the LVP

The 2015 proposed regulations provide that a CFC partner's share of partnership property is determined based on the partner's LVP, while the partner's share of a partnership obligation is determined in accordance with the partner's interest in partnership profits. The final regulations use the LVP method for both. The 2015 proposed regulations provide that the LVP of partners in a partnership should be determined upon formation and upon the occurrence of certain "reevaluation events" described in Reg. § 1.704-1(b)(2)(iv)(f)(5) or Reg. § 1.704-1(b)(2)(iv)(s)(1). The final regulations retain these rules and add the requirement that a partner's LVP also be redetermined if on the first day of the partnership's taxable year the LVP for any partner would differ from the most recently determined LVP of that partner by more than 10 percent.

Special allocations

The 2015 proposed regulations define a special allocation as an allocation of income (or, where appropriate, gain) from partnership property to a partner under a partnership agreement that differs from the partner's LVP in a particular taxable year. The final regulations clarify that a special allocation is an allocation of book income or gain, rather than a tax allocation such as the allocations required under Section 704(c). In addition, the final regulations clarify that, for purposes of these regulations, a special allocation means only an allocation of income (or, where appropriate, gain) from a subset of the property of the partnership to a partner other than in accordance with the partner's LVP in a particular tax year.

Obligations of Foreign Partnerships

The general rule in the final regulations adopts an aggregate approach that treats an obligation of a foreign partnership as a separate obligation of each partner in proportion to the partners' interest in partnership profits (determined under the LVP method). Treasury was not persuaded by taxpayer comments that the aggregate approach was overbroad and not consistent with the policy underlying Section 956. The partner's share of a U.S. obligation can be greater than its LVP percentage if the partnership distributes cash to the partner exceeding that amount.

Effective Dates

The anti-avoidance rules apply to tax years of CFCs ending on or after September 1, 2015, and to tax years of U.S. shareholders in which or with which such tax years end, for property acquired, including property treated as acquired as the result of a deemed exchange of property pursuant to Section 1001, on or after September 1, 2015. The remaining rules apply to tax years of CFCs ending on or after November 3, 2016, and tax years of U.S. shareholders in which or with which such tax years end.

For more information, please contact Sam Kaywood at 404.881.7481 or Matthew Moseley at 202.239.3828.

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