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## IRS Applies the §956 Indirect Investment Rule to a Partnership Loan

By Lowell D. Yoder, Esq.  
McDermott Will & Emery LLP  
Chicago, Illinois

The IRS recently issued a Chief Counsel Advice (CCA) applying the §956 indirect investment rule to a loan made by a foreign partnership to one of its CFC partners, which used the funds to invest in U.S. property.<sup>1</sup> The CCA treats the other CFC partners of the partnership as indirectly holding U.S. property held by the borrowing CFC partner. This conclusion is questionable.

Under the facts of the CCA, a U.S. corporation (USP) owns, directly and indirectly, a number of CFCs. Several of the CFCs (CFC-Ps) are partners in a foreign entity that is classified as a partnership (FPS). A foreign disregarded entity (FDE) owned by the partnership functions as an internal finance company receiving deposits from related CFCs with excess cash, and making loans to other CFCs.

During one taxable year, FDE loaned funds to one of the CFC partners (CFC-P1); let's assume \$60 million. CFC-P1 also borrowed from its CFC parent (assume \$40 million). CFC-P1 then loaned \$100 million to USP, and the loan was outstanding over one quarter-end.

Section 951(a)(1)(B) requires a "United States shareholder" (hereafter, U.S. shareholder) to include in income the amount determined under §956. The

first step is to calculate the amount invested by a CFC in U.S. property, which is the aggregate of the amounts of U.S. property held on the last day of each quarter divided by four. The amount included in the U.S. shareholder's income is the amount invested in U.S. property reduced by previously taxed income, and limited by the amount of the CFC's untaxed earnings and profits.

A loan to a related U.S. corporation falls within the definition of U.S. property.<sup>2</sup> Thus, the \$100 million loan to USP was an investment in U.S. property held by CFC-P1. Since the loan was outstanding only over one quarter-end, the §956 amount would be \$25 million (i.e., \$100 million divided by four) before taking into account adjustments for earnings and profits.

For the sake of discussion, assume that CFC-P1 had no previously taxed income, and had \$10 million of untaxed earnings and profits. The §956 amount based on the earnings and profits of CFC-P1 would be \$10 million. Accordingly, generally USP would include \$10 million in its income under §951(a)(1)(B).<sup>3</sup>

The CCA addresses whether the earnings and profits of the other CFC-Ps should be taken into account under the indirect investment rule of Reg. §1.956-1T(b)(4). Assume the aggregate amount of the earnings and profits of all of the CFC-Ps exceeds \$100 million, and they have no previously taxed income. If the indirect investment rule applied, the CCA indicates that the amount of the inclusion in the income of USP would be \$25 million, taking into account the earnings and profits of the other CFC-Ps.

<sup>2</sup> §956(c)(1)(C), §956(c)(2)(F) and §956(c)(2)(L).

<sup>3</sup> The CCA states that the exceptions for certain short-term loans were unavailable. See Notice 2008-91, 2008-43 I.R.B. 1001; Notice 88-108, 1988-2 C.B. 446.

<sup>1</sup> CCA 201420017.

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 illustrates this rule where one CFC makes a loan to another CFC with no earnings and profits, and the second CFC makes a loan to a U.S. related person. The example treats the first CFC as holding the loan to the related U.S. person for purposes of applying §956.<sup>4</sup>

Under the facts in the CCA, the first issue is whether the language of Reg. §1.954-1T(b)(4) applies to a loan made by a partnership to a CFC. The plain language provides that the indirect investment rule applies to a CFC that funds an investing foreign corporation, but not to a partnership that funds an investing foreign corporation. The examples in the regulations and the cases that address this regulation have only applied the temporary regulation where the CFC holding the U.S. property was funded by another CFC, and no authority has applied the indirect investment rule where a partnership funds an investing CFC.

The IRS in the CCA, however, concluded that the language of the temporary regulation applies to a partnership that funds another CFC's U.S. property investment. The CCA states that the application of the regulation does not depend on a direct funding by a CFC, reading the language as requiring only that one of the principal purposes of the funding be the avoidance of §956. In effect, it treats the partnership as an aggregate and the CFC partners as having directly funded CFC-P1.

The CCA looks to Reg. §1.956-2(a)(3) for support. That provision treats CFC partners as owning an interest in U.S. property that is held by a partnership. While acknowledging that this regulation does not directly apply for purposes of the indirect investment rule, the CCA states that applying the indirect investment rule to the FPS loan to CFC-P1 effectuates the purpose of that provision, because if FPS had held the loan directly, the CFC partners would be considered as holding the loan.

<sup>4</sup> The cases that have considered the indirect investment rule have applied it where a CFC parent makes a capital contribution to a CFC subsidiary with no earnings and profits which then invests the funds in U.S. property on a long-term basis. *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 USTC ¶50,373 (D.N.J. 2010), *aff'd*, 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). Whether Reg. §1.956-1T(b)(4), which has been temporary for a quarter of a century, constitutes a valid exercise of the IRS's rulemaking authority has not been challenged in court.

The CCA, however, fails to address cases that have consistently rejected the IRS's arguments seeking to apply Subpart F to partnerships owned by CFCs by treating the partnership as an aggregate. In *Brown Group, Inc. v. Commissioner*,<sup>5</sup> a U.S. corporation owned a Cayman Islands CFC which was an 88% partner in a Cayman Islands partnership. The Cayman Islands partnership earned sales commissions for purchasing footwear in Brazil on behalf of the U.S. parent. The IRS asserted that Subpart F should be applied as if the Cayman Islands CFC earned the commissions, which would cause such income to be foreign base company sales income. The Eighth Circuit rejected this theory, concluding that it is a well-established principle that a partnership should generally be treated as an entity and income should be characterized at the partnership level. Because the then definition of "related person" did not include a partnership related to a CFC or to the U.S. parent, the court held that the commissions were not Subpart F income. The opinion further noted that even if the Cayman Islands partnership were a related person, it could not have Subpart F income because it was a partnership, not a CFC.<sup>6</sup>

The Ninth Circuit similarly applied an entity approach in another Subpart F case. In *MCA, Inc. v. United States*,<sup>7</sup> a CFC was a 95% partner in a partnership and received royalties from the partnership. The court held that the royalties were not Subpart F income because under the then definition of "related person," a partnership controlled by a CFC was not a related person.<sup>8</sup>

Based on the above cases, the general principle of treating a partnership as an entity should control the interpretation of the indirect investment rule. Under such analysis, the temporary regulation should not apply to the loan made by FPS — a partnership — to CFC-P1 to treat the other CFC partners as holding the loan made by CFC-P1 to USP, and should not otherwise apply to a loan made by a partnership because it is not a CFC.

Assuming for the sake of argument that the indirect investment rule was found potentially applicable to

<sup>5</sup> 77 F.3d 217 (8th Cir. 1996).

<sup>6</sup> The Treasury subsequently amended the regulations causing such income to be Subpart F income in the future, but note that those regulations do not treat a partnership as an aggregate for all Subpart F purposes, and treat partnerships as entities for certain determinations. For aggregate treatment, *see, e.g.*, Reg. §1.708-1(a)(8)(ii), §1.952-1(g)(1), §1.954-2(b)(4)(i)(B) and §1.954-2(b)(5)(i)(B); for entity treatment, *see, e.g.*, Reg. §1.954-2(a)(5)(ii), §1.954-3(a)(6), and §1.954-4(b)(2)(iii).

<sup>7</sup> 685 F.2d 1099 (9th Cir. 1982).

<sup>8</sup> The Code was later amended to include within the definition of "related person" a partnership controlled by a CFC. §954(d)(3).

the loan made by FPS to CFC-P1 — such that the CFC partners would be treated as loaning the \$60 million to CFC-P1 and thus potentially within the scope of the rule — the indirect investment rule would apply only if there was a principal purpose to avoid the application of §956 to the CFC partners. The CCA concludes that the principal purpose requirement is met. It points to the following:

- The amount of the §956 inclusion would be substantially greater if FPS had loaned the funds directly to USP; and
- The close proximity in time between when FPS lent the amount to CFC-P1 and when CFC-P1 made the loan to USP.

The CCA concludes that USP's statement that the purpose of the FPS loan was for funding an investment that triggered a §956 inclusion was not sufficient to show that there was not a principal purpose to avoid the application of §956. The CCA states that it is not necessary that the funding be for the entire amount of the investment in U.S. property.

The CCA's application of the principal purpose requirement is an unwarranted stretch. The principal purpose test has been applied where one CFC with earnings and profits funds a second CFC without earnings and profits, and the second CFC invests the proceeds in U.S. property with the intent to provide funding to the U.S. without being subject to taxation under §956. The indirect investment rule is applied in such situation to take into account the earnings and profits of the CFC that provided the funds for the U.S. property investment. But, under the facts in the CCA, apparently the taxpayer sought to use §956 affirmatively to cause an inclusion of the earnings and profits of CFC-P1 under §956, which planning is accepted by the IRS.<sup>9</sup> In such case, there is no purpose to provide funding to the U.S. via a CFC without earnings

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<sup>9</sup> Section 960(c) presupposes that taxpayers may affirmatively trigger an inclusion under §951(a)(1)(B). See also Rev. Rul. 90-112, 1990-2 C.B. 186; Reg. §1.902-1(f) Ex. 4; PLR 8912037; PLR 8114032, FSA 961121; FSA 950823; Notice 2008-91 (making expanded short-term obligation exception elective, presumably to accommodate affirmative use of §956); Staff of the Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (May 4, 1987), at 1085-86, 1089-90; *Amstead Industries, Inc. v. Commissioner*, Doc. No. 47616-86, discussed in Tax Notes Int'l (July 1989), at p. 72.

and profits to avoid the application of §956. Indeed, there is no purpose of funding the U.S. at all, but rather triggering an inclusion of CFC earnings and profits, as further demonstrated by the short-term nature of the loan to the U.S. over one quarter-end. Inferring a principal purpose of avoidance where there has indeed been an inclusion, simply because there may have been alternative transactions that could have produced greater U.S. tax at the end of the day, would seem to extend the indirect investment rule into uncharted territory. It will commonly be the case that, considering all of a multinational group's various financing flows, a different combination of transactions might be imagined that would produce more tax. The broad application of the indirect investment rule under the facts of the CCA is beyond its purpose and the application contemplated by the drafters as evidenced by the language of the regulation.

In sum, the IRS treats a loan made by a partnership to a CFC that invests in U.S. property as subject to the indirect investment rule, such that the CFC partners are treated as holding the U.S. property for purposes of §956. This conclusion is inconsistent with the fundamental rule of treating partnerships as entities and case law that consistently applies the entity approach to Subpart F determinations.<sup>10</sup> Furthermore, it is unwarranted to conclude that the principal purpose test of the indirect investment rule is met for a loan made by a partnership to a CFC where the funds are used to make a short-term loan to a U.S. affiliate with the objective of triggering an inclusion under §956.<sup>11</sup>

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<sup>10</sup> Courts have consistently rejected IRS arguments to interpret §956 broadly to carry out perceived policies. See *Ludwig v. Commissioner*, 68 T.C. 979 (1977) (rejected IRS policy argument to treat a pledge of stock as an investment in U.S. property); *The Limited, Inc. v. Commissioner*, 286 F.3d 324 (6th Cir. 2002) (rejecting the IRS argument to treat a CFC loan to a related domestic finance entity as not qualifying for the banking exception). Two other cases held that certain investments made by CFCs were subject to current U.S. taxation, not 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 Group, Inc. v. Commissioner*, T.C. Memo 2013-109 (court held that certain CFC investments were in substance dividends to the U.S. parent; case is on appeal).

<sup>11</sup> CFC-P1 could have borrowed from a bank for the short period to fund the loan to USP and clearly not have been subject to the indirect investment rule, which further shows the inappropriateness of applying the indirect investment rule under the facts of the CCA.