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Global Tax Alert

US proposed regulations under IRC Sections 954 and 958 have important consequences for subpart F and GILTI regimes, among other provisions

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Executive summary

The United States (US) Department of the Treasury and the Internal Revenue Service (collectively, Treasury) released, on 17 May 2019, proposed regulations (the proposed regulations) under Internal Revenue Code[1] (IRC) Sections 954 and 958 (REG-125135-15) that would have important consequences for computing "Subpart F income" and "GILTI" (global intangible low-taxed income) inclusions (as well as for other provisions). In general, the proposed regulations would be effective only prospectively, i.e., for tax years of "controlled foreign corporations" (CFCs) ending on or after the date Treasury publishes the proposed regulations in final form (and to the tax years of "United States shareholders" in which or with which those tax years end). The proposed regulations generally would result in two major changes:

- First, they would modify how certain constructive ownership rules under Section 318(a) apply for purposes of characterizing a person as a "related person" with respect to a CFC under Section 954(d)(3). Notwithstanding that the proposed regulations are generally effective only prospectively, these modifications would apply immediately to an amount that a CFC receives or accrues on or after 17 May 2019, if the receipt or accrual is "accelerated" with a principal purpose of avoiding the modifications.

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- Second, they would modify the manner in which royalties paid or accrued by a CFC are treated for purposes of applying the "safe harbor" threshold of the "active marketing exception" to "foreign personal holding company income" (FPHCI, a component of Subpart F income) for certain rents earned by the CFC.

As part of the Act commonly referred to as the *Tax Cuts and Jobs Act* (the TCJA), Congress repealed former Section 958(b)(4). That provision had prevented Section 318(a)(3)'s "downward" constructive ownership rules from attributing stock owned by a non-US person to a US person. Neither the proposed regulations themselves nor their Preamble (the Preamble) refers to Section 958(b)(4). It does not appear that the release of the proposed regulations will affect whether Treasury issues regulations on the repeal of former Section 958(b)(4).

Detailed discussion

Modifications to the constructive ownership rules for related-person status

For purposes of applying Section 318(a)'s constructive ownership rules to classify a person as a "related person" with respect to a CFC under Section 954(d)(3) (occasionally, hereinafter, **to classify a person as related to a CFC**), the proposed regulations would make two changes: The downward constructive ownership rules would no longer apply, and the "option" constructive ownership rules would not apply when an option is "used" with a principal purpose of qualifying a person as related to a CFC. Although these modifications are generally effective only prospectively, the Preamble states that CFCs may apply the modifications to tax years ending on or after 17 May 2019, if they apply the modifications to the constructive ownership rules (presumably, all of them) consistently for all such tax years.

Background

Whether a person qualifies as a related person with respect to a CFC under Section 954(d)(3) is relevant to classifying certain income earned by a CFC as Subpart F income (or not). As one example, amounts earned by a CFC in connection with certain sales and services transactions do not constitute "foreign base company sales income" (FBCSaI) or "foreign base company services income" (each a component of Subpart F income) unless a related person participates in the transaction in a specified manner. As another example, dividends, interest, rents and royalties received or accrued by a CFC from another CFC can only be excluded from FPHCI under the "look-through" rule of Section 954(c)(6) if the two CFCs are related to each other. Related-person status is also relevant to other provisions that incorporate Section 954(d)(3), including Sections 267A (which denies a deduction for certain hybrid instruments and entities), 1297(b)(2) (relating to PFICs), and 1471(e)(2) (relating to FATCA).

Section 954(d)(3) and current Treas. Reg. Section 1.954-1(f) describe when a person is related to a CFC: namely, if the person is (i) an individual, corporation, partnership, trust, or estate (an entity) that "controls," or is "controlled" by, the CFC; or (ii) an entity that is "controlled" by the same person or persons that "control" the CFC. "Control" of an entity means the ownership, "directly or indirectly," of more than 50% (measured by voting power or value) of the entity's equity or beneficial interests (as the case may be).

Section 954(d)(3) provides that rules "similar to the rules of [IRC S]ection 958" apply in determining related-person status. The latter Section sets out rules that attribute the ownership of stock actually owned by one person to another. These rules apply for purposes of different IRC Sections. Under one rule in Section 958(a)(2), a shareholder of a corporation, a partner in a partnership, or a beneficiary of a foreign entity (collectively, equityholder) is treated as owning a proportionate amount of any stock actually owned by the foreign entity. Section 958(b) sets out — with reference to Section 318(a) — another set of rules (commonly known as the constructive ownership rules). Among them, Section 318(a)(3) attributes stock ownership "downward"; i.e., ownership of 100% of the stock that an equityholder actually owns is attributed to the relevant entity (whether domestic or foreign, if an entity is a corporation; the equityholder also must own at least 50% (measured by value) of the corporation's equity interests (i.e., stock)) (the downward constructive ownership rules). Further, Section 318(a)(4) attributes stock ownership to a person with an option to acquire that stock (i.e., as if the option had been exercised) (the option constructive ownership rule).

"[To] determine direct or indirect ownership," current Treas. Reg. Section 1.954-1(f)(2)(iv) requires, for purposes of current Treas. Reg. Section 1.954-1(f), the "principles" of Section 958 to be applied without regard to whether (i) an entity is foreign or domestic, or (ii) an individual is a citizen or resident of the United States. One consequence of this rule is that, applying Section 958(a)(2), stock actually owned by a *domes*tic entity is treated as owned proportionately by

the entity's equityholder. The current Treasury regulations do not otherwise modify how the rules of Section 958 apply in evaluating whether a person is related to a CFC under Section 954(d)(3).

Modifications to the downward constructive ownership rules

The proposed regulations would render inapplicable the downward constructive ownership rules for purposes of related-person determinations. As just noted, for an entity other than a corporation, ownership of the stock actually owned by the entity's equityholder is attributed "downward" to the entity irrespective of the extent of the value or voting power of the equityholder's interest in the entity. Downward attribution to a corporation, in contrast, requires the equityholder to own at least 50% (measured by value) of the corporation's stock.

According to the Preamble, Treasury has proposed this modification to avoid certain "inappropriate results" under the current Treasury regulations. The Preamble sets out two examples of such results.

- First, if two otherwise unrelated persons are partners in a partnership, then — regardless of the value or voting power of their respective interests in the partnership — the partnership is treated under the downward constructive ownership rules as controlling any corporations (or other entities) that the partners respectively control. Accordingly, the entity controlled by one partner is related to the entity controlled by the other partner (as well as to the partnership).
- Second, two persons each could own a 50% equity interest in a joint venture entity that is classified as a corporation for US federal income tax purposes. The joint venture entity would be treated as controlling any corporation (or other entity) that each joint venturer, respectively, controls; related-person status between those two entities would follow.

Treasury notes in the Preamble that related-person status might enable taxpayers to exclude certain amounts received or accrued by a CFC from FPHCI under Section 954(c)(6). Additionally, that status might require taxpayers to treat income a CFC derives from a sales transaction as FBCSaI. This is inappropriate, according to Treasury, because no person owns more than 50% of the partnership or joint venture corporation that is treated (under the current Treasury regulations) as controlling the two respective corporations (or other entities).

To the extent that related-person status results from the ownership attribution rules of Section 958 *other than* the downward constructive ownership rules, the proposed regulations would not change that result. Thus, notwithstanding that a partnership would no longer be treated under the proposed regulations as owning the stock actually owned by one of its partners, to the extent a partner held a 51% interest in the partnership, the partnership would continue to be related to a corporation controlled by the partner. This is because the same person (the 51% partner) would control both the partnership and the corporation, even without the application of the downward constructive ownership rules.

The proposed modifications to the downward constructive ownership rules generally would be effective only prospectively, i.e., for CFC tax years ending on or after the date on which Treasury publishes the proposed regulations in final form (and to the taxable years of United States shareholders in which or with which such tax years end). The modifications, however, are immediately effective as to an amount that a CFC receives or accrues on or after 17 May 2019, if the receipt or accrual is "accelerated" with a principal purpose of avoiding the modifications.

Modification to the option constructive ownership rule

The proposed regulations also would render inapplicable the option constructive ownership rule for purposes of related-person determinations — provided, however, that a principal purpose for using an option (or an interest similar to an option) to acquire an equity interest is to cause a person to become related to a CFC (the related-person option rule). The proposed regulations specify that, for this purpose, an interest that is similar to an option includes (among other examples) a warrant, convertible debt instrument, put, or equity interest subject to risk of forfeiture.

Again, Treasury indicates that the application of the option constructive ownership rule in the context of Section 954(d)(3) can lead to inappropriate results. One such result is illustrated by the example of two otherwise unrelated domestic corporations that own 51% and 49% (measured by value), respectively, of the stock of a foreign joint venture corporation. The joint venture corporation would constitute a CFC solely by reason of the 51% shareholder's interest. If the 49% shareholder owned 100% of another CFC stock's, and that CFC lent money to the joint-venture CFC, the 49% shareholder might desire to apply Section 954(c)(6) to exclude the corresponding interest income of the lender CFC from

FPHCI. That position requires the two CFCs to be related to one another under Section 954(d)(3). To that end, the 49% shareholder might purchase from the 51% shareholder an option to acquire stock representing 2% (measured by value) of the stock of the joint venture CFC. Treasury indicates that allowing taxpayers effectively to elect related-person status in this manner is inappropriate. Provided that a principal purpose for the use of the option were treating the two CFCs as related to each other, the proposed regulations would render inapplicable the option constructive ownership rule for purposes of Section 954(d)(3) — such that the two CFCs would not be related to one another.

In addition to the related-person option rule, the proposed regulations would add a second, similar rule. If a principal purpose for using an option (or an interest similar to an option) to acquire an equity interest is to qualify dividends, interest, rents, and royalties received or accrued by a CFC from a foreign corporation (the payor) as eligible to be excluded from FPHCI under Section 954(c)(6), then the dividends, etc., would not be treated as being received or accrued from a CFC payor. Because that status — in addition to related-person status — is a condition to the application of Section 954(c)(6), that provision would not operate to exclude the dividends, etc., from FPHCI. This rule was first announced in Section 7(d) of Notice 2007-9, which indicated that the rule (the Notice 2007-9 option rule) would be effective for foreign corporation tax years beginning after 31 December 2006.

In view of the (arguably broader) related-person option rule, why is Treasury also proposing the Notice 2007-9 option rule? One reason might be that the Notice 2007-9 option rule focuses narrowly on Section 954(c)(6), which is set to expire for foreign corporation tax years beginning on or after 1 January 2020 (and to US shareholder tax years with or in which such tax years end). Another reason: It appears that, though Treasury might prefer the related-person option rule to the Notice 2007-9 option rule, Treasury decided not to make the related-person option rule effective retroactively (i.e., for foreign corporation tax years beginning after 31 December 2006) due to Section 7805(b).

Consistent with Notice 2007-9, therefore, the Notice 2007-9 option rule in the proposed regulations would be effective for CFC tax years beginning after 31 December 2006 (and to US shareholder tax years in which or with which such tax years end). In contrast, the related-person option rule generally would be effective only prospectively, with an exception (i.e., immediate effectiveness) for an amount that a CFC receives or accrues on or after 17 May 2019, if the receipt or accrual is "accelerated" with a principal purpose of avoiding the related-person option rule.

Modifications to the active marketing exception to FPHCI

In connection with the position that a CFC's rental income is excluded from FPHCI under the so-called active marketing exception, the proposed regulations would treat certain royalties paid or accrued by the CFC in the same manner as rents paid or accrued by the CFC are treated under the current Treasury regulations. These proposed modifications would be effective only prospectively.

Background

Rents and royalties received or accrued by a CFC generally constitute FPHCI. Section 954(c)(2)(A) and Treas. Reg. Section 1.954-2(b)(6) set out an exception: Rents and royalties are not FPHCI to a CFC if the CFC derives them in the active conduct of a trade or business and receives them from a person other than a related person (as determined under Section 954(d)(3), described earlier). Treas. Reg. Section 1.954-2(c) sets out the four exclusive (and independent) tests to be satisfied if rents are to be considered derived in the active conduct of a trade or business; the analogue for royalties is Treas. Reg. Section 1.954-2(d), which contains two exclusive (and independent) tests for qualifying royalties.

One of the specified tests for rental and royalty income is the active marketing exception. To satisfy that exception, the CFC must maintain and operate an organization in a foreign country or countries that markets, or markets and services, the leased or licensed property — and the organization must be "substantial" in relation to the rents or royalties derived from the leased or licensed property.

Whether a CFC's organization is substantial generally requires evaluating all the facts and circumstances. The current Treasury regulations, however, include a safe harbor for both rental and royalty income. Focusing on rental income, a CFC's organization is considered substantial in relation to the rental income if "active expenses" equal or exceed 25% of the "adjusted leasing profit." The term "active leasing expenses" generally refers to the sum of the deductions that are (i) incurred by the organization, (ii) properly allocable to the rental income and (iii) allowable under Section 162 if the CFC were a domestic corporation; it excludes (under the current Treasury regulations) deductions

for rents paid or accrued by the organization (among other deductions). The term "adjusted leasing profit" generally refers to the CFC's gross income from rents, reduced (under the current Treasury regulations) by the rents paid or accrued by the CFC with respect to such rental income (among other amounts).

The exclusion from active leasing expenses of, and the reduction to adjusted leasing profit for, rents paid or accrued by the CFC (the exclusion/reduction provisions) apply when a CFC derives rents from subleasing property that the CFC leases from another person. Treasury characterizes the exclusion/reduction provisions of the safe harbor as reflecting the principle that the substantiality of the CFC's organization ought to be evaluated on the basis of expenses and profit *net* of any rental payments the CFC (i.e., the lessee/sublessor) makes to the owner of the property (i.e., the lessor) for the use of the property. Similar rules apply to the safe harbor for royalty income.

For both the safe harbor that applies to rental income and the safe harbor that applies to royalty income, the exclusion/reduction provisions encompass only amounts paid or accrued by the CFC *that are characterized in the same manner* (i.e., as rents or royalties) as the tested items of gross income of the CFC. That is, when applying the active marketing exception as to *rents* earned by the CFC, the exclusion/reduction provisions apply to rents (but not to royalties) paid or accrued by a CFC; when applying the exception as to royalty income of a CFC, the exclusion/reduction provisions apply to royalties (but not to rents) paid or accrued by the CFC.

In the Preamble, Treasury indicates that it is aware that a CFC can (i) earn amounts characterized as rents from leasing to other persons property that it does not own and (ii) take the position that the amounts that the CFC pays to the owner of the property are characterized as royalties. As just noted, under the current Treasury regulations, the exclusion/reduction provisions of the safe harbor that applies to CFC rental income does not encompass amounts paid or accrued by the CFC that are characterized as royalties. Consequently, characterizing amounts paid or accrued by a CFC as royalties would lead to a different result under that safe harbor than if the amounts were characterized as rents. The Preamble includes an example: A CFC might pay $100 for a computer program that the CFC transfers in turn to another person in exchange for $150 in a transaction characterized as a lease under Treas. Reg. Section 1.861-18. Treasury asserts that the determination of whether the CFC satisfies the safe harbor as to its rental income should not depend on whether the transaction under which the CFC received the computer program is characterized as a lease or a license under Treas. Reg. Section 1.861-18.

To address this inconsistency, the proposed regulations would amend exclusion/reduction provisions in the safe harbor as applies to CFC rental income, so those provisions would encompass rents *as well as royalties* paid or accrued by the CFC. The proposed regulations would *not* make a corresponding change to the safe harbor that applies to royalty income (i.e., such that the exclusion/reduction provisions in that safe harbor encompass amounts paid or accrued by a CFC that are characterized as rents). The Preamble does not explain why that change is not also warranted.

The proposed modifications just described would be effective for CFC tax years of ending on or after the date that on which Treasury publishes the proposed regulations in final form (and to United States shareholder tax years of in which or with which such tax years end).

Implications

When effective, the proposed regulations could cause amounts that a taxpayer had not treated as Subpart F income to qualify as Subpart F income (and vice versa). With the TCJA's enactment of the GILTI regime (Section 951A), classifying an amount as Subpart F income generally no longer undermines the indefinite deferral of US federal income tax on that amount. Now, of course, most CFC earnings are subject to current taxation as a Subpart F income or GILTI inclusion — but subject to different rates (for corporate United States shareholders) and different rules (e.g., foreign tax credit carryovers). The proposed regulations would also affect provisions that incorporate the Section 954(d)(3) definition of related person. Accordingly, they would be relevant for purposes of applying (among several others) Sections 267A, 1297(b)(2), and 1471(e)(2). Taxpayers should consider whether the proposed regulations could affect their positions under the Subpart F and GILTI regimes and these other provisions.

The factual scenarios to which the proposed regulations would pertain, however, are fairly narrow — and, further, could be considered relatively uncommon. Most taxpayers have been applying the Notice 2007-9 option rule since the issuance of Notice 2007-9. Accordingly, the impact of the related-person option rule is effectively restricted to positions relying on the

use of options to create related-person status for a purpose *other than* the Section 954(c)(6) exception to FPHCI. It is likely that few taxpayers have planned affirmatively into related-person status based on the downward constructive ownership rules. For other taxpayers, rendering those rules inapplicable generally would be welcome if only because it would no longer be necessary — in taking the position that two entities are not related to one another — to confirm that the equityholders or beneficiaries of the respective entities are not, for example, partners in the same partnership. In particular, these modifications are likely to be helpful in the mutual fund and private equity contexts. Finally, the proposed modifications to the active marketing exception are of consequence only to taxpayers that apply that exception to their CFCs and that have treated amounts paid or accrued by the CFCs as royalties, notwithstanding treating amounts earned by the CFCs with respect to the same property as rents.

Most significant might be what the proposed regulations would not address. First, the proposed modifications to the way the constructive ownership rules apply to determine related-person status would not affect other determinations for which those rules are relevant. Thus, for example, the downward and option constructive ownership rules would continue to the extent that they would cause (among other results) a foreign corporation to be treated as a CFC or a United States person to be treated as a United States shareholder. Second, the proposed regulations appear unrelated (at least in substance) to the repeal of former Section 958(b)(4) (in the TCJA). Accordingly, the release of these proposed regulations arguably will not affect whether Treasury issues regulations on the repeal of former Section 958(b)(4).

Endnote

1. All "Section" references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.

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