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Memorandum**

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subject: Application of Treas. Reg. §1.956-1T(b)(4) to the CFC Partner 1 Loan

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

LEGEND

US Parent =

CFC Partners =

CFC Partner 1 =

CFC 2 =

FPS =

DE1 =

Date 1 =
Date 2 =

Year 1 =

Month 12 =

State =

Country 1 =
Country 2 =
Country 3 =

Amount 1 =
Amount 2 =
Amount 3 =

Quote 1 =

Quote 2 =

Quote 3 =

ISSUE

Whether, under Treas. Reg. §1.956-1T(b)(4), US Parent must include amounts in income under sections 951(a)(1)(B) and 956 as a result of the FPS Loan, for Tax Year 1?

CONCLUSION

Yes. Under Treas. Reg. §1.956-1T(b)(4), US Parent must include amounts in income under sections 951(a)(1)(B) and 956 as a result of the FPS Loan, for Tax Year 1.¹

FACTS

US Parent is a State corporation and the common parent of an affiliated group of corporations that file a consolidated U.S. federal income tax return (the US Group or Taxpayer). The US Group's taxable year ends on the last day of Month 12.

¹ This advice considers only the application of Treas. Reg. §1.956-1T(b)(4) and not the application of any judicial doctrines.

Throughout the taxable year ending on the last day of Month 12 in Year 1 (Tax Year 1), US Parent indirectly wholly owned numerous controlled foreign corporations within the meaning of section 957 (CFCs). Certain of these CFCs (the CFC Partners) were partners in FPS, a business entity organized under the laws of Country 1 that is classified as a partnership for U.S. federal income tax purposes. Like the taxable year for the US Group, the taxable year for FPS and the CFC Partners ends on the last day of Month 12.

During Tax Year 1, FPS owned DE1, a business entity organized under the laws of Country 2, which is disregarded as an entity separate from its owner for U.S. federal income tax purposes. During Year 1, DE1 operated as an internal finance company for the US Parent organization. It received deposits from related entities that had excess cash and loaned cash to other related entities.

US Parent indirectly wholly owned CFC 2, a CFC organized under the laws of Country 3. CFC 2 directly owned all of CFC Partner 1 (one of the CFC Partners), except for a de minimis interest that was owned by a domestic limited liability company that is a disregarded entity for U.S. federal income tax purposes.

On Date 1, DE1 loaned Amount 1 to CFC Partner 1 (the FPS Loan), and CFC 2 loaned Amount 2 to CFC Partner 1. On the same day, CFC Partner 1 loaned Amount 3 (the sum of Amount 1 and Amount 2) to US Parent (the CFC Partner 1 Loan).

On Date 2, US Parent repaid the CFC Partner 1 Loan. CFC Partner 1 also repaid the FPS Loan to DE1 on Date 2.

One quarter of the CFC Partners' Tax Year 1 ended between Date 1 and Date 2. No exception was available for CFC Partner 1 to treat the CFC Partner 1 Loan as not an "obligation" for purposes of section 956.² Accordingly, US Parent reported an inclusion under sections 951(a)(1)(B) and 956 for Year 1 as a result of the CFC Partner 1 Loan, based on a position that CFC Partner 1 held U.S. property of Amount 3.

The earnings and profits of the CFC Partners were such that US Parent's inclusion under sections 951(a)(1)(B) and 956 would have been substantially greater had DE1 loaned Amount 1 directly to US Parent, rather than lending Amount 1 to CFC Partner 1 followed by CFC Partner 1 loaning the total Amount 3. This is because the earnings and profits of CFC Partner 1 were limited such that lending Amount 3, instead of Amount 2 (that is, lending the incremental Amount 1), would not increase US Parent's income inclusion under sections 951(a)(1)(B) and 956.

² See, e.g., Notice 2008-91, 2008-43 I.R.B. 1001; Notice 88-108, 1988-2 C.B. 446 (providing that an exception under section 956 for certain short-term loans does not apply if the CFC holds for 180 or more days (in the case of Notice 2008-91) or 60 or more days (in the case of Notice 88-108) obligations that would otherwise constitute U.S. property).

In an internal memorandum, a tax department employee of US Parent appears to acknowledge that the IRS may determine that US Parent's section 956 inclusion should look to the earnings and profits of the CFC Partners because of the funding from DE1.³ The memorandum goes on to state that this determination should not prevail because the FPS Loan was intended to facilitate section 956 rather than avoid it.⁴ This statement appears to refer to US Parent's position that the CFC Partner 1 Loan resulted in an inclusion under section 956.⁵

US Parent stated that the purpose for the FPS Loan was funding.⁶ In response to a question on how CFC Partner 1 used the FPS Loan proceeds, US Parent stated that CFC Partner 1 made the CFC Partner 1 Loan on Date 1.⁷

LAW AND ANALYSIS

I. Section 956 in General

Every person who is a United States shareholder (as defined in section 951(b)) of a CFC and who owns stock in such corporation on the last day in such year, on which such corporation is a CFC, is required to include in gross income for its taxable year in which or with which such taxable year of the corporation ends, the amount determined under section 956 with respect to that shareholder for that taxable year (but only to the extent not excluded from income under section 959(a)(2) (i.e., previously taxed subpart F income). Section 956(a) defines that amount for any taxable year as the lesser of-

(1) the excess (if any) of-

(A) such shareholder's pro rata share of the average of the amounts of United States property held (directly or indirectly) by the controlled foreign corporation ["CFC"] as of the close of each quarter of such taxable year, over

(B) the amount of earnings and profits ["E&P"] described in section 959(c)(1)(A) with respect to such shareholder, or

³ Quote 1; US Parent's response to IDR 274.

⁴ Quote 2; US Parent's response to IDR 274.

⁵ US Parent's response to IDR 274.

⁶ Quote 3; US Parent's response to IDR 341.

⁷ Id.

(2) such shareholder's pro rata share of the applicable earnings of such controlled foreign corporation.

The statute also provides that the amount taken into account under section 956(a)(1) with respect to any property is its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

The term "United States property" generally includes an obligation of a domestic corporation that is a United States shareholder (as defined in section 951(b)) of the CFC.⁸ Accordingly, a United States shareholder includes income under sections 951(a)(1)(B) and 956 if its CFC holds an obligation of the shareholder as of the close of a quarter of the CFC's taxable year. The amount of the inclusion is determined with respect to the CFC's basis in the obligation averaged over the quarters in its year when it holds the obligation. However, as noted above, the inclusion amount will be limited in cases where the CFC has earnings and profits described in section 959(c)(1)(A) or where the shareholder's pro rata share of the CFC's applicable earnings is less than the amount that it would otherwise include.

Legislative history to section 956 provides that "if the facts indicate that the controlled foreign subsidiary facilitated a loan to, or borrowing by, a U.S. shareholder, the controlled foreign corporation is considered to have made a loan to (or acquired an obligation of) the U.S. shareholder."⁹ This statement is accompanied by an example concluding that a CFC is treated as having invested in U.S. property for purposes of section 956 if it makes a deposit in a bank and the deposit is either followed or preceded by the loan of a similar amount to the CFC's U.S. shareholder by the bank.

Treas. Reg. §1.956-1T(b)(4) provides that:

a controlled foreign corporation will be considered to hold indirectly... investments in U.S. property acquired by any other foreign corporation that is controlled by the controlled foreign corporation, 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 with respect to the controlled foreign corporation. For purposes of this paragraph (b), a foreign corporation will be controlled by the controlled foreign corporation if the foreign corporation and the controlled

⁸ Section 956(c)(1)(C), 956(c)(2)(F), 956(c)(2)(L). As the FACTS section of this advice notes, exceptions for short-term loans do not apply to the CFC Partner 1 Loan. See, e.g., Notice 2008-91, 2008-43 I.R.B. 1001; Notice 88-108, 1988-2 C.B. 446.

⁹ H.R. Rep. No. 94-658, at 217 (1976); S. Rep. No. 94-938, at 227 (1976).

foreign corporation are related parties under section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c).

Courts have approved the application of this rule.¹⁰

Treas. Reg. §1.956-2(a)(3) provides that 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 U.S. property.

II. The CFC Partners Are Deemed to Hold a Portion of the CFC Partner 1 Loan

Under Treas. Reg. §1.956-1T(b)(4), the CFC Partners are deemed to hold a portion of the CFC Partner 1 Loan equal to Amount 1—that is, the amount of the FPS Loan.

A. CFC Partner 1 Loan is U.S. Property

Under section 956(c) and Treas. Reg. §1.956-2(a)(1)(iii), the CFC Partner 1 Loan is U.S. property for purposes of section 956 because it is an obligation of US Parent, a U.S. person, and no exceptions apply.¹¹

B. CFC Partner 1 is Controlled by the CFC Partners for Purposes of Treas. Reg. §1.956-1T(b)(4)

CFC Partner 1 is controlled by the CFC Partners for purposes of Treas. Reg. §1.956-1T(b)(4) because US Parent (indirectly) wholly owns the CFC Partners, including CFC Partner 1. Accordingly, they are all members of the same controlled group as defined in section 267(f), and are related parties for purposes of section 267(b).

C. CFC Partner 1 was Funded by the FPS Loan

¹⁰ See Schering-Plough Corp. v. United States, 651 F.Supp.2d 219, at 249-50 (D.N.J. 2009), *aff'd*, Merck & Co., Inc. v. United States, 652 F.3d 475 (3d Cir. 2011) (approving application of Treas. Reg. §1.956-1T(b)(4)); The Limited v. Comm'r, 113 T.C. 169, 191-92 (1999), *rev'd on other grounds*, 286 F.3d 324 (6th Cir. 2002) (approving application of Treas. Reg. §1.956-1T(b)(4)).

¹¹ See section 956(c)(2)(F) and 956(c)(2)(L). The short-term exceptions noted in n.2, *supra*, would not apply to any obligations considered to be held by the CFC Partners as a result of applying Treas. Reg. § 1.956-1T(b)(4) because the CFC Partners held other obligations for periods that exceed the threshold established in those notices.

If CFC Partner 1 had borrowed directly from the other CFC Partners, rather than from FPS (the partnership in which they are partners), it would be clear that the borrowing constitutes a “funding” for purposes of Treas. Reg. §1.956-1T(b)(4). The result is the same when a CFC borrows from a partnership, the partners of which are related CFCs.

First, the application of Treas. Reg. §1.956-1T(b)(4) does not depend on a “direct” funding by a CFC—that is, a loan from a CFC directly to a CFC, as opposed to a loan from a partnership the partners of which are CFCs. The regulation, in relevant part, applies “if one of the principal purposes for... funding... such other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation.”

Second, applying the rule to this fact pattern comports with Treas. Reg. §1.956-2(a)(3), which treats a CFC as owning an interest in U.S. property when it is a partner in a partnership that owns U.S. property. If DE1 had loaned Amount 1 directly to US Parent, then Treas. Reg. §1.956-2(a)(3) would apply to treat the CFC Partners as holding an interest in U.S. property. As mentioned in the FACTS section of this advice, this would have resulted in US Parent having a larger inclusion under sections 951(a)(1)(B) and 956. Thus, applying Treas. Reg. §1.956-1T(b)(4) in this case effectuates the purpose of Treas. Reg. §1.956-2(a)(3) because it prevents the funding of CFC Partner 1 by FPS from allowing US Parent to avoid the application of section 956 to the other CFC Partners.

D. One of the Principal Purposes of Funding CFC Partner 1 was to Avoid the Application of Section 956 with Respect to the CFC Partners

The substantially lower inclusion reported by US Parent, as compared to the inclusion that US Parent would have had if DE1 had lent directly to US Parent, is strong evidence that one of the principal purposes of funding CFC Partner 1 was to avoid the application of section 956 with respect to the CFC Partners. The close proximity in time between when FPS lent Amount 1 to CFC Partner 1, and when CFC Partner 1 lent Amount 3 to US Parent, is also strong evidence of the same purpose. US Parent’s statement that the purpose of the FPS Loan was for funding is not sufficient to show otherwise.¹²

The internal memorandum, mentioned in the FACTS section of this advice, is also not persuasive. That document stated that the anti-abuse rule should not apply because the FPS Loan was intended to facilitate (rather than avoid) the application of section 956. Presumably, the statement means the FPS Loan facilitated the application of section 956 to CFC Partner 1. The application of the anti-abuse rule does not turn on whether section 956 is avoided entirely. Instead, the rule’s application turns on whether a principal purpose for funding a related foreign corporation is to avoid the application of section 956 with respect to the funding CFC (here, the CFC Partners).

¹² Quote 3; US Parent’s response to IDR 341.

CONCLUSION

Treas. Reg. §1.956-1T(b)(4) applies to treat the CFC Partners as holding a portion of the CFC Partner 1 Loan. The amount of U.S. property held by the CFC Partners is determined as if (i) FPS held an amount of the CFC Partner 1 Loan equal to the amount of the FPS Loan (the funded amount), and (ii) each CFC Partner held an interest in the funded amount equal to its interest in FPS.

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS

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