

## IRS Expands the Application of the Code Sec. 956 Anti-Conduit Rule

Code Sec. 956 treats a loan made by a controlled foreign corporation (CFC) to a related U.S. corporation as an investment in U.S. property, which triggers an inclusion in the income of the CFC's U.S. shareholders. The amount included in the income of the U.S. shareholders is the amount of the loan reduced by the CFC's previously taxed earnings, and limited to the CFC's untaxed earnings and profits.<sup>1</sup>

Code Sec. 956 is applied on a separate basis to each CFC in a multinational group. Under certain limited circumstances, however, one CFC could be treated as holding U.S. property held by another CFC. Reg. §1.956-1T(b)(4) provides that, at the discretion of the IRS, a CFC will be considered as indirectly holding U.S. property held by a related foreign corporation "if one of the principal purposes for creating, organizing or funding (through capital contributions or debt) such other foreign corporation was to avoid the application of section 956 to the controlled foreign corporation."

The background and application of this anti-conduit regulation indicate that it was aimed at a situation where one CFC with earnings and profits funds another CFC that does not have earnings and profits, and the second CFC loans the funds to a related U.S. person (or invests in other U.S. property).<sup>2</sup> While the loan to the related U.S. person is an investment in U.S. property, there is no income inclusion resulting from the CFC holding the loan because it does not have any earnings and profits. If the anti-conduit rule applies, the first CFC providing the funds would be treated as holding the loan, and therefore its earnings and profits would be taken into account for purpose of determining the amount included in the income of the U.S. shareholder.

This anti-conduit regulation does not apply to all situations where one CFC funds another CFC. The funding must be by loan or capital contribution. In addition, the rules contemplate a contemporaneous funding, such that the loan or capital contribution is used to fund the U.S. property investment.<sup>3</sup> There must also be a principal purpose to avoid the application of Code Sec. 956 to the funding CFC. For example, the regulations provide that the anti-conduit rule did not apply to a CFC that sold products to another CFC for trade receivables payable in 60 days where the CFC paid the receivables according to their terms.

Two cases have addressed the application of Reg. §1.956-1T(b)(4). The courts held that the anti-conduit regulation applied where a CFC parent made a capital contribution to a newly formed CFC subsidiary with no earnings and profits, and the CFC subsidiary then loaned those funds to a related U.S. person for an indefinite period.<sup>4</sup>

The IRS recently issued two Chief Counsel Advices (CCAs) that purport to expand the application of the anti-conduit rule.<sup>5</sup> They apply the anti-conduit rule where the CFC holding the U.S. property itself has substantial earnings and profits.

Under one scenario, the taxpayer apparently desired to affirmatively use Code Sec. 956 to trigger an inclusion from a lower-tier CFC's earnings and profits (CFC-S). To illustrate, assume CFC-S borrows \$20 million from its foreign parent (CFC-P), and then loans the \$20 million to CFC-P's U.S. parent (USP). The



Walden Klawner  
CCH



**LOWELL D. YODER** is a Partner in the Chicago office of McDermott Will & Emery LLP, and head of the U.S. & International Tax Practice Group.

loan is outstanding over two quarter ends and is treated as an investment of \$10 million in U.S. property. CFC-S has \$8 million of untaxed earnings and profits with a foreign taxes pool of \$8 million. Applying Code Sec. 956 to CFC-S, USP has an inclusion in income of \$8 million, and pursuant to Code Sec. 960 as applicable during the years at issue, this inclusion brings deemed-paid taxes of \$8 million. Thus, no U.S. tax is due, and USP has excess foreign tax credits of \$2.4 million.<sup>6</sup>

The CCAs determined that the anti-conduit rule applied to treat CFC-P as indirectly holding the \$20 million loan to USP.<sup>7</sup> Assume that CFC-P has earnings and profits of \$45 million and a taxes pool of \$5 million. The IRS concluded that \$10 million of the earnings and profits of CFC-P was subject to U.S. taxation, resulting in \$2.5 million of U.S. tax.

Under a second scenario, assume the facts of the above example, except that CFC-S has \$10 million of previously taxed earnings. While CFC-S will be considered as investing \$10 million of its earnings in U.S. property (a \$20 million loan to USP outstanding for two quarters), there would be no deemed dividend to USP from CFC-S under Code Sec. 956 because the amount invested would be reduced to zero by the \$10 million of previously taxed earnings. In one of the CCAs, however, the IRS applied the anti-conduit rule to treat CFC-P as holding the \$20

million loan, and accordingly treated \$10 million of its low-taxed earnings and profits as subject to tax under Code Sec. 956.

The CCAs reason that the anti-conduit rules should apply because the back-to-back loans were made on the same day and in similar amounts. They observe that if CFC-P had directly made the loan to USP, there would be a larger inclusion, and the amount of deemed paid foreign tax credits would be less. Without explanation, the CCAs treat the entire amount of the inclusion as coming from CFC-P, ignoring the earnings and profits of CFC-S.

This appears to be the first time the IRS has expressed its view that the anti-conduit rule can apply to ignore the earnings and profits of the CFC holding the U.S. property, and thereby deprive a taxpayer of foreign tax credit benefits or effectively tax the investing CFC's previously taxed earnings. This is inconsistent with the concern of the rule to apply Code Sec. 956 to a CFC with earnings and profits that funds another CFC without earnings and profits to make an investment in U.S. property (*i.e.*, effective repatriation of the funding CFC's earnings).<sup>8</sup> CFC-S could have borrowed from a third party and achieved the intended U.S. tax results, and thus it seems that the main impact of the position expressed in the CCAs is to increase a U.S. company's finance costs.<sup>9</sup>

## ENDNOTES

<sup>1</sup> Code Secs. 951(a)(1)(B) and 956.

<sup>2</sup> For a detailed discussion of the history of the anti-conduit rule, see Lowell D. Yoder and Katherine M. Christenson, *The Limited, Inc. v. Comr.: Strategy to Use Foreign Earnings in the United States Subject to §956*, 29 TAX MGMT. INT'L J. 141, March 10, 2000.

<sup>3</sup> *Cf.*, Reg. §1.304-4 (broadened the language of a similar regulation prospectively to cover additional financing arrangements, with no similar change to Reg. §1.956-1T(b)(4)); see Yoder, *Final Regs. §1.304-4: Broad Anti-Avoidance Rules*, 42 TAX MGMT. INT'L J. 239, April 12, 2013. See also Notice 2014-32, 2014-20 IRB 1006, §4.03 (prospective broadening of the funding arrangements taken into account for purposes of an anti-abuse rule in Reg. §1.367(b)-10(d)); Reg. §1.881-3 (broader anti-conduit rules

for purposes of denying U.S. treaty benefits, specifically providing for the application of those rules regardless of the sequencing of the transactions).

<sup>4</sup> *Schering-Plough Corp.*, DC-NJ, 2009-2 USTC ¶150,614, 651 FSupp2d 219, *order denying motion for retrial*, *Merck & Co.*, DC-N.J., 2010-1 USTC ¶150,373, *aff'd*, *Merck & Co.*, CA-3, 2011-1 USTC ¶150,461, 652 F3d 475; *The Limited, Inc.*, 113 TC 169, Dec. 53,533 (1999), *rev'd on other grounds*, CA-6, 2002-1 USTC ¶150,353, 286 F3d 324.

<sup>5</sup> CCA 201420017 (Dec. 27, 2013); CCA 201446020 (July 29, 2014).

<sup>6</sup> Code Sec. 960(c) was amended in 2010 to eliminate foreign tax credit benefits that resulted under the "hopscotch" rule that applied to inclusions under Code Sec. 956, capping the amount of foreign taxes associated with a

Code Sec. 956 amount as though it were cash distributed by CFC-S to CFC-P, and then to USP. See Lowell D. Yoder, *Section 956 Inclusion: New Limit on Foreign Tax Credits Deemed Paid*, 39 TAX MGMT. INT'L J., 785, Dec. 10, 2010.

<sup>7</sup> The CCAs do not treat CFC-S as holding any amount of the loan for purposes of Code Sec. 956.

<sup>8</sup> See T.D. 8209 (June 14, 1988) ("This rule generally prevents a CFC from contributing cash to a lower-tier CFC with no earnings and profits to be used to make an investment in U.S. property in avoidance of section 956.")

<sup>9</sup> For additional discussion of the inappropriateness of applying the anti-conduit rule under the facts in the CCAs, see Lowell D. Yoder, *IRS Applies the §956 Indirect Investment Rule to a Partnership Loan*, 43 TAX MGMT. INT'L J. 630 (Oct. 10, 2014) (discussing CCA 20140017).

This article is reprinted with the publisher's permission from the INTERNATIONAL TAX JOURNAL, a bimonthly journal published by CCH, a part of Wolters Kluwer. Copying or distribution without the publisher's permission is prohibited. To subscribe to the Journal of INTERNATIONAL TAX JOURNAL or other CCH Journals please call 800 449 8114 or visit CCHGroup.com. All views expressed in the articles and columns are those of the author and not necessarily those of CCH, a part of Wolters Kluwer or any other person.