



# TaxNewsFlash

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## KPMG report: Ownership-attribution rules for CFC related persons; rents from active conduct of trade or business (proposed regulations)

Proposed regulations (REG-125135-15) under sections 954 relating to the definition of “related person” for foreign base company income (FBCI) purposes, and the active rent exception for foreign personal holding company income (FPHCI) purposes appear in today’s edition of the Federal Register.

Read the text of the [proposed regulations](#) [PDF 298 KB] from the U.S. Treasury Department and IRS and published in the Federal Register on May 20, 2019.

This report provides initial impressions and observations about these proposed rules.

### Background

Section 954(d)(3) defines “related person” for purposes of the FBCI rules in section 954, as well as a number of other provisions in subpart F and outside of subpart F. In general, a person is a related person with respect to a controlled foreign corporation (CFC) if the person controls or is controlled by the CFC, or is controlled by the same person that controls the CFC. Control is determined based on a “more than 50%” ownership standard. For this purpose, the statute provides that “rules similar to” the section 958 constructive ownership rules apply in determining ownership.

Section 958(b) and the underlying regulations generally apply the section 318(a) constructive ownership rules, with certain modifications. In general, under these rules, stock owned by a partner is treated as owned by a partnership—regardless of the partner’s ownership in the partnership. Similarly, stock owned by any beneficiary of a trust is treated as owned by the trust. On the other hand, stock owned by a shareholder is treated as owned by a corporation only if the shareholder owns at least 50% of the value of the corporation. In addition, an option holder is treated as owning the underlying stock for purposes of determining whether a person is a related person.

Under section 954(c)(6), dividends, interest, rents, and royalties received or accrued by a CFC from a CFC that is a related person (as defined in section 954(d)(3)) generally are excluded from FPHCI to the

extent attributable to income of the related person that is neither subpart F income nor income that is effectively connected with a U.S. trade or business. Section 954(c)(6) is applicable to tax years of foreign corporations beginning after December 31, 2005, and before January 1, 2020.

In early 2007, the IRS issued Notice 2007-9 that describes rules expected to be incorporated into regulations, including an anti-abuse rule related to the use of options or interests similar to options. Notice 2007-9 provides that the option anti-abuse rule (as described in the notice) is effective for tax years of foreign corporations beginning after December 31, 2006.

Rent generally is included in FPHCI unless an exception applies. Under section 954(c)(2), rent derived in the active conduct of a trade or business and received from a person that is not a related person is excluded from FPHCI (“active rent exception”). The section 954 regulations provide the exclusive rules for satisfying the active rent exception—including rules relating to an active marketing exception. In relevant part, these rules contain a safe harbor for establishing the substantiality of an organization for purposes of applying the active marketing exception, which compares “active leasing expenses” with “adjusted leasing profit,” as defined in the regulations. For this purpose, rent paid by a sub-lessor CFC—that leases (rather than owns) the property that generates the rent—is not taken into account in determining active leasing expenses or adjusted leasing profit.

## **Overview of the proposed regulations**

### **Definition of “related person” in section 954(d)(3)**

The proposed regulations limit the application of the section 958(b) attribution rules for purposes of applying the section 954(d)(3) related-person rules in two ways.

- Under the proposed rules, the “downward attribution” rules in section 318(a)(3) do not apply for related-person determinations. As a result, stock owned by a partner, beneficiary, or shareholder is not treated as owned by a partnership, trust, or corporation. This rule is applicable for tax years of CFCs ending after the date the final regulations are published.
- Under an anti-abuse rule, the option attribution rules in section 318(a)(4) do not apply for related-person determinations in certain situations. Specifically, the holder of an option to acquire stock or an equity interest, or an interest similar to such option, is not treated as owning the underlying stock or equity interest if a principal purpose of acquiring the option or similar interest is to treat a person as a related person (“option anti-abuse rule”). This rule generally is applicable for tax years of CFCs ending after the date the final regulations are published. In addition, the proposed rule applies to tax years of CFCs ending on or after May 17, 2019, with respect to amounts that are received or accrued by the CFC on or after May 17, 2019, to the extent the amounts are received or accrued with a principal purpose of avoiding the application of the option anti-abuse rule.

### **KPMG observation**

Under the section 318(a)(3) downward attribution rules, the stock directly held by an owner and indirectly held through its entity is aggregated in determining stock ownership. This rule applies in all cases for partners and beneficiaries, and for all shareholders that own at least 50% of the corporation. Similar to the downward attribution rules, one prong of the related-party definition treats an entity as related to a CFC if the same person owns more than 50% of the entity and the CFC. Under both of these rules, stock ownership would not be reduced by separating the ownership of an entity between an owner and its entity, although the rules apply based on different ownership thresholds. In light of the similarity between the two statutory rules, the decision to turn off the downward attribution in the

proposed rule is a sensible choice because it effectively allows the more specific section 954(d)(3)(B) related-party rule to apply rather than the more general section 318(a)(3) downward attribution rules.

### **KPMG observation**

As described in the preamble to the proposed rules, a partnership, trust, or corporation can be treated as a related person with respect to a CFC owned by its partner, beneficiary, or shareholder under the related-person definition, even though the proposed rules prevent downward attribution. For example, if a partner owns 51% of a partnership and 51% of a CFC, the partnership would not be treated as controlling the CFC under the proposed rules because the partner's interest in the CFC would not be attributed down to the partnership. Nonetheless, the partnership would be a related person with respect to the CFC because the partner controls both the partnership and the CFC as a result of owning 51% of each entity.

### **KPMG observation**

The prohibition of downward attribution rules will result in fewer persons treated as related persons with respect to a CFC. This could have favorable or unfavorable consequences, depending on the underlying substantive rule and a taxpayer's facts and circumstances.

- For example, the proposed rule would limit the application of the foreign base company sales income and foreign base company services income rules that apply to transactions with related persons, which generally is favorable.
- On the other hand, the proposed rule would limit the income that can qualify for the section 954(c)(6) exception to FPHCI, which generally is unfavorable (unless the income is high-taxed income that can be excluded from both subpart F income and tested income for global intangible low-taxed income purposes, in which case the proposed rule is favorable).

### **Notice 2007-9 anti-abuse rule for options**

The proposed rules include the option anti-abuse rule described in Notice 2007-9.

- In determining whether a CFC's income is received or accrued from a related person for section 954(c)(6) purposes, the option attribution rules in section 318(a)(4) do not apply if a principal purpose of the use of the option or similar interest is to cause a foreign corporation to be a CFC in order to apply section 954(c)(6) ("section 954(c)(6) anti-abuse rule"). In that case, the holder of an option to acquire stock or an equity interest or an interest similar to an option is not treated as owning the underlying stock or equity interest
- The section 954(c)(6) anti-abuse rule applies to tax years of CFCs beginning after December 31, 2006, and ending before the date the final regulations are published. In addition, the proposed rule applies to tax years of CFCs ending on or after May 17, 2019, with respect to amounts that are received or accrued by the CFC on or after May 17, 2019, to the extent the amounts are received or accrued with a principal purpose of avoiding the application of the section 954(c)(6) anti-abuse rule.

### **KPMG observation**

The section 954(c)(6) anti-abuse rule and the option anti-abuse rule are largely similar, other than the narrow scope of the section 954(c)(6) rule and the time-frame during which the rules apply. The section 954(c)(6) anti-abuse rule essentially applies the option anti-abuse rule—solely for section 954(c)(6) purposes—for a period of time before the option anti-abuse rule becomes applicable. Based on Notice 2007-9, the rule applies for tax years that begin after December 31, 2006. The rule ceases to apply

when the option anti-abuse rule becomes applicable. At that point, the separate rule is unnecessary because transactions subject to the section 954(c)(6) anti-abuse rule would be subject to the option anti-abuse rule (which applies for section 954(c)(6) related-party determinations).

### **KPMG observation**

The issuance of the section 954(c)(6) anti-abuse rule raises questions as to whether other anti-abuse rules described in Notice 2007-9 also will be issued with retroactive applicability. The likelihood of Treasury issuing regulations described in the notice, including anti-abuse rules, may decrease over time, particularly if section 954(c)(6) is not extended to apply to tax years that begin after January 1, 2020.

### **Active rent exception**

For purposes of the active rent exception to FPHCI, the proposed rules exclude from active leasing expenses and adjusted leasing profit all amounts (including royalties and rents) paid or incurred by a CFC for the right to use the property that generated the rental income.

### **KPMG observation**

Under the current active rent exception regulations, rent paid by a CFC that leases property is not taken into account for purposes of determining active leasing expenses and adjusted leasing profit because the rent is not viewed as related to the organization (which is the subject of the substantiality safe harbor). The preamble to the proposed rules states that payments by the CFC for the right to use property should be treated consistently for this purpose, regardless of whether the payment is characterized as rent or royalty. Thus, the proposed rules extend the existing exclusion for rent to include all amounts paid by the CFC for the right to use the property that generates the rental income, including royalties. The proposed rules are viewed as a reasonable way to accomplish the goal of consistent treatment of CFCs that derive rental income from property that they do not own—the same general rules would apply regardless of whether the CFC itself licenses or leases the underlying property from another person.

### **Applicability dates and reliance**

The applicability dates for the proposed rules fall into three categories:

- Tax years of CFCs ending on or after the date the final regulations are published, for the general attribution rules for determining related persons and the active rent exception rules
- Tax years of CFCs beginning after December 31, 2006, and ending before the date the final regulations are published, for the section 954(c)(6) option anti-abuse rules
- Tax years of CFCs ending on or after May 17, 2019, with respect to amounts received or accrued by a CFC after May 17, 2019, for purposes of applying the option anti-abuse attribution rules

With respect to the general attribution rules that apply prospectively, a CFC is permitted to rely on the proposed rules for tax years ending before the final regulations are published, provided the CFC consistently applies all of the proposed rules. As a result, it appears that a U.S. shareholder does not need to consistently apply the proposed rules with respect to all of its CFCs, although each CFC needs to consistently apply the proposed rules for all purposes.

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