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Tax Alert

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IRS Chief Counsel Shrugs Off Taxpayer’s Section 956 Gambit

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In a recently released Chief Counsel Advice Memorandum[1] (the “Memorandum”), the IRS Office of Chief Counsel (International) addressed an interesting and somewhat creative internal financing structure deployed by a taxpayer seeking to minimize a deemed dividend inclusion under Section 956.[2] If only because it is not every day that we learn new things about Section 956, the Memorandum is worth considering.

Section 956 was enacted more than fifty years ago as part of the “Subpart F” provisions of the Code. Section 956 is based on the concept that when a “controlled foreign corporation” (or “CFC”) invests in certain types of U.S. property, the corporation’s U.S. parent (or other significant U.S. shareholders) has achieved the functional equivalent of a repatriation of the foreign subsidiary’s earnings. Under Section 956, the U.S. shareholders are to be treated as if they received a dividend from the foreign corporation, based on the amount of the actual investment as well as the foreign subsidiary’s earnings that have not been repatriated previously. Accordingly, Section 956 is an integral part of the anti-deferral regime that U.S.-based multinationals must contend with in managing the “worldwide” tax system in effect in the U.S. Indeed, Subpart F has received an extraordinary amount of attention in recent months, as it is often cited as one of the reasons that U.S. multinationals continue to seek ways to “invert” or otherwise re-domesticate into jurisdictions that promise more favorable tax treatment of offshore earnings. In order to stop this trend, many lawmakers and commentators have sounded the call for broader tax reform, including a reduction in the comparatively high U.S. corporate tax rate or a more “territorial” tax regime.

For purposes of the Memorandum, the salient provision is Section 956(c), which treats an obligation of a related U.S. person as an item of U.S. property that triggers deemed dividend treatment.[3] Therefore, when a CFC makes a loan to its U.S. parent, the transaction is treated as a dividend, and the U.S. parent generally must include as a dividend the amount of such loan, limited by the U.S. parent’s pro rata share of the CFC’s earnings. This limitation was the key to the fact pattern described in the Memorandum.

The relevant facts in the Memorandum are as follows. U.S. Parent (“USP”) was the common parent of an affiliated group of domestic corporations. USP also indirectly owned a number of CFC subsidiaries. A few of these CFC subsidiaries (the “CFC Partners”) were partners in FPS, a foreign entity treated as a partnership for U.S. federal income tax purposes. FPS, through a disregarded entity subsidiary, acted as an internal finance company for the group. FPS, as well as another CFC in the group, extended loans to one of the CFC Partners (“CFC Partner 1”), which then on-loaned the combined proceeds to USP (the “CFC Partner 1 Loan”). USP reported an inclusion of dividend income as required by Section 956(c). Notably, however, the amount of the inclusion was less than the total amount of the loan, as a result of the earnings of CFC Partner 1 serving as a limitation. At issue in the Memorandum was whether it was proper for USP to so limit the Section 956 inclusion.

In concluding that USP’s treatment of the financing was improper, and that USP should have considered the earnings of all the CFC Partners in determining its deemed dividend, the IRS chief counsel relied almost exclusively on an anti-abuse rule found in Treas. Reg. section 1.956-1T(b)(4). That regulation provides, in relevant part, 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 rule, control is determined under the principles of Section 267.

Based on this regulation, the Memorandum concluded that *all* the CFC Partners were treated as holding (indirectly) a ratable portion of the CFC Partner 1 Loan. The technical basis for this conclusion was that the loan from FPS to CFC Partner 1 was functionally equivalent to a loan from all the CFC Partners to CFC Partner 1, since the CFC Partners were all partners in FPS. Accordingly, the CFC Partners could be said to have "funded" CFC Partner 1 through debt. The lower dividend inclusion actually reported by USP established "strong evidence" of the avoidance purpose required under the regulation as well. Additionally, the loan from FPS to CFC Partner 1 was followed almost immediately (on the same day) by the on-loan to USP, thereby negating any true business purpose for the arrangement.[4]

The Memorandum also noted that its result comports with Treas. Reg. section 1.956-2(a)(3), which provides that any U.S. property held by a partnership will be treated as held ratably by its CFC partners. This rule adopts an aggregate approach to partnerships under Section 956 and is a highly logical rule in that it prevents a relatively easy end-around Section 956 through the use of partnership entities.[5]

A quick check reveals that neither of the regulations relied on in the Memorandum has been cited more than a couple of times in published or unpublished guidance from the IRS (although the anti-abuse rule of Treas. Reg. section 1.956-1T(b)(4) has been cited in a few reported court decisions). The Memorandum is therefore noteworthy, especially at a time where U.S. international taxation is at the top of the legislative agenda. U.S. multinationals must tread carefully when implementing offshore financing structures.

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Endnotes

[1] CCA 201420017 (5/16/14).

[2] All "Section" references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

[3] It is fair to say that most of the activity and the scholarship in Section 956 focuses on Section 956(d), which addresses situations in which a CFC provides credit support for loan obligations of its U.S. parent. That provision gives rise to numerous interpretive questions and interesting fact patterns that give practitioners varying degrees of heartache. Section 956(d) was not directly at issue in the Memorandum.

[4] The Memorandum also dismissed a "creative" argument put forth by the taxpayer; namely, that since they affirmatively reported *some* dividend income under Section 956, it could not be treated as having had a purpose to *avoid* the application of Section 956.

[5] See also Rev. Rul. 90-112, 1990-2 C.B. 186.

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