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Regulations: “United States property,” foreign partnerships, active rents and royalties

The U.S. Treasury Department and IRS today released for publication in the Federal Register final regulations (T.D. 9792) and by cross-reference, proposed regulations (REG-114734-16), concerning the treatment as “United States property” of certain property held by controlled foreign corporations (CFCs) in connection with transactions involving partnerships.

The final regulations also provide conforming updates to reflect the current law as well as rules for determining:

- Whether a CFC is considered to derive rents and royalties in the active conduct of a trade or business for purposes of determining foreign personal holding company income (FPHCI)

- Whether a CFC holds "United States property" as a result of certain related-party factoring transactions

Regulations that were proposed in September 2015 and in June 1988 are finalized, and corresponding temporary regulations are withdrawn.

Read text of today’s **final regulations** [PDF 287 KB] and the **proposed regulations** [PDF 205 KB]. Read also a related **notice of partial withdrawal** [PDF 175 KB] of the 1988 proposed regulations.

Today’s releases will be published in the Federal Register on November 3, 2016. Comments and requests for a public hearing concerning the proposed regulations are due 90 days after publication in the Federal Register. The effective date of the regulations is described at the end of this report.

Background

In September 2015, temporary and proposed regulations were issued under sections 954 and 956 that addressed a number of issues in the "Subpart F" regime, that provide that a CFC that is a partner in a partnership determines its share of "United States property" held by the partnership in accordance with the CFC's liquidation value percentage in the partnership, or based on a special allocation of income (or gain) from the property. Read an initial discussion of these 2015 regulations in ***TaxNewsFlash-United States***.

The preamble to today's final regulations explains that written comments were received on the proposed regulations under section 954. The final regulations adopt the proposed rules, with changes made in response to the comments received on the proposed rules. No changes were made in finalizing the regulations proposed under section 954.

Regulations (again, temporary and proposed) were issued in June 1988, and included guidance under section 956(c)(3) for treating as "United States property" certain trade or service receivables acquired by a CFC from a related U.S. person in certain factoring transactions. The preamble to today's final regulations explains that the regulations under section 956(c)(3) are finalized "without substantive change." The corresponding temporary regulations are withdrawn, as well as the portion of the 1988 proposed regulation that was finalized. The other portions of the 1988 proposed regulations remain in proposed form.

The preamble to the final regulations also announces that Rev. Rul. 90-112 that addressed the application of section 956 when a CFC is a partner in a partnership that holds property that would be "United States property" if owned directly by the CFC is withdrawn by today's releases.

Section 956—overview

Section 956 determines the amount that a "United States shareholder" of a CFC must include in gross income with respect to the CFC under section 951(a)(1)(B). This amount is determined, in part, based on the average of the amounts of "United States property" held, directly or indirectly, by the CFC at the close of each quarter during its tax year. The amount taken into account with respect to any "United States property" generally is the adjusted basis of the property, reduced by any liability to which the property is subject.

Section 956(e) grants the Secretary authority to prescribe such regulations as may be necessary to carry out the purposes of section 956, including regulations to prevent the avoidance of section 956 through reorganizations or otherwise.

Overview of 2016 final regulations

The preamble to today's final regulations explains that the regulations retain the basic approach and structure of the 2015 proposed regulations and the applicable portion of

the 1988 proposed regulations relating to the section 956 aspects of related-party factoring transactions, with certain revisions.

Among the changes made to the section 956 rules, the final regulations:

- Make conforming changes to Reg. section 1.956-1, reflecting statutory changes enacted in 1993, regarding the methodology for calculating the amount determined under section 956 with respect to a “United States shareholder” of a CFC

- Reject comments to revert to the "funding" language in the prior temporary regulations that addressed the section 956 anti-avoidance rule in Reg. section 1.956-1(b), or to define the term "funding." However the final regulations add new examples to illustrate when a "funding" can trigger the anti-avoidance rule. Two of the new examples address common transactions and illustrate the distinction between funding transactions that are subject to the anti-avoidance rule and common business transactions to which the anti-avoidance rule does not apply. For instance, a new example illustrates a sale of property for cash in the ordinary course of business and a repayment of a loan, to which the anti-avoidance rules does not apply. Another example is based on a situation described in Rev. Rul. 87-89, and illustrates that a CFC may be treated as holding “United States property” as a result of a deposit with an unrelated bank that would not have made a loan to another person on the same terms, absent the CFC’s deposit

- Re-designate an example that illustrates a coordination rule to prevent a CFC from being treated as holding duplicative amounts of “United States property” as a result of a single partnership interest

- Retain the application of the anti-avoidance rule in the case of a partnership in which the funding CFC is a partner

- Expand the coordination rule to prevent a CFC from being treated as holding duplicative amounts of “United States property” under the anti-avoidance rule as result of making a loan to the partnership, and add a new example to illustrate this provision

- Adopt rules that, as proposed to address the application of section 956 to property acquired by a CFC in certain related-party factoring transactions

- Provide that the outside basis limitation in Rev. Rul. 90-112, which limited a partner’s share of partnership property to the partner’s basis in its partnership interest, is not warranted and thus state that Rev. Rul. 90-112 is obsoleted (but taxpayers may rely on the outside basis limitation for tax years ending prior to these final regulations)

- Retain the liquidation value percentage method for determining a partner’s attributable share of partnership property as well as an exception when a partner’s allocation of income from a subset of partnership property is made other than in accordance with the partner’s liquidation value percentages in a particular tax year

and the allocation does not have a principal purpose of avoiding the purposes of section 956

- Provide that a partner's liquidation value percentage must be redetermined in certain additional circumstances—specifically if the liquidation value percentage for any partner on the first day of the partnership's tax year would differ from the most recently determined liquidation value percentage of that partner by more than 10 percentage points

- Revise the definition of "special allocations" to clarify that a special allocation is an allocation of section 704(b) book income or gain (not a tax allocation as required under section 704(c))

- Retain the aggregate approach that generally treats an obligation of a foreign partnership as an obligation of its partners

- Provide that the liquidation value percentage method is also to be used to determine a partner's share of a foreign partnership's obligation, both to conform the methods used for allocating partnership property and obligations (the proposed regulations had allocated partnership obligations based on the partner's interest in partnership profits) as well as to address potential complexity and uncertainty in calculating a partner's interest in partnership profits

- Retain the exception to the aggregate approach to exclude foreign partnerships in which neither the CFC that holds the partnership's obligation nor any person related to the CFC is a partner—obligations of such foreign partnerships are treated as obligations of non-United States persons

- Reject comments to expand the exception to the aggregate approach to also exclude foreign partnerships that act as a coordination center for a taxpayer's cash pooling system and foreign partnerships in which a United States person and its related persons own less than some de minimis interest in partnership profits and capital

- Added a new requirement to the special rule in the proposed regulation that applies when a foreign partnership uses the proceeds of a loan from a CFC to make a distribution to a partner related to the CFC, and the distribution would not have been made "but for" the loan. Under the final regulations, the foreign partnership is deemed to satisfy the "but for" requirement when it makes a distribution of liquid assets to the extent the foreign partnership did not have sufficient liquid assets to make the distribution immediately prior to the distribution, without taking into account the loan from the CFC

- Report that the IRS and Treasury are continuing to study comments concerning multiple inclusions under section 956(d)

KPMG observation—partnership items

Determining the liquidation value percentage

The regulations require that the liquidation value percentage of the partners be determined on any revaluation event (including post-non-compensatory option exercise revaluation events) even if the partnership does not, in fact, revalue. In addition, the partnership is required to redetermine the liquidation value percentage on the first day of the partnership's tax year if the liquidation value percentage of any partner would differ from the most recently determined one by 10 percentage points.

Effectively, this means that any partnership, when a CFC might have a share of "United States property" by reason of being a member of the partnership or by reason of loaning to the partnership, has to run a fair market value-based hypothetical liquidation every year on the first day of the year to determine the liquidation value percentage to be used for that year.

Applying the exception for special allocations

The definition of "special allocations" in Reg. section 1.956-4(b)(ii) uses the words "book income" or "book gain" but does not define it. Presumably, this means section 704(b) book income or gain since the preamble indicates the definition has been provided to make clear that section 704(c) allocations are not "special allocations" for purposes of this rule.

The special allocation exception is based on allocations that are in turn based on a "subset" of partnership property. In any case, therefore, when there are tracking allocations to different partnership activities, the special allocation exception will be the rule, rather than the liquidation value percentage, except for "controlled partnerships" following finalization of the proposed regulations.

The exception for special allocations does not define or provide guidance on what a partner's interest in profits is when there are varying interests in a property. The examples provide that the two partners share 80% and 20% in operating income and 20% and 80% in gains on sale. The facts of the example indicate that the property is "anticipated to appreciate in value but generate relatively little income." Based on this, the example states that "…given the income and gain anticipated with respect to the FPRS property", the partners' share of the property is based on the gain on sale provision. The regulations do not provide any guidance as to what factors are used to determine a partners' interest in profits for purposes of this rule when profits from the property can vary. The example infers that an expectation as to the relative shares of income may be determinative, but there is no rule provided—leaving application of this standard uncertain.

The special allocations rule ignores the partner's share of existing capital value in the property and focuses solely on future appreciation. The IRS and Treasury indicate in the preamble that a commentator pointed this out and provided an alternative rule that would determine a partner's share in the property based on capital value plus share of appreciation, but discounted this due to substantial administrative complexity, providing no alternative rule.

Overview of 2016 proposed regulations

The preamble to the proposed regulations reiterates that the IRS and Treasury have concluded that the liquidation value percentage method and the exception for certain special allocations provide a reasonable means of determining a partner's interest in property held by a partnership for purposes of section 956 because they generally result in an allocation of specific items of property that corresponds with each partner's economic interest in that property. However, as further explained, the IRS and Treasury are concerned that special allocations with respect to a partnership that is controlled by a single multinational group are unlikely to have economic significance for the group as a whole, and can facilitate tax planning that is inconsistent with the purposes of section 956. Accordingly, today's proposed regulations revise Reg. section 1.956-4(b) to provide that a partner's attributable share of each item of property of a partnership controlled by the partner would be determined solely in accordance with the partner's liquidation value percentage—even if income or gain from the property is subject to a special allocation.

Specifically, under Prop. Reg. section 1.956-4(b)(2)(iii), the exception in Reg. section 1.956-4(b)(2)(ii) for special allocations would not apply in the case of a partnership controlled by the partner. A partner would be treated as controlling a partnership if the partner and the partnership are related within the meaning of section 267(b) or section 707(b), but substituting "at least 80%" for "more than 50%". The examples in Reg. section 1.956-4(b)(3) are proposed to be modified in accordance with the proposed rule.

KPMG observation

The IRS and Treasury's concern that special allocations can facilitate inappropriate tax planning for section 956 purposes is consistent with the view expressed in Notice 2015-54 that in some cases partnership transactions involving special allocations can lead to inappropriate results. It is unclear whether the focus on special allocations is limited to controlled partnership transactions in the international context, or is part of a broader concern with special allocations for controlled partnerships in general.

Effective date for 2016 proposed regulations

These proposed regulations are proposed to be effective for tax years of CFCs ending on or after the date of publication in the Federal Register of the Treasury decision that finalizes the proposed regulations and tax years of "United States shareholders" in which or with which the tax years end, with respect to property acquired on or after the date of publication in the Federal Register of the Treasury decision adopting them as final regulations.

The preamble notes that the IRS may, when appropriate, challenge transactions under currently applicable Code or regulatory provisions or judicial doctrines.

Effective dates for 2016 final regulations

The preamble to the final regulations sets forth the following effective date provisions:

- The rules in Reg. section 1.954-2(c)(1)(i) and (d)(1)(i) (regarding the **active development test**) apply to rents or royalties, as applicable, received or accrued during tax years of CFCs ending on or after September 1, 2015, and to tax years of "United States 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.

- The rules in Reg. section 1.954-2(c)(1)(iv), (c)(2)(ii), (d)(1)(ii), and (d)(2)(ii) (regarding the **active marketing test**), as well as the rules in Reg. section 1.954-2(c)(2)(iii)(E), (c)(2)(viii), (d)(2)(iii)(E), and (d)(2)(v) (regarding **cost-sharing arrangements**), apply to rents or royalties, as applicable, received or accrued during tax years of CFCs ending on or after September 1, 2015, and to tax years of "United States shareholders" in which or with which the tax years end, to the extent that such rents or royalties are received or accrued on or after September 1, 2015.

- The section 956 **anti-avoidance rules** in Reg. section 1.956-1(b) apply to tax years of CFCs ending on or after September 1, 2015, and to tax years of "United States shareholders" in which or with which such tax years end, with respect to 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 rules regarding **factoring transactions** in Reg. section 1.956-3 (other than Reg. section 1.956-3(b)(2)(ii)) apply to trade or service receivables acquired (directly or indirectly) after March 1, 1984.

The remaining rules in the final regulations apply to tax years of CFCs ending on or after November 3, 2016 (the date of publication in the Federal Register) and tax years of "United States shareholders" in which or with which that tax years ends with respect to property acquired, obligations acquired or held, and pledges and guarantees entered into on different dates depending on the specific rule:

- The following rules apply to property or obligations acquired, or pledges or guarantees entered into, on or after September 1, 2015, including property or obligations (or pledges or guarantees) considered acquired or entered into on or after September 1, 2015, as a result of a deemed exchange under section 1001:

    - Reg. section 1.956-4(c) (dealing with **obligations of foreign partnerships**)

    - Reg. sections 1.956-2(c), 1.956-4(d), and 1.956-1(e)(2) (dealing with **pledges and guarantees**, including pledges and guarantees by a partnership and with respect to obligations of a foreign partnership); and

    - Reg. section 1.956-3(b)(2)(ii) (dealing with **trade and service receivables** acquired from related United States persons indirectly through nominees, pass-through entities, or related foreign corporations)

- The following rules apply to all obligations held on or after November 3, 2016:
    - Reg. section 1.956-2(a)(3) (treating an **obligation of a disregarded entity** as an obligation of its owner); and
    - Reg. section 1.956-4(e) (generally treating an **obligation of a domestic partnership** as an obligation of a United States person)
    - Reg. section 1.956-4(b) (dealing with **partnership property indirectly held** by a CFC) applies to property acquired on or after November 3, 2016.

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