

Memorandum

Proposed IRC Section 956 Regulations Treat Obligations of A Foreign Partnership as Obligations of Its Partners

September 9, 2015

Introduction

On September 1, 2015, the Internal Revenue Service (“IRS”) and Treasury Department issued temporary regulations and proposed regulations under Section 956 of the Internal Revenue Code of 1986, as amended (the “Code”) regarding the application of Section 956 of the Code to transactions involving partnerships.¹ Current market practice is to treat an obligation of a foreign partnership as an obligation of a non-United States person. However, the new regulations generally provide that an obligation of a foreign partnership should be treated as obligations of the partners of the foreign partnership, and, thus, as United States property to the extent of the foreign partnership’s U.S. partners. These proposed regulations may impact the ability of foreign subsidiaries of a foreign partnership to provide credit support for an obligation of a foreign partnership in certain circumstances.

Background

Pursuant to Sections 951 and 956 of the Code, and subject to certain exceptions and limitations, “United States Shareholders” (generally United States shareholders who own 10% or more of the total combined voting power of the relevant corporation) of controlled foreign corporations (“CFCs”) are required to include in income the earnings and profits of the CFC on a current basis, whether or not such income is distributed, in the event the CFC holds “United States property.” The legislative history of Section 956 states that the section was enacted to prevent certain United States shareholders of CFCs from inappropriately deferring taxation of CFC earnings and profits by preventing the repatriation of income in a manner that does not

¹ Although not otherwise discussed herein, as part of the same regulatory package, Temporary Regulations were also issued under Section 954 of the Code which generally provide that to qualify for the active rents and royalties exception to the definition of foreign personal holding company income, a controlled foreign corporation itself must perform the relevant activities through its own officers or employees.

subject the income to taxation in the United States. Among other items, United States property generally includes certain obligations of a United States person. Under Section 956(d) of the Code, a CFC is considered to hold an obligation of a United States person if the CFC is a “pledgor or guarantor of such obligation.” This rule encompasses indirect pledges and guarantees, such that a CFC is treated as if it had pledged or guaranteed a United States obligation if the CFC’s assets serve at any time as security for such obligation.

The Proposed Regulations

Obligations of Foreign Partnerships Treated As Obligations of the Partners of the Partnership

The proposed regulations expand Section 956 of the Code by generally treating an obligation of a foreign partnership as a United States obligation to the extent of the foreign partnership’s U.S. partners. The proposed regulations determine each United States partner’s share of the obligation in accordance with the partner’s interest in partnership profits. However, the Treasury Department and the IRS are soliciting comments on whether the liquidation value percentage method or another method would be a more appropriate basis. The proposed regulations provide an exception to the general rule for obligations of foreign partnerships in which neither the applicable CFC nor any person related to the CFC is a partner.

Unlike the treatment of obligations of a foreign partnership, the proposed regulations provide that an obligation of a domestic partnership is an obligation of a United States person, regardless of whether the partners in the partnership are United States persons. Additionally, the proposed regulations also confirm that for purposes of Section 956 of the Code, an obligation of a disregarded entity is treated as an obligation of the owner of the disregarded entity.

Pledges and Guarantees under the Proposed Regulations

The proposed regulations extend the pledge and guarantee rule such that a partnership that guarantees an obligation of a United States person will be treated as holding the obligation for purposes of Section 956 of the Code. Furthermore, the proposed regulations would treat the CFC partners of the partnership that is the pledgor or guarantor as holding a share of that obligation. The proposed regulations also apply the indirect pledge or guarantee rule to domestic and foreign partnerships such that a partnership would be considered a pledgor or guarantor of an obligation of a United States person if the partnership’s assets serve indirectly as security for the obligation.

The preamble to the proposed regulations states that the IRS’ view of current law is that the amount taken into account by a CFC in determining the amount of its United States property with respect to a pledge or guarantee is the unpaid principal amount of the obligation regardless of whether there are multiple pledgers or guarantors that are CFCs which could cause multiple inclusions with respect to the same obligation that exceed, in the aggregate, the unpaid principal amount of the obligation. The proposed regulations extend this rule to apply where a partnership is a pledgor or guarantor of an obligation, such that each pledgor or

guarantor is treated as holding the entire unpaid principal amount of the obligation to which its pledge or guarantee relates. The IRS is soliciting comment regarding whether it may be necessary to allocate the amount of the obligation among the relevant CFCs so as to eliminate the potential for multiple inclusions and, instead, limit the aggregate inclusions to the unpaid principal amount of the obligation.

Effective Date

The proposed regulations are proposed to be effective for taxable years of CFCs ending on or after the publication date of the final regulations. The proposed regulations include a grandfathering provision which would not apply a majority of the rules (including the treatment of foreign partnership obligations as obligations of the partners of the partnership) to property acquired, or pledges or guarantees entered into, before September 1, 2015. However, if there is a deemed exchange of a loan by reason of a modification to the transaction on or after September 1, 2015, the grandfathering rule would not apply.

The Temporary Regulations

Generally

Current regulations provide that a CFC indirectly holds any United States property acquired by any foreign corporation that the CFC controls if a principal purpose for creating, organizing, or funding such other corporation is to avoid the application of Section 956. The temporary regulations expand this rule to include transactions involving partnerships controlled by the CFC. The temporary regulations also address the situation where a CFC funds a foreign partnership (or guarantees borrowing by a foreign partnership) and the foreign partnership then makes a distribution to a U.S. partner related to the CFC. Under the regulation, a portion of the partnership obligation is treated as an obligation of the distributee partner.

Effective Date

The temporary regulations generally apply to taxable years of CFCs ending on or after September 1, 2015, and to taxable years of United States shareholders in which or with which such taxable years end. The temporary regulations contain a grandfathering rule similar to the proposed regulations.

Conclusion

Despite the government's acknowledgement in the preamble that many of the comments received recommended that the general rule under Section 956 should treat an obligation of a foreign partnership held by a CFC as an obligation of a foreign person, the proposed regulations instead attribute an obligation of a foreign partnership to each of the partnership's U.S. partners. This rule is inconsistent with the treatment of obligations of a domestic partnership, which are treated as obligations of a United States person for purposes of Section 956 purposes regardless of the composition of the partnership's members. While the IRS

and Treasury are seeking comments regarding certain aspects of the proposed regulations, the government appears to view this rule as necessary to curb perceived abuses regarding the use of partnerships to structure transactions to avoid the Section 956 rules.

We will continue to monitor developments regarding the proposed regulations, which remain subject to change, including any future related IRS notices.

If you have any questions or would like additional information, please do not hesitate to contact any member of the Firm's Tax Practice.

John Creed

+1-212-455-3485
jcreed@stblaw.com

Marcy Geller

+1-212-455-3543
mgeller@stblaw.com

Jonathan Goldstein

+1-212-455-2048
jgoldstein@stblaw.com

Robert Holo

+1-212-455-2514
rho@stblaw.com

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UNITED STATES

New York
425 Lexington Avenue
New York, NY 10017
+1-212-455-2000

Houston
600 Travis Street, Suite 5400
Houston, TX 77002
+1-713-821-5650

Los Angeles
1999 Avenue of the Stars
Los Angeles, CA 90067
+1-310-407-7500

Palo Alto
2475 Hanover Street
Palo Alto, CA 94304
+1-650-251-5000

Washington, D.C.
900 G Street, NW
Washington, D.C. 20001
+1-202-636-5500

EUROPE

London
CityPoint
One Ropemaker Street
London EC2Y 9HU
England
+44-(0)20-7275-6500

ASIA

Beijing
3901 China World Tower
1 Jian Guo Men Wai Avenue
Beijing 100004
China
+86-10-5965-2999

Hong Kong
ICBC Tower
3 Garden Road, Central
Hong Kong
+852-2514-7600

Seoul
25th Floor, West Tower
Mirae Asset Center 1
26 Eulji-ro 5-Gil, Jung-Gu
Seoul 100-210
Korea
+82-2-6030-3800

Tokyo
Ark Hills Sengokuyama Mori Tower
9-10, Roppongi 1-Chome
Minato-Ku, Tokyo 106-0032
Japan
+81-3-5562-6200

SOUTH AMERICA

São Paulo
Av. Presidente Juscelino
Kubitschek, 1455
São Paulo, SP 04543-011
Brazil
+55-11-3546-1000