[4830-01-p]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9733]

RIN 1545-BJ49

United States Property Held by Controlled Foreign Corporations in Transactions Involving Partnerships; Rents and Royalties Derived in the Active Conduct of a Trade or Business

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final and temporary regulations.

SUMMARY: This document contains temporary regulations regarding the treatment as United States property of property held by a controlled foreign corporation (CFC) in connection with certain transactions involving partnerships. In addition, the temporary regulations provide rules regarding when a CFC is considered to derive rents and royalties in the active conduct of a trade or business for purposes of determining foreign personal holding company income (FPHCI). These regulations affect United States shareholders of CFCs. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register**. The final regulations revise and add cross-references to coordinate the application of the temporary regulations.

DATES: Effective Date: These regulations are effective on **[INSERT DATE OF PUBLICATION IN THE FEDERAL REGISTER]**.

Applicability Dates: For dates of applicability, see §§1.954-2T(j) and 1.956-1T(g).

FOR FURTHER INFORMATION CONTACT: Rose E. Jenkins, (202) 317-6934 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to 26 CFR part 1 under of the Internal Revenue Code (Code). Section 956 determines the amount that a United States shareholder (as defined in section 951(b)) of a CFC must include in gross income with respect to the CFC under section 951(a)(1)(B). This amount is determined, in part, based on the average amount of United States property held, directly or indirectly, by the CFC at the close of each quarter during its taxable year. Subject to certain exceptions, United States property generally includes obligations of United States persons that are related to the CFC. Sections 956(c)(1)(C), 956(c)(2)(F), and 956(c)(2)(L). In general, the amount taken into account for section 956 purposes with respect to any United States property is the adjusted basis of the property, reduced by any liability to which the property is subject. See section 956(a) and §1.956-1(e).

Section 956(e) grants the Secretary authority to prescribe such regulations as may be necessary to carry out the purposes of section 956, including regulations to prevent the avoidance of section 956 through reorganizations or otherwise. In addition, section 956(d) grants the Secretary authority to prescribe regulations pursuant to which

a CFC that is a pledgor or guarantor of an obligation of a United States person is considered to hold the obligation.

Section 1.956-1T(b)(4) provides in relevant part that, at the District Director's discretion, a CFC will be considered to hold indirectly investments in United States property acquired by any other foreign corporation that is controlled by the CFC 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 CFC.

This document also contains amendments to 26 CFR part 1 under section 954. Section 954 defines foreign base company income (FBCI), which generally is income earned by a CFC that is taken into account in computing the amount that a United States shareholder of the CFC must include in income under section 951(a)(1)(A). FBCI includes FPHCI, as defined in section 954(c), which, in turn, generally includes rents and royalties. Section 954(c)(1)(A). However, rents and royalties are excluded from FPHCI if they are received from a person other than a related person and derived in the active conduct of a trade or business within the meaning of section 954(c)(2)(A) and §1.954-2(c) and (d) (active rents and royalties exception). Temporary regulations in this document provide guidance on the active rents and royalties exception, including the treatment of cost sharing arrangements for purposes of the exception.

Explanation of Provisions

1. Modifications of Anti-Avoidance Rule in §1.956-1T(b)(4)

A. Modifications of existing rules

These regulations modify §1.956-1T(b)(4) so that the rule can also apply when a foreign corporation controlled by a CFC is funded other than through capital contributions or debt. In addition, these temporary regulations add an example involving the funding of one CFC by another CFC that controls it to illustrate the application of the anti-avoidance rule when a principal purpose for funding the first CFC is to avoid the application of section 956 with respect to the funding CFC, even though there would be a section 956 inclusion with respect to the CFC that received the funding. This example illustrates that the CFCs' tax attributes associated with a section 956 inclusion (such as total earnings and profits, previously taxed earnings and profits, and foreign tax credit pools) are taken into account in determining whether a principal purpose of a funding was to avoid the application of section 956 with respect to the funding CFC. In addition, this example makes clear that if a CFC is considered to indirectly hold United States property pursuant to §1.956-1T(b)(4), then the CFC that actually holds the United States property will not also be considered to hold the property for purposes of section 956. See Example 3 in §1.956-1T(b)(4)(iv).

These regulations also modify Example 1 and Example 2 of §1.956-1T(b)(4) to more closely reflect the language of new §1.956-1T(b)(4)(iv). The Department of the Treasury (Treasury Department) and the IRS do not view these modifications as a substantive change.

Moreover, §1.956-1T(b)(4) applies if "one of the principal purposes" for the transaction is to avoid the application of section 956 with respect to the CFC. These temporary regulations apply when "a principal purpose" for the transaction is to avoid the application of section 956 with respect to the CFC. The Treasury Department and

the IRS do not view this modification as a substantive change, since both formulations appropriately reflect that there may be more than one principal purpose for a transaction. Accordingly, §1.956-1T(b)(4) may be applied if a principal purpose of a transaction is to avoid the application of section 956, even if there also were other principal purposes for the transaction.

Finally, the Treasury Department and the IRS have concluded that §1.956-1T(b)(4) should apply without requiring the IRS to exercise its discretion, and, therefore, have modified the rule to be self-executing. This modification, as well as the modification to what constitutes a funding, is consistent with a previous change to a similar rule in §1.304-4(b). See TD 9477, 74 FR 69021 (Dec. 30, 2009).

B. New partnership rule

Existing §1.956-1T(b)(4) applies only to transactions that involve foreign corporations that are controlled by a CFC. The Treasury Department and the IRS understand that taxpayers may be using partnerships to structure transactions that are similar to the types of transactions addressed by §1.956-1T(b)(4). For example, with a principal purpose of avoiding the application of section 956, a CFC may contribute cash to a partnership in exchange for an interest in the partnership, which in turn lends the cash to a United States shareholder of the CFC. In such a case, a taxpayer may take the position that the CFC is not treated as indirectly holding the entire obligation of the United States shareholder but instead is treated as holding the obligation only to the extent of the CFC's interest in the partnership under §1.956-2(a)(3).

These types of partnership transactions raise concerns similar to those that are currently addressed by §1.956-1T(b)(4). Accordingly, these temporary regulations

expand §1.956-1T(b)(4) to include transactions involving partnerships that are controlled by the CFC. These temporary regulations also contain a coordination rule in §1.956-1T(b)(4)(iii), which provides that the new partnership rule in §1.956-1T(b)(4)(i)(C) applies only to the extent that the amount of United States property that a CFC would be treated as holding under the rule exceeds the amount that it would be treated as holding under §1.956-2(a)(3).

2. New Rule Governing Foreign Partnership Distributions Funded by CFCs

The Treasury Department and the IRS also understand that CFCs are engaging in transactions in which a CFC lends funds to a foreign partnership, which then distributes the proceeds from the borrowing to a U.S. partner who is related to the CFC and whose obligation would be United States property if it were held (or treated as held) by the CFC. Alternatively, the CFC could guarantee a loan to a foreign partnership, which then could distribute the loan proceeds to a related U.S. partner. Taxpayers take the position that section 956 does not apply to these transactions even though the CFC's earnings are effectively repatriated to a related U.S. partner.

In response to these transactions, the temporary regulations add §1.956-1T(b)(5) to address certain cases in which a CFC funds a foreign partnership (or guarantees a borrowing by a foreign partnership) and the foreign partnership makes a distribution to a U.S. partner that is related to the CFC. For purposes of section 956, §1.956-1T(b)(5) treats the partnership obligation as an obligation of the distributee partner to the extent of the lesser of the amount of the distribution that would not have been made but for the funding of the partnership or the amount of the foreign partnership obligation. For example, if a related United States shareholder of a CFC has an interest in a foreign

partnership, the CFC lends $100 to the partnership, and the partnership distributes $100 to the United States shareholder in a distribution that would not have been made but for the loan from the CFC, then the entire $100 partnership obligation held by the CFC will be treated as an obligation of the United States shareholder that qualifies as United States property. Section 1.956-1T(b)(5) generally has the same purpose and effect as proposed §1.956-4(c)(3) contained in the notice of proposed rulemaking on this subject in the Proposed Rules section of this issue of the **Federal Register** (REG-155164-09) and will be removed upon the finalization of proposed §1.956-4(c)(3).

3. Active Rents and Royalties Exception to FPHCI

Although rents and royalties generally are included in FPHCI under section 954(c)(1)(A), rents and royalties derived in the active conduct of a trade or business and received from a person that is not a related person are excluded from FPHCI under the active rents and royalties exception in section 954(c)(2)(A) and §1.954-2(b)(6). The section 954 regulations provide the exclusive rules for determining whether rents and royalties are derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A). Specifically, §1.954-2(c) provides four alternative ways for rents to be derived in the active conduct of a trade or business, and §1.954-2(d) provides two alternative ways for royalties to be derived in the active conduct of a trade or business. One way for a CFC to derive rents and royalties in the active conduct of a trade or business is to satisfy an “active development” test, which, among other things, requires the CFC to be “regularly engaged” either in the “manufacture or production of, or in the acquisition and addition of substantial value to,” certain property (§1.954-2(c)(1)(i), applicable to rents); or in the “development, creation or production of, or in the

acquisition of and addition of substantial value to," certain property (§1.954-2(d)(1)(i), applicable to royalties) (collectively, active development tests). Although certain of the alternative ways (specifically, the active management and marketing tests) in which a CFC can satisfy the active rents and royalties exception require that the relevant activities be performed by the CFC's own officers or staff of employees (§1.954-2(c)(1)(ii), (iv), and (d)(1)(ii)), the active development tests do not expressly contain this requirement. But see §1.954-2(d)(3) Example 5 (indicating that royalties received by a CFC that financed independent persons in development activities were not considered derived in the active conduct of a trade or business for purposes of section 954(c)(2)(A)).

In addition to the active development tests, another way for a CFC to derive rents and royalties in the active conduct of a trade or business is to satisfy an "active marketing" test, which, among other things, requires the CFC to operate in a foreign country an organization that is regularly engaged in the business of marketing, or marketing and servicing, the leased or licensed property, and that is "substantial" in relation to the amount of rents or royalties derived from the leased or licensed property. See §1.954-2(c)(1)(iv) and (d)(1)(ii). Pursuant to a safe harbor in the regulations, an organization is "substantial" if the active leasing or licensing expenses equal or exceed 25 percent of the adjusted leasing or licensing profits. See §1.954-2(c)(2)(ii) and (d)(2)(ii). The regulations generally define active leasing expenses and active licensing expenses to mean, subject to certain exceptions, deductions that are properly allocable to rental or royalty income and that would be allowable under section 162 if the CFC were a domestic corporation. See §1.954-2(c)(2)(iii) and (d)(2)(iii).

In general, the active rents and royalties exception is intended to distinguish between a CFC that passively receives investment income and a CFC that derives income from the active conduct of a trade or business. See S. Rep. No. 87-1881, 87th Cong., 2d Sess., at 83 (1962). Accordingly, the policy underlying the active rents and royalties exception requires that the CFC itself actively conduct the business that generates the rents or royalties. The Treasury Department and the IRS have determined that, consistent with this policy, the CFC must perform the relevant activities (that is, activities related to the manufacturing, production, development, or creation of, or, in the case of an acquisition, the addition of substantial value to, the property at issue) through its own officers or staff of employees in order to satisfy the active development tests. Thus, §1.954-2T(c)(1)(i) and (d)(1)(i) expressly provide that the CFC lessor or licensor must perform the required functions through its own officers or staff of employees.

The Treasury Department and the IRS also have concluded that the policy of the active rents and royalties exception allows the relevant activities undertaken by a CFC through its officers or staff of employees to be performed in more than one foreign country. Thus, §1.954-2T(c)(1)(iv) and (d)(1)(ii) provide that (i) a CFC's officers or staff of employees may be located in one or more foreign countries; and (ii) an organization that meets the requirements of the active marketing test can be maintained and operated by the officers or staff of employees either in a single foreign country or in multiple foreign countries collectively. Similarly, §1.954-2T(c)(2)(ii) and (d)(2)(ii) indicate that an organization can be in a single foreign country or in multiple foreign countries collectively for purposes of determining the substantiality of the foreign organization.

In applying the active development tests and active marketing tests, questions have arisen as to the treatment of cost sharing arrangements under which a person other than the CFC actually conducts relevant activities. Consistent with the policy underlying the active rents and royalties exception that requires the CFC itself to conduct the relevant activities, §1.954-2T(c)(2)(viii) and (d)(2)(v) clarify that CST Payments and PCT Payments (as defined in §1.482-7(b)(1)) made by a CFC will not cause the CFC's officers and employees to be treated as undertaking the activities of the controlled participant to which the payments are made. This clarification applies for purposes of the active development tests and the active marketing tests, including for purposes of determining whether an organization that engages in marketing is substantial. Similarly, §1.954-2T(c)(2)(iii)(E) and (d)(2)(iii)(E) provide that deductions for CST Payments and PCT Payments are excluded from the definition of active leasing expenses and active licensing expenses, respectively. Thus, CST Payments and PCT Payments are not active leasing expenses or active licensing expenses for purposes of determining whether an organization is "substantial" under the safe harbor test.

4. Effective/Applicability Dates

The rules in §1.956-1T(b)(4) described in Part 1 of this preamble apply to taxable years of CFCs ending on or after [**INSERT DATE OF FILING AT THE FEDERAL REGISTER**], and to taxable years of United States shareholders in which or with which such taxable years end, with respect to property acquired, including property treated as acquired as the result of a deemed exchange of property pursuant to section 1001, on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**. The rule in §1.956-1T(b)(5) described in Part 2 of this preamble applies to taxable years of CFCs

ending on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**, and to taxable years of United States shareholders in which or with which such taxable years end, in the case of distributions made on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**. The rules regarding the active development test in §§1.954-2T(c)(1)(i) and (d)(1)(i) described in Part 3 of this preamble apply to rents or royalties, as applicable, received or accrued during taxable years of CFCs ending on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**, and to taxable years of United States shareholders in which or with which such taxable years end, but only with respect to property manufactured, produced, developed, or created, or, in the case of acquired property, property to which substantial value has been added, on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**. The rules regarding the active marketing test in §§1.954-2T(c)(1)(iv), (c)(2)(ii), (d)(1)(ii), and (d)(2)(ii) described in Part 3 of this preamble, as well as the rules regarding cost-sharing arrangements in §§1.954-2T(c)(2)(iii)(E), (c)(2)(viii), (d)(2)(iii)(E), and (d)(2)(v) also described in Part 3 of this preamble, apply to rents or royalties, as applicable, received or accrued during taxable years of CFCs ending on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**, and to taxable years of United States shareholders in which or with which such taxable years end, to the extent that such rents or royalties that are received or accrued on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**. No inference is intended as to the application of the provisions amended by these temporary regulations under current law. The IRS may, where appropriate, challenge transactions, including those described in these temporary regulations and

this preamble, under currently applicable Code or regulatory provisions or judicial doctrines.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory assessment is not required. It has been determined that sections 553(b) and (d) of the Administrative Procedure Act (5 U.S.C. chapter 5) do not apply to these regulations. For applicability of the Regulatory Flexibility Act (5 U.S.C. chapter 6), refer to the cross-referenced notice of proposed rulemaking published elsewhere in this issue of the **Federal Register**. Pursuant to section 7805(f) of the Internal Revenue Code, these regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal authors of these regulations are Barbara E. Rasch and Rose E. Jenkins of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding entries in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *
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Section 1.956-1T also issued under 26 U.S.C. 956(d) and 956(e).
* * * * *

Par. 2. Section 1.954-2 is amended by:

a. Revising paragraphs (c)(1)(i), (c)(1)(iv), and (c)(2)(ii);

b. Adding paragraphs (c)(2)(iii)(E) and (c)(2)(viii);

c. Revising paragraphs (d)(1)(i) and (ii) and (d)(2)(ii); and

d. Adding paragraphs (d)(2)(iii)(E), (d)(2)(v), and (j).

The revisions and additions read as follows:

§1.954-2 Foreign personal holding company income.

* * * * *

(c) * * *

(1) * * *

(i) [Reserved]. For further guidance, see §1.954-2T(c)(1)(i).

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(iv) [Reserved]. For further guidance, see §1.954-2T(c)(1)(iv).

(2) * * *

(ii) [Reserved]. For further guidance, see §1.954-2T(c)(2)(ii).

(iii) * * *

(E) [Reserved]. For further guidance, see §1.954-2T(c)(2)(iii)(E).

* * * * *

(viii) [Reserved]. For further guidance, see §1.954-2T(c)(2)(viii).

* * * * *

(d) * * *

(1) * * *

(i) [Reserved]. For further guidance, see §1.954-2T(d)(1)(i).

(ii) [Reserved]. For further guidance, see §1.954-2T(d)(1)(ii).

(2) * * *

(ii) [Reserved]. For further guidance, see §1.954-2T(d)(2)(ii).

(iii) * * *

(E) [Reserved]. For further guidance, see §1.954-2T(d)(2)(iii)(E).

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(v) [Reserved]. For further guidance, see §1.954-2T(d)(2)(v).

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(j) [Reserved]. For further guidance, see §1.954-2T(j).

Par. 3. Section 1.954-2T is added to read as follows:

§1.954-2T Foreign personal holding company income (temporary).

(a)(1) through (c)(1) introductory text [Reserved]. For further guidance, see §1.954-2(a)(1) through (c)(1).

(i) Property that the lessor, through its own officers or staff of employees, has manufactured or produced, or property that the lessor has acquired and, through its own officers or staff of employees, added substantial value to, but only if the lessor, through its officers or staff of employees, is regularly engaged in the manufacture or production of, or in the acquisition and addition of substantial value to, property of such kind;

(c)(1)(ii) and (iii) [Reserved]. For further guidance, see §1.954-2(c)(1)(ii) and (c)(1)(iii).

(iv) Property that is leased as a result of the performance of marketing functions by such lessor through its own officers or staff of employees located in a foreign country or countries, if the lessor, through its officers or staff of employees, maintains and operates an organization either in such country or in such countries (collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the leased property and that is substantial in relation to the amount of rents derived from the leasing of such property.

(c)(2)(i) [Reserved]. For further guidance, see §1.954-2(c)(2)(i).

(ii) Substantiality of foreign organization. For purposes of paragraph (c)(1)(iv) of this section, whether an organization either in a foreign country or in foreign countries (collectively) is substantial in relation to the amount of rents is determined based on all the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of rents if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 25 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section. In addition, for purposes of aircraft or vessels leased in foreign commerce, an organization will be considered substantial if active leasing expenses, as defined in paragraph (c)(2)(iii) of this section, equal or exceed 10 percent of the adjusted leasing profit, as defined in paragraph (c)(2)(iv) of this section. For purposes of paragraphs (c)(1)(iv) and (c)(2) of this section and §1.956-2(b)(1)(vi), the term aircraft or vessels includes component parts, such as engines that are leased separately from an aircraft or vessel.

(c)(2)(iii) introductory text through (c)(2)(iii)(D) [Reserved]. For further guidance, see §1.954-2(c)(2)(iii) through (c)(2)(iii)(D).

(E) Deductions for CST Payments or PCT Payments (as defined in §1.482-7(b)).

(c)(2)(iv) through (c)(2)(vii) [Reserved]. For further guidance, see §1.954-2(c)(2)(iv) through (c)(2)(vii).

(viii) Cost sharing arrangements (CSAs). For purposes of paragraphs (c)(1)(i) and (iv) of this section, CST Payments or PCT Payments (as defined in §1.482-7(b)(1)) made by the lessor to another controlled participant (as defined in §1.482-7(j)(1)(i)) pursuant to a CSA (as defined in §1.482-7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the lessor's own officers or staff of employees.

(c)(3) and (d)(1) introductory text [Reserved]. For further guidance, see §1.954-2(c)(3) and (d)(1).

(i) Property that the licensor, through its own officers or staff of employees, has developed, created, or produced, or property that the licensor has acquired and, through its own officers or staff of employees, added substantial value to, but only so long as the licensor, through its officers or staff of employees, is regularly engaged in the development, creation, or production of, or in the acquisition and addition of substantial value to, property of such kind; or

(ii) Property that is licensed as a result of the performance of marketing functions by such licensor through its own officers or staff of employees located in a foreign country or countries, if the licensor, through its officers or staff of employees, maintains and operates an organization either in such foreign country or in such foreign countries

(collectively), as applicable, that is regularly engaged in the business of marketing, or of marketing and servicing, the licensed property and that is substantial in relation to the amount of royalties derived from the licensing of such property.

(d)(2)(i) [Reserved]. For further guidance, see §1.954-2(d)(2)(i).

(ii) Substantiality of foreign organization. For purposes of paragraph (d)(1)(ii) of this section, whether an organization either in a foreign country or in foreign countries (collectively) is substantial in relation to the amount of royalties is determined based on all of the facts and circumstances. However, such an organization will be considered substantial in relation to the amount of royalties if active licensing expenses, as defined in paragraph (d)(2)(iii) of this section, equal or exceed 25 percent of the adjusted licensing profit, as defined in paragraph (d)(2)(iv) of this section.

(d)(2)(iii) introductory text through (d)(2)(iii)(D) [Reserved]. For further guidance, see §1.954-2(d)(2)(iii) through (d)(2)(iii)(D).

(E) Deductions for CST Payments or PCT Payments (as defined in §1.482-7(b)).

(d)(2)(iv) [Reserved]. For further guidance, see §1.954-2(d)(2)(iv).

(v) Cost sharing arrangements (CSAs). For purposes of paragraphs (d)(1)(i) and (ii) of this section, CST Payments or PCT Payments (as defined in §1.482-7(b)(1)) made by the licensor to another controlled participant (as defined in §1.482-7(j)(1)(i)) pursuant to a CSA (as defined in §1.482-7(a)) do not cause the activities undertaken by that other controlled participant to be considered to be undertaken by the licensor's own officers or staff of employees.

(d)(3) through (i) [Reserved]. For further guidance, see §1.954-2(d)(3) through (i).

(j) Effective/applicability date. Paragraphs (c)(1)(i) and (d)(1)(i) of this section apply to rents or royalties, as applicable, received or accrued during taxable years of controlled foreign corporations ending on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**, and to taxable years of United States shareholders in which or with which such taxable years end, but only with respect to property manufactured, produced, developed, or created, or in the case of acquired property, property to which substantial value has been added, on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**. Paragraphs (c)(1)(iv), (c)(2)(ii), (c)(2)(iii)(E), (c)(2)(viii), (d)(1)(ii), (d)(2)(ii), (d)(2)(iii)(E), and (d)(2)(v) of this section apply to rents or royalties, as applicable, received or accrued during taxable years of controlled foreign corporations ending on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**, and to taxable years of United States shareholders in which or with which such taxable years end, to the extent that such rents or royalties are received or accrued on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**. See §§1.954-2(c)(1)(i), (c)(1)(iv), (c)(2)(ii), (c)(2)(iii), (d)(1)(i), (d)(1)(ii), (d)(2)(ii), and (d)(2)(iii), as contained in 26 CFR part 1 revised as of April 1, 2015, for rules applicable to rents or royalties, as applicable, received or accrued before **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**.

(k) Expiration date. The applicability of paragraphs (c)(1)(i), (c)(1)(iv), (c)(2)(ii), (c)(2)(iii)(E), (c)(2)(viii), (d)(1)(i), (d)(1)(ii), (d)(2)(ii), (d)(2)(iii)(E), and (d)(2)(v) of this section expires on or before **[INSERT DATE THREE YEARS AFTER DATE FILED WITH THE OFFICE OF THE FEDERAL REGISTER]**.

Par. 4. Section 1.956-1 is amended by:

1. Adding paragraphs (b)(4), (b)(5), (f), and (g)(1) through (3).

2. Redesignating paragraph (e)(6)(vii) as paragraph (g)(4) and revising it.

The additions and revisions read as follows:

§1.956-1 Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

* * * * *

(b) * * *

(4) [Reserved]. For further guidance, see §1.956-1T(b)(4).

(5) [Reserved]. For further guidance, see §1.956-1T(b)(5).

* * * * *

(f) [Reserved]. For further guidance, see §1.956-1T(f).

(g) introductory text through (g)(3) [Reserved]. For further guidance, see §1.956-1T(g) through (g)(3).

(4) Paragraph (e)(6) of this section applies to property acquired in exchanges occurring on or after June 24, 2011. For transactions that occur prior to June 24, 2011, see §1.956-1T(e)(6) as contained in 26 CFR Part 1 revised as of April 1, 2011.

Par. 5. Section 1.956-1T is amended by revising paragraph (b)(4), and adding paragraphs (b)(5), (e)(6), (g), and (h) to read as follows:

§1.956-1T Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property (temporary).

* * * * *

(b) * * *

(4) Certain indirectly held United States property--(i) General rule. For purposes of section 956, United States property held indirectly by a controlled foreign corporation includes--

(A) United States property held on behalf of the controlled foreign corporation by a trustee or a nominee;

(B) United States property acquired by any other foreign corporation that is controlled by the controlled foreign corporation if a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation; and

(C) Property acquired by a partnership that is controlled by the controlled foreign corporation if the property would be United States property if held directly by the controlled foreign corporation, and a principal purpose of creating, organizing, or funding by any means (including through capital contributions or debt) the partnership is to avoid the application of section 956 with respect to the controlled foreign corporation.

(ii) Control. For purposes of paragraphs (b)(4)(i)(B) and (C) of this section, a controlled foreign corporation controls a foreign corporation or partnership if the controlled foreign corporation and the other foreign corporation or partnership are related within the meaning of or section 707(b). For this purpose, in determining whether two corporations are members of the same controlled group under, a person is considered to own stock owned directly by such person, stock owned for the purposes of, and stock owned with the application of section 267(c).

(iii) Coordination rule. Paragraph (b)(4)(i)(C) of this section applies only to the extent that the amount of United States property that is treated as held indirectly by a controlled foreign corporation under that paragraph exceeds the amount of United States property that is treated as held by the controlled foreign corporation under §1.956-2(a)(3).

(iv) Examples. The following examples illustrate the rules of this paragraph (b)(4). In each example, unless otherwise provided, P is a domestic corporation that wholly owns two controlled foreign corporations, FS1 and FS2.

Example 1. (i) Facts. FS1 sells inventory to FS2 in exchange for trade receivables due in 60 days. Avoiding the application of section 956 with respect to FS1 was not a principal purpose of establishing the trade receivables. FS2 has no earnings and profits and FS1 has substantial accumulated earnings and profits. FS2 makes a loan to P equal to the amount it owes FS1 under the trade receivables. FS2 pays the trade receivables according to their terms.

(ii) Result. FS1 will not be considered to indirectly hold United States property under this paragraph (b)(4) because the funding of FS2 through the sale of inventory in exchange for the establishment of trade receivables was not undertaken with a principal purpose of avoiding the application of section 956 with respect to FS1.

Example 2. (i) Facts. The facts are the same as in Example 1, except that, with a principal purpose of avoiding the application of section 956 with respect to FS1, FS1 and FS2 agree to defer FS2's payment obligation, and FS2 does not timely pay the receivables.

(ii) Result. FS1 is considered to hold indirectly United States property under this paragraph (b)(4), because there was a funding of FS2, a principal purpose of which was to avoid the application of section 956 with respect to FS1.

Example 3. (i) Facts. FS1 has $100x of post-1986 undistributed earnings and profits and $100 post-1986 foreign income taxes, but does not have any cash. FS2 has earnings and profits of at least $100x, no post-1986 foreign income taxes, and substantial cash. Neither FS1 nor FS2 has earnings and profits described in section 959(c)(1) or section 959(c)(2). FS2 loans $100x to FS1. FS1 then loans $100x to P. An income inclusion by P of $100x under sections 951(a)(1)(B) and 956 with respect to FS1 would result in foreign income taxes deemed paid by P under section 960. A principal purpose of funding FS1 through the loan from FS2 is to avoid the application of section 956 with respect to FS2.

(ii) Result. Under paragraph (b)(4)(i)(B) of this section, FS2 is considered to indirectly hold the $100x obligation of P that is held by FS1. As a result, P has an income inclusion of $100x under sections 951(a)(1)(B) and 956 with respect to FS2, and the foreign income taxes deemed paid by P under section 960 is $0. P does not have an income inclusion under sections 951(a)(1)(B) and 956 with respect to FS1 related to the $100x loan from FS1 to P.

Example 4. (i) Facts. FS1 has substantial earnings and profits. P and FS1 are the only partners in a foreign partnership, FPRS. FS1 contributes $600x cash to FPRS in exchange for a 60% interest in the partnership, and P contributes real estate located outside the United States ($400x value) to FPRS in exchange for a 40% interest in the partnership. There are no special allocations in the FPRS partnership agreement. FPRS lends $100x to P. Under §1.956-2(a)(3), FS1 is treated as holding United States property of $60x (60% x $100x) as a result of the FPRS loan to P. A principal purpose of creating, organizing, or funding FPRS is to avoid the application of section 956 with respect to FS1.

(ii) Result. Before taking into account paragraph (b)(4)(iii) of this section, because FS1 controls FPRS and a principal purpose of creating, organizing, or funding FPRS was to avoid the application of section 956 with respect to FS1, FS1 is considered under paragraph (b)(4)(i)(C) of this section to indirectly hold the $100x obligation of P that would be United States property if held directly by FS1. However, under paragraph (b)(4)(iii) of this section, FS1 is treated as holding United States property under paragraph (b)(4)(i)(C) only to the extent the amount held indirectly under paragraph (b)(4)(i)(C) of this section exceeds the amount of United States property that FS1 is treated as holding under §1.956-2(a)(3). The amount of United States property that FS1 is treated as indirectly holding under paragraph (b)(4)(i)(C) of this section ($100x) exceeds the amount determined under §1.956-2(a)(3) ($60x) by $40x. Thus, FS1 is considered to hold United States property within the meaning of section 956(c) in the amount of $100x ($60x under §1.956-2(a)(3) and $40x under paragraphs (b)(4)(i)(C) and (b)(4)(iii) of this section).

(5) Certain foreign partnership distributions funded by CFCs--(i) General rule. For purposes of section 956, an obligation of a foreign partnership that is held (or that would be treated as held under §1.956-2(c) if the obligation were an obligation of a United States person) by a controlled foreign corporation is treated as a separate obligation of a partner in the partnership when--

(A) The foreign partnership distributes an amount of money or property to the partner;

(B) The foreign partnership would not have made the distribution but for a funding of the partnership through the obligation; and

(C) The partner is related to the controlled foreign corporation within the meaning of section 954(d)(3).

(ii) Amount of obligation. Notwithstanding §1.956-1(e), the amount that is treated as an obligation of the distributee partner pursuant to paragraph (b)(5)(i) of this section is equal to the lesser of the amount of the partnership distribution that would not have been made but for the funding of the partnership or the amount (as determined under §1.956-1(e)) of the obligation of the foreign partnership that is held (or that would be treated as held under §1.956-2(c) if the obligation were an obligation of a United States person) by the controlled foreign corporation.

(iii) Example. (A) Facts. P, a domestic corporation, wholly owns FS, a controlled foreign corporation. P owns a 70% interest in FPRS, a foreign partnership. A domestic corporation that is unrelated to P and FS owns the remaining 30% interest in FPRS. FPRS borrows $100x from FS, and distributes $80x to P. FPRS would not have made the distribution to P but for the funding by FS.

(B) Result. Under paragraph (b)(5)(i) of this section, a portion of the obligation of FPRS that FS holds is treated as an obligation of P, which constitutes United States property, because FPRS made a distribution to P that FPRS would not have made but for the funding of FPRS through the obligation held by FS. Under paragraph (b)(5)(ii) of this section, the amount that is treated as an obligation of P is the lesser of the amount of the distribution, $80x, or the amount of the entire obligation of FPRS held by FS, $100x. For purposes of section 956, therefore, on the date the loan to FPRS is made, FS is considered to hold United States property of $80x.

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(e)(6) [Reserved]. For further guidance, see §1.956-1(e)(6).

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(g) Effective/applicability date. (1) Paragraph (b)(4) of this section applies to taxable years of controlled foreign corporations ending on or after **[INSERT DATE OF**

FILING AT THE FEDERAL REGISTER], and to taxable years of United States shareholders in which or with which such taxable years end, with respect to property acquired on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**. See paragraph (b)(4) of §1.956-1T, as contained in 26 CFR part 1 revised as of April 1, 2015, for the rules applicable to taxable years of controlled foreign corporations ending before **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]** and property acquired before **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**. For purposes of this paragraph (g)(1), a deemed exchange of property pursuant to section 1001 on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]** constitutes an acquisition of the property on or after that date.

(2) Paragraph (b)(5) of this section applies to taxable years of controlled foreign corporations ending on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**, and to taxable years of United States shareholders in which or with which such taxable years end, in the case of distributions made on or after **[INSERT DATE OF FILING AT THE FEDERAL REGISTER]**.

(3) [Reserved].

(4) [Reserved]. For further guidance, see §1.956-1(g)(4).

(h) Expiration date. The applicability of paragraphs (b)(4) and (b)(5) of this section expires on or before **[INSERT DATE THREE YEARS AFTER DATE FILED WITH THE OFFICE OF THE FEDERAL REGISTER]**.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: July 30, 2015.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

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