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Section 956: IRS Treats Foreign Property as U.S. Property

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INTRODUCTION

IRS Notice at Odds with Code §956

The Internal Revenue Service recently issued Notice 2014-52,¹ treating a loan made by a controlled foreign corporation (CFC) to a foreign corporation as an investment in U.S. property for purposes of §956.² The statutory basis for this administrative rule is lacking.

The new rule applies to CFCs owned by a U.S. corporation that combines on or after September 22, 2014, with a foreign corporation under a new foreign parent in a so-called inversion transaction. For the Notice to apply, the inversion transaction must involve at least 60% but less than 80% continuity on the part of the U.S. corporation's former shareholders. The new rule does not apply to inverted structures established before September 22, 2014, nor does it ap-

ply to U.S. corporations that combine with foreign corporations under new foreign parents at any time via non-inversion transactions (e.g., outright acquisitions by larger foreign groups).

Expanded Definition of U.S. Property

For those situations to which it applies, the Notice purports to expand the definition of "United States property" (U.S. property) to include a loan made by a CFC to the new foreign parent (or to a non-CFC foreign subsidiary of the foreign parent).³ The loan is treated as an investment in U.S. property regardless of how the loan proceeds are used, e.g., the foreign parent may distribute the funds to its public shareholders as a dividend or use the funds to expand business operations outside the United States.

Treating a loan made by a CFC to the foreign parent (or its foreign subsidiaries) as an investment in U.S. property causes the amount of the loan to be included in the income of the U.S. corporate parent of the CFC, limited to the amount of the CFC's earnings and profits.⁴ The Notice prescribes this deemed dividend result even if the funds are not made available to the U.S. corporate parent nor otherwise invested in the United States.

The Subpart F rules provide that a loan held by a CFC results in an inclusion in the income of its U.S. shareholders only if the loan falls within the definition

¹ 2014-42 I.R.B. 712.

² All section ("§") references are to the U.S. Internal Revenue Code, as amended, or the regulations thereunder.

³ Notice 2014-52 also applies to stock investments made by the CFCs in the foreign parent or its foreign subsidiaries, and guarantees by the CFCs of obligations of those foreign corporations. The new definition of "United States property" applies for the 10-year period following the inversion.

⁴ §951(a)(1)(B), §956(a).

of “United States property.” Section 956(c)(1) defines “United States property” to include tangible property located in the United States, stock or obligations of related U.S. persons, certain intangible property used in the United States, certain pledges of stock in a CFC as credit support for an obligation of a related U.S. person, and a guarantee by a CFC of an obligation of a related U.S. person. The definition of “U.S. person” includes a U.S. corporation, but not a foreign corporation.⁵

Thus, the definition of “United States property” does not include a loan to a foreign corporation. An example in the regulations illustrates that a loan made by one CFC to a related CFC is not an investment in U.S. property.⁶

Conduit Rule Not Applicable

The regulations contain an anti-abuse rule that treats certain loans to a foreign corporation as an investment in U.S. property — but only if the foreign corporation serves as a conduit for an investment of the loan proceeds in U.S. property. 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 (by loan or capital contribution) such other foreign corporation was to avoid the application of §956 to the CFC. An example in the regulations applies this rule to a CFC that makes a loan to another CFC with no earnings and profits, and the second CFC makes a loan to a related U.S. person. The example treats the first CFC as holding the loan to the related U.S. person for purposes of applying §956, and thus takes into account the earnings and profits of the first CFC that funded the investment in U.S. property.

Two cases have addressed the application of Reg. §1.956-1T(b)(4). The courts held that the indirect investment regulation applied where a CFC parent made a capital contribution to a CFC subsidiary with no earnings and profits, and the CFC subsidiary then loaned the funds to a related U.S. person. The CFC parent that funded the investment was treated as if it directly held the investment in the U.S. property held by the CFC subsidiary, and therefore the earnings and profits of the parent were taken into account for purposes of applying §956.⁷

⁵ §957(c), §7701(a)(3), §7701(a)(4), §7701(a)(5), §7701(a)(30).

⁶ Reg. §1.956-1T(b)(4) *Ex. 1*.

⁷ *Schering-Plough Corp. v. United States*, 651 F. Supp. 2d 219 (D.N.J. 2009), *order denying motion for retrial, Merck & Co v. United States*, 2010-1 U.S.T.C. ¶50,373 (D.N.J. 2010), *aff'd*,

Section 956(e) Inapposite

The IRS in Notice 2014-52, however, does not rely on this conduit rule, because the new §956 rule applies regardless of whether the loan proceeds are used by the foreign borrower to invest in U.S. property. Rather, the IRS invokes §956(e) as the authority for its new definition of “United States property.”

Section 956(e) provides, “The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to prevent the avoidance of the provisions of this section through reorganizations or otherwise.” This grant of regulatory authority was added by the Omnibus Budget Reconciliation Act of 1993. That Act also added §956A, which provided an inclusion in the income of U.S. shareholders under Subpart F for amounts a CFC held as investments in “excess passive assets.” With respect to §956(e), the Conference Committee Report states, “Within this authority [of §956(e)], the conferees anticipate that the Treasury may prescribe regulations that, for example, would prevent taxpayers from taking advantage of the differences between the excess passive assets rules and the rules of section 956.” The government has never issued regulations under §956(e), and §956A was subsequently repealed in 1996.⁸

Thus, it appears that a primary motivation for enacting §956(e) was to provide Treasury authority to coordinate the application of the §956 investment in U.S. property rules with the §956A investment in excess passive assets rules. It is obvious that the rule in Notice 2014-52 treating CFC loans to a foreign corporation as an investment in U.S. property is not necessary to coordinate the application of §956 and §956A because the latter provision was repealed. It is also not apparent why the new definition of U.S. property is necessary to “carry out the purposes of section 956,” or to “prevent the avoidance of the provisions of [§956],” when there is no investment of the funds of the CFC in U.S. property. The Notice acknowl-

Merck & Co., 652 F.3d 475 (3d Cir. 2011); *The Limited, Inc. v. Commissioner*, 113 T.C. 169 (1999), *rev'd on other grounds*, 286 F.3d 324 (6th Cir. 2002). The IRS has applied a similar conduit rule to CFC loans to a foreign corporation where the funds were invested in U.S. property by the intermediary foreign corporation. Rev. Rul. 87-89, 1987-2 C.B. 195; Rev. Rul. 76-192, 1976-1 C.B. 205.

⁸ Pub. L. No. 104-188. One notice has been published stating that the IRS and Treasury will issue regulations under §956(e) to provide that a CFC may choose to exclude from the definition of the term “obligation” an obligation held by the CFC that would otherwise constitute an investment in U.S. property, provided the obligation is collected within 60 days from the time incurred. That notice was intended to provide an exception to the definition of “United States property” for certain short-term loans by CFCs to related U.S. corporations. Notice 2008-91, 2008-43 I.R.B. 1001; *see also* Notice 2010-12, 2010-4 I.R.B. 326.

edges that the purpose of §956 is to prevent the repatriation of income to the United States without U.S. taxation, a result not achieved where there is no investment of funds in U.S. property. There is no avoidance of the purposes of §956 where the application of the provision is “avoided” by *not making any kind of direct or indirect investment in U.S. property at all.*

COURTS REJECT IRS ‘LOOPHOLE’ ARGUMENTS

The courts have uniformly rejected the IRS’s attempts to expansively interpret the term “United States property.” Two cases refused to apply §956 beyond the plain meaning of the statutory definition of U.S. property, even though the courts acknowledged that the policy underlying §956 supported the IRS’s position.

‘Ludwig’

The Tax Court in *Ludwig v. Commissioner*⁹ refused to expand the §956 definition of “United States property” to fill a perceived loophole, rejecting the IRS’s argument that a U.S. shareholder’s pledge of CFC stock as collateral for a loan rendered the CFC a “guarantor” of the loan and therefore subject to §956. In *Ludwig*, a U.S. shareholder pledged all of the stock in a CFC as collateral for a loan. Section 956(c) provides that a CFC is considered as holding an obligation of a U.S. person if it is a pledgor or a guarantor of such an obligation. The IRS argued that the pledge of the CFC stock by the U.S. shareholder fell within the meaning of “guarantor,” and thus the CFC should be viewed as holding an obligation of a U.S. person, which constituted an investment in U.S. property.

In rejecting the government’s argument, the Tax Court first pointed out that neither the Code nor the regulations defined “guarantor” for purposes of §956. It then stated that, “[i]n the absence of any such specific technical definition, the term should be given its normal and customary meaning.”¹⁰

The Tax Court referred to the definition of “guarantor” in Black’s Law Dictionary, as well as how that term has been interpreted for purposes of other provisions of the Code and in the state of New York, which governed the taxpayer’s loan agreement. Those sources all defined a “guarantor” as one who is liable to make payment if the primary obligor defaults. Since the CFC was not a party to any agreement with the lender, the Tax Court found that the pledge of CFC stock by the U.S. shareholder was not a guarantee by the CFC for purposes of §956.

The IRS, however, argued that the legislative history requires that the word “guarantor” be given a special meaning beyond its normal usage. The IRS’s rationale is set forth in Rev. Rul. 76-125,¹¹ which involved similar facts, and the Tax Court quotes from that ruling as follows:

The purpose of section 956 of the Code is to terminate the tax deferral privilege with respect to the earnings of controlled foreign corporations when such earnings are directly or indirectly repatriated. S. Rep. No. 1881, 87th Cong., 2d Sess. 80, 87–88 (1962), 1962-3 C.B. 707 at 794, states, in part, “Generally, earnings brought back to the United States are taxed to the shareholders on the grounds that this is substantially the equivalent of a dividend being paid to them.” Consistent with the intent of section 956, section 956(c) is interpreted to hold that use of the assets or credit of a controlled foreign corporation as collateral for an obligation of a United States person shall be considered a repatriation of earnings.

The ruling further states that, under its facts, although the agreement was signed only by the U.S. shareholder, the net effect of the agreement was a guaranty of the U.S. shareholder loan by the CFC, because the CFC’s assets would be available to answer for the debt of the U.S. shareholder in the event of a default.

The Tax Court acknowledged that the taxpayer realized a benefit from pledging the CFC stock. Nevertheless, it said that §956(c) does not reach every benefit realized by a U.S. shareholder from owning stock in a CFC. The Tax Court states:

We think Rev. Rul. 76-125, *supra*, and respondent’s position in this case attempt to stretch the statute and regulations to cover a situation with which they do not deal. True, the legislative history of Subpart F in which sections 951 and 956 appear makes it quite clear that one of its objectives is to tax United States shareholders of controlled foreign corporations on the indirect repatriation of income earned by such corporations but not distributed as dividends (and in many instances, not subjected to tax by the jurisdiction of incorporation). . . . But section 956(c) says nothing about pledging stock of the controlled foreign corporation Had Congress intended to cover the stock pledge arrangement, if could have, and would have, done so.

⁹ 68 T.C. 979 (1977).

¹⁰ *Id.* at 984.

¹¹ 1976-1 C.B. 204, *considered in* GCM 35763 (Apr. 1, 1974).

Therefore, despite a general legislative purpose to treat a CFC as distributing its earnings when its assets serve as collateral for a loan to a U.S. shareholder, the Tax Court found no basis for applying that rule to the pledged stock because the arrangement did not fall within the commonly understood meaning of “guarantor.” The Tax Court states, “If the draftsmen’s handiwork fell short of fully accomplishing the objectives sought, it must be left to Congress to repair such shortfall.”¹²

‘The Limited’

Similarly, in *The Limited, Inc. v. Commissioner*,¹³ the Sixth Circuit reversed the Tax Court’s holding that §956 applied to certain investments because the Tax Court “raced to the legislative history,” rather than interpreting the statutory words according to their customary meaning. Under the facts of that case, MFE-HK, a Hong Kong CFC, had excess cash of \$175 million which The Limited desired to access for its U.S. business operations. The \$175 million was used to purchase certificates of deposit in World Financial Network National Bank (WFNNB). WFNNB was a U.S. corporation organized under the National Bank Act, and was owned 100% by The Limited. WFNNB’s principal business was the issuance of credit cards to customers of various stores owned by the taxpayer.

While the CDs generally would be considered as loans to a related U.S. person subject to §956, the taxpayer took the position that the CDs qualified under the exception for “deposits with persons carrying on the banking business” then provided in §956(b)(2)(A). The Tax Court, however, held that the bank deposits exception did not apply, resulting in a \$175 million deemed dividend to the taxpayer. The Sixth Circuit reversed the Tax Court.

The Tax Court studied the legislative history underlying the deemed dividend rules of §956 and the exception for bank deposits, and concluded that Congress could not have intended to permit the \$175 million in loans by MFE-HK to a U.S. affiliate to escape current taxation. The judge believed that the bank deposits exception was intended to be available only when the U.S. bank facilitates the domestic business of the CFC. The Tax Court further determined that Congress did not intend for the exception to apply to deposits with related entities.

¹² 68 T.C., at pp. 989–92. Treasury and the IRS subsequently issued regulations treating certain pledges of CFC stock as investments in U.S. property. Reg. §1.956-2(c). Whether this regulation constitutes a valid exercise of Treasury’s rulemaking authority has not been challenged in court.

¹³ 286 F.3d 324 (6th Cir. 2002), *rev’d*, 113 T.C. 169 (1999).

In reversing the Tax Court, the Sixth Circuit concluded that resorting to legislative history and policy for the intent of Congress is not appropriate if the text of the statute may be read unambiguously and reasonably. The Sixth Circuit first determined that, under an ordinary and natural reading, WFNNB carried on “the banking business.” As a result, the court stated that “there is little need to stretch a common understanding of ‘the banking business’ to exclude WFNNB here.” The court further noted that the plain language of §956(b)(2)(A) at issue had no related-party prohibition. The Tax Court, therefore, could not insert such requirement into the bank deposits exception, and there was no need to examine the legislative history on this point because the statute was clear. The Sixth Circuit agreed that, as a matter of policy, a related-party prohibition would have made sense. Nevertheless, the court concluded that it was not the Tax Court’s role to inject its own policy determinations into the plain language of statutes: “While obviously not the policy that the Tax Court would promote were it an uber-legislature, interpreting §956(b)(2)(A) without a related-party prohibition hardly rises to a level of unreasonableness that merits ignoring the plain text of the statute.”¹⁴

CONCLUSION: POLITICAL ADMINISTRATION OF TAX LAWS

The treatment in Notice 2014-52 of a loan to a foreign corporation as an investment in U.S. property is fundamentally opposed to the holdings and rationale of *Ludwig* and *The Limited*. Section 956(c) defines loans as U.S. property only if made to corporations that are domestic corporations, and a foreign corporation by definition is a corporation “that is not domestic.” A loan to a foreign parent in an inverted structure unequivocally falls outside the statutory definition of “United States property.”

While the general policy underlying §956 — to tax as a dividend earnings of a CFC effectively repatriated to the United States — may have supported the IRS’s position in the above cases, in contrast there is no

¹⁴ 286 F.3d, at 336. Congress subsequently amended the statute prospectively to limit the exception to deposits with a bank holding company or a corporation owned by a bank holding company or financial holding company, but without a related-party prohibition. §956(c)(2)(A). Two other cases held that certain investments made by CFCs were subject to current U.S. taxation, not based on an expansive interpretation of the definition of “United States property” or on policy grounds, but rather based on the relevant court’s findings with respect to the substance of the transactions. *Schering-Plough Corp.*, above (court treated a swap arrangement as in substance a loan by a CFC to a U.S. affiliate); *Barnes Grp., Inc. v. Commissioner*, T.C. Memo 2013-109, *aff’d*, No. 13-04298 (2d Cir. 2014) (court held that certain CFC investments were in substance dividends to the U.S. parent).

§956 policy support for the rule in Notice 2014-52. The principal application of the new rule treating loans to foreign corporations as U.S. property does not involve earnings of a CFC being invested in the United States or assets of a CFC serving as support for obligations of related U.S. persons. In the more than 50-year history of §956, there has not been the slightest indication that Congress ever intended for that provision to apply in the manner prescribed by the Notice.

Moreover, as the courts have clearly stated, policy cannot be a basis for expanding the statutory definition of “United States property.” The same criticism expressed by the Sixth Circuit Court of Appeals in *The Limited* would seem to apply here: “While obviously not the policy that the [IRS or Treasury] would promote were it the uber-legislature . . . it must be left to Congress to repair the shortfall.” Notice 2014-52 attempts to usurp the legislative prerogative of Congress, effectively circumventing important checks and balances. Although the narrow targeting of the Notice may enable the IRS to avoid any taxpayer challenge to this position in court — whereas such a challenge would have been assured had the Notice applied to established inverted structures or to foreign acquisitions of U.S. companies more generally —

the Notice establishes a disturbing precedent with respect to the principle of separation of powers and evidences a political administration of the tax laws.¹⁵

¹⁵ It would be appropriate for Congress to respond to Notice 2014-52 as it did to Notice 98-11, 1998-6 I.R.B. 18. In 1998 Treasury and the IRS issued Notice 98-11, announcing plans to issue regulations that would effectively create categories of Subpart F income beyond the definitions provided in the statute for certain hybrid arrangements, stating that this was necessary to carry out the rules and policies underlying Subpart F. Both the Chairman and ranking Member of the House Ways and Means Committee sent letters to the Treasury Secretary questioning Treasury’s authority to issue the regulations, and stating that the Notice addresses tax policy that should be addressed only through the legislative process. They urged Treasury to withdraw the Notice, and not issue the regulations. Subsequently, a provision passed by the Senate as part of the IRS Restructuring and Reform Bill of 1998 would have placed a six-month moratorium on the implementation of the regulations, and would have required that regulations issued under Notice 98-11 be withdrawn, stating that Congress, not Treasury or the IRS, should determine international tax policy issues presented with respect to the treatment of hybrid transactions under Subpart F. In response, Treasury and the IRS delayed the effective date of the regulations for five years. The regulations have never become effective. Notice 98-35, 1998-27 I.R.B. 35. See Yoder, *Notice 98-35: Subpart F Hybrid Entity Regulations in Suspense*, 27 Tax Mgmt. Int’l J. 427 (Sept. 11, 1998).