

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 301

[REG-104537-97]

RIN 1545-AV11

Guidance under Subpart F Relating to Partnerships and Branches.

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking, notice of proposed rulemaking by cross-reference to temporary regulations and notice of public hearing.

SUMMARY: The IRS and Treasury Department are issuing temporary regulations, published elsewhere in this issue of the **Federal Register**, relating to the treatment under subpart F of certain branches of a controlled foreign corporation (CFC) that are treated as separate entities for foreign tax purposes . The text of the temporary regulations also serves as the text of these proposed regulations. In addition, this document contains proposed regulations relating to the treatment of a CFC's distributive share of partnership income. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written comments must be received by June 24, 1998.

Outlines of oral comments to be discussed at the public hearing scheduled for July 15, 1998, must be received by June 24, 1998.

ADDRESSES: Send submissions to: CC:DOM:CORP:R (REG-104537-97), room 5226, Internal Revenue Service, POB 7604, Ben Franklin

Station, Washington DC 20044. Submissions may be hand delivered between the hours of 8 a.m. and 5 p.m. to: CC:DOM:CORP:T:R (REG-104537-97), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington DC. Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at [http://www.irs.ustreas.gov/prod/tax\\_regs/comments.html](http://www.irs.ustreas.gov/prod/tax_regs/comments.html). The public hearing will be held in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC 20224. FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Valerie Mark, (202) 622-3840; concerning submissions and the hearing, Mike Slaughter (202) 622-7190 (not toll-free numbers). SUPPLEMENTARY INFORMATION:

## **Background**

### **I. In General**

In these proposed regulations, and in temporary regulations published elsewhere in this issue of the **Federal Register**, the Treasury and IRS set forth a framework for dealing with the issues posed by the use of certain entities which are regarded as fiscally transparent for the purposes of U.S. tax law, with regard to the application of subpart F of the Internal Revenue Code.

Subpart F was enacted by Congress to limit the deferral of U.S. taxation of certain income earned outside the United States by foreign corporations controlled by U.S. persons. Limited

deferral was retained after the enactment of subpart F to protect the competitiveness of controlled foreign corporations (CFCs) doing business overseas. See S. Rep. No. 1881, 87th Cong., 2d Sess. 78-80 (1962). This limited deferral furthers the objective of allowing a CFC engaged in an active business, and located in a foreign country for appropriate economic reasons, to compete in a similar tax environment with non-U.S. owned corporations located in the same country.

Conversely, one of the purposes of subpart F is to prevent CFCs from converting active income that is not easily moveable and is earned in a jurisdiction in which a business is located for non-tax reasons into passive, easily moveable income shifted to a lower tax jurisdiction primarily for tax avoidance. Moreover, when subpart F was first enacted it was realized that related person transactions can be easily manipulated to reduce both United States and foreign taxes. Consequently, in enacting subpart F, Congress provided that transactions of CFCs that involve related persons generally give rise to subpart F income with certain enumerated exceptions.

Hybrid branches, by definition, are not regarded as fiscally transparent under foreign law. Thus, they are particularly well suited for the type of tax avoidance described above. In light of the recent proliferation of hybrid branches, Treasury and the IRS believe that it is appropriate to consider the issues related to transactions involving hybrid branches, or other hybrid entities, under subpart F.

The use of other organizations that are fiscally transparent for U.S. tax purposes, including partnerships, raise additional issues. These entities may or may not be fiscally transparent under foreign law. In the context of subpart F, issues similar to those raised in connection with hybrid branches are raised in connection with partnerships. (Other fiscally-transparent entities, such as grantor trusts, will be the subject of guidance issued in conjunction with the finalization of regulations under section 672(f).)

The entity classification regulations of §§301.7701-1 through 301.7701-3 (the check-the-box regulations) make entity classification generally elective, in part so that taxpayers can choose a tax status consistent with their business objectives. This administrative provision, however, was not intended to change substantive law. Particularly in the international area, however, the ability to more easily achieve fiscal transparency can lead to inappropriate results under certain substantive international provisions of the Code. Thus, the Treasury and the IRS believe that it is necessary to provide additional guidance regarding the use of hybrid entities in the international context. See preamble to T.D. 8697, 61 Fed. Reg. 66585 (December 18, 1996).

## II. Controlled Foreign Corporation's Distributive Share of Partnership Income

In Brown Group, Inc. v. Commissioner, 77 F.3d 217 (8th Cir. 1996), vacating and remanding 104 T.C. 105 (1995), a Cayman

Islands partnership with a Cayman Islands CFC partner earned commission income from selling footwear purchased in Brazil on behalf of the CFC's U.S. parent. This commission income would have been subpart F income, specifically foreign base company sales income under section 954(d), to the CFC if it had earned this commission income directly and under the same circumstances in which the partnership earned this income. The Tax Court held that the CFC's distributive share of this commission income was subpart F income. The Eighth Circuit, vacating and remanding the Tax Court's decision, held that the CFC's distributive share of this commission income was not subpart F income.

In response to the Eighth Circuit's opinion, the IRS announced that it intended to issue regulations under subpart F to confirm its position that whether a CFC partner's distributive share of partnership income is subpart F income generally is determined at the CFC partner level. See Notice 96-39 (1996-2 C.B. 209).

These proposed regulations would address the treatment of a CFC partner's distributive share of partnership income under subpart F. These regulations apply to all categories of subpart F income, not only to foreign base company sales income, which was at issue in Brown Group. These regulations would provide specific rules that apply to determine a CFC partner's distributive share of foreign personal holding company income, foreign base company sales income, foreign base company services income, and earnings invested in United States property.

The approach taken by these proposed regulations is based on the provisions of subchapter K and subpart F and the policies underlying those provisions. The legislative history of subchapter K indicates that a partnership distributive share should be characterized by using the approach that best serves the Code or regulations section at issue. Subpart F limits deferral of U.S. income tax on common types of passive income received by CFCs, as well as on certain other types of easily moveable income. To allow a CFC to avoid subpart F treatment for items of income by the simple expedient of receiving them as distributive shares of partnership income, rather than directly, is contrary to the intent of subpart F.

**Explanation of Provisions**

Under these proposed regulations, income and deductions would be characterized at the partnership level. If any part of the partnership's gross income would be subpart F income if received directly by partners that are CFCs, it must be separately stated under section 702. Comments are requested as to whether this rule should not apply for ownership levels under certain thresholds. The regulations under section 702 also would be clarified to expressly provide that an item must be separately stated when, if separately taken into account by any partner, the separately stated item would affect the income tax liability of that partner or any other person. This clarification incorporates in the regulations the position of the IRS. See Rev. Rul. 86-138 (1986-2 C.B. 84) (holding that a subsidiary

partnership in a multi-tiered arrangement must separately state items which, if separately taken into account by any partner of any partnership in the multi-tiered arrangement, would affect the income tax liability of that partner).

The regulations under section 952 would also be clarified to expressly include within the definition of subpart F income a CFC's distributive share of any item of gross income of a partnership to the extent the income would have been subpart F income if received by the CFC partner directly. The proposed regulations would further provide that, generally, in determining whether a distributive share of partnership income is subpart F income, whether an entity is a related person and whether activity takes place in or outside the CFC's country of incorporation is determined with respect to the CFC partner and not the partnership. Thus, on the Brown Group facts, the income in issue would retain its character as commission income from the sale of shoes purchased in Brazil on behalf of a U.S. parent for sale in the U.S. It would be determined at the CFC partner level that the shoes were manufactured and sold for use outside of the CFC's country of incorporation (Cayman Islands), and that the U.S. parent was a related person with respect to the CFC. Thus, the income would be foreign base company sales income.

The proposed and temporary regulations also address the question of whether a CFC's distributive share of partnership income can qualify for the exceptions from foreign personal holding company income treatment. Some of these exceptions are

based on whether the income is earned in a transaction with a related person that is incorporated, or uses property, in the CFC's country of incorporation. The proposed and temporary regulations address the application of those exceptions. Other exceptions are based on the activities performed by the CFC in connection with the property through which it earns the income. The proposed regulations would provide that the exceptions requiring activity will generally apply if the exception would have applied to the income had the partnership itself been a CFC. This requirement is not met if the partnership can qualify for the exception only by taking into account the separate activities of its partners (e.g., the partnership owns property and the CFC provides the management services).

These proposed regulations would amend the rules regarding the application of the manufacturing exception of §1.954-3(a)(4). The regulations would clarify the Service's current position that, in general, a controlled foreign corporation can apply the exception only if it has performed the manufacturing activities itself. Thus, manufacturing activities of a contract manufacturer will not be taken into account.

Nevertheless, the manufacturing activities of a partnership may be taken into account under the distributive share rules when the partnership sells the property that it manufactures. These proposed regulations would clarify how the manufacturing exception of §1.954-3(a)(4) applies in the context of the distributive share rules. As previously noted, the general rules



would provide that income that could be foreign base company sales income at the CFC partner level is separately stated and that determinations as to relatedness and the relevant country are made at the partner level. Consistent with the framework outlined above, these regulations would allow a CFC's distributive share of sales income to be excluded, under the manufacturing exception of §1.954-3(a)(4), when the partnership's activities with respect to the property it sells (without regard to the CFC partner's activities) would be sufficient to constitute manufacturing.

Treasury and the IRS are considering applying foreign base company sales income rules in the context of manufacturing branches of partnerships. Comments are requested as to the appropriate scope of such rules.

Under the general rule for determining whether a CFC partner's distributive share includes subpart F income, a CFC partner's distributive share of partnership income earned from performing services for or on behalf of a person that is a related person with respect to the CFC partner will be foreign base company services income. These proposed regulations also would describe how the substantial assistance rule of §1.954-4(b)(1)(iv) applies when the CFC earns services income through a partnership. When the partnership is performing services for a person unrelated to the CFC partner but the CFC partner provides substantial assistance to the partnership contributing to the performance of those services, the partner and the partnership

would be regarded as separate entities and the substantial assistance provided from the CFC to the partnership would cause the CFC's distributive share of the services income to be treated as foreign base company services income. Treasury and the IRS are considering applying similar principles to branches. Comments are requested on this issue.

Finally, consistent with Rev. Rul. 90-112 (1990-2 C.B. 186), the regulations would provide that, for purposes of section 956, a CFC partner's investment in U.S. property includes the U.S. property held by a partnership to the extent of the CFC's ownership interest in the partnership. Comments are requested on this issue.

### III. Hybrid Branches

Temporary regulations, published elsewhere in this issue of the **Federal Register** amend the Income Tax Regulations (26 CFR part 1) relating to sections 952 and 954 by adding rules relating to the treatment under subpart F of certain branches of a CFC or a partnership in which a CFC is a partner that are treated as separate entities for foreign tax purposes. The text of those temporary regulations also serves as the text of the proposed regulations. The preamble to the temporary regulations explains the reasons for the addition.

### IV. Proposed Effective Date

These regulations are proposed to apply for taxable years of a controlled foreign corporation beginning on or after the date the final regulations are published in the **Federal Register**. For

prior periods, the IRS will rely on principles and authorities under subpart F and subchapter K to apply an aggregate approach, including §1.701-2(e) and (f) of the regulations for periods for which it is effective.

### **Special Analyses**

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedures Act (5 U.S.C. chapter 5) does not apply to these regulations, and, because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Code, this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

### **Comments and Public Hearing**

Before these proposed regulations are adopted as final regulations, consideration will be given to any written comments (preferably a signed original and eight (8) copies) that are timely submitted to the IRS. All comments will be available for public inspection and copying.

A public hearing has been scheduled for July 15, 1998, at 10 a.m., in room 2615, Internal Revenue Building, 1111 Constitution Avenue NW., Washington DC. Because of access

restrictions, visitors will not be admitted beyond the building lobby more than 15 minutes before the hearing starts.

The rules of 26 CFR 601.601(a)(3) apply to the hearing.

Persons that wish to present oral comments at the hearing must submit written comments by June 24, 1998, and submit an outline of topics to be discussed and time to be devoted to each topic (signed original and eight (8) copies) by June 24, 1998.

A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### **Drafting Information**

The principal author of these regulations is Valerie Mark of the Office of the Associate Chief Counsel (International), IRS. However, other personnel from the IRS and Treasury Department participated in their development.

#### **List of Subjects**

##### 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

##### 26 CFR Part 301

Employment taxes, Estate taxes, Excise taxes, Gift taxes, Income taxes, Penalties, Reporting and recordkeeping requirements.

#### **Proposed Amendments to the Regulations**

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for 26 CFR part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 2 Section §1.702-1 is amended as follows:

1. Paragraph (a)(8)(ii) is revised.
2. A new paragraph (c)(1)(v) is added.

The addition and revision read as follows:

§1.702-1 Income and credits of partner.

(a) \* \* \*

(8) \* \* \*

(ii) Each partner must also take into account separately the partner's distributive share of any partnership item which, if separately taken into account by any partner, would result in an income tax liability for that partner, or for any other person, different from that which would result if that partner did not take the item into account separately. Thus, if any partner is a controlled foreign corporation, as defined in section 957, items of income that would be gross subpart F income if taken into account by the controlled foreign corporation must be separately stated for all partners. Under section 911(a), if any partner is a bona fide resident of a foreign country who may exclude from gross income the part of the partner's distributive share which qualifies as earned income as defined in section 911(b), the

earned income of the partnership for all partners must be separately stated. Similarly, all relevant items of income or deduction of the partnership must be separately stated for all partners in determining the applicability of section 183 (relating to activities not engaged in for profit) and the recomputation of tax thereunder for any partner.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(v) In determining whether the de minimis or full inclusion rules of section 954(b)(3) apply.

\* \* \* \* \*

Par. 3. In §1.952-1, paragraphs (b) through (f) are redesignated as paragraphs (c) through (g), respectively, and a new paragraph (b) is added to read as follows:

§1.952-1 Subpart F income defined.

\* \* \* \* \*

(b) Treatment of distributive share of partnership income--

(1) In general. A controlled foreign corporation's distributive share of any item of income of a partnership is income that falls within a category of subpart F income described in section 952(a) to the extent the item of income would have been income in such category if received by the controlled foreign corporation directly. For specific rules regarding the treatment of a distributive share of partnership income under certain provisions of subpart F, see §§1.954-1(g); 1.954-2(a)(5); 1.954-3(a)(6);

1.954-4(b)(2)(iii); and 1.954-6(g).

(2) Example. The application of this paragraph (b) may be illustrated by the following example.

Example. CFC, a controlled foreign corporation, is an 80-percent partner in PRS, a foreign partnership. PRS earns \$100 of interest income that is not export financing interest, as defined in section 954(c)(2)(B), from a person unrelated to CFC. This interest income would have been foreign personal holding company income to CFC, under section 954(c), if it had received this income directly. Accordingly, CFC's distributive share of this interest income, \$80, is foreign personal holding company income.

\* \* \* \* \*

Par. 4. Section 1.954-1 is amended as follows:

1. Paragraphs (c)(1)(i)(A) through (D) are redesignated as (c)(1)(i)(A)(1) through (4), respectively.

2. A new paragraph heading for newly designated paragraph (c)(1)(i)(A) is added.

3. New paragraphs (c)(1)(i)(B) through (E) are added.

4. Paragraph (g) is added.

The additions read as follows:

§1.954-1 Foreign base company income.

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(i) Deductions against gross foreign base company income--

(A) In general. \* \* \*

\* \* \* \* \*

(B) through (E) [The text of the proposed paragraphs (c)(1)(i)(B) through (E) is the same as the text of §1.954-1T(c)(1)(i)(B) through (E) published elsewhere in this issue of

the **Federal Register**].

\* \* \* \* \*

(g) Distributive share of partnership income--(1)

Application of related person and country of organization tests.

Unless otherwise provided, to determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been subpart F income if received by it directly, under §1.952-1(b), if a provision of subpart F requires a determination of whether an entity is a related person, within the meaning of section 954(d)(3), or whether an activity occurred within or outside the country under the laws of which the controlled foreign corporation is created or organized, this determination shall be made by reference to such controlled foreign corporation and not by reference to the partnership.

(2) Example. The application of paragraph (g)(1) of this section is illustrated by the following example:

Example. (i) CFC1, a controlled foreign corporation organized in Country A, is an 80-percent partner in Partnership, a partnership organized in Country B. CFC2, a controlled foreign corporation organized in Country B, owns the remaining 20 percent interest in Partnership. CFC1 and CFC2 are owned by a common U.S. parent, USP. CFC2 manufactures Product A in Country B. Partnership earns sales income from purchasing Product A from CFC2 and selling it to third parties located in Country B that are not related persons with respect to CFC1 or CFC2. For purposes of determining whether CFC1's distributive share of Partnership's sales income is foreign base company sales income under section 954(d), CFC1 is treated as if it purchased Product A from CFC2 and sold it to third parties in Country B. Under section 954(d)(3), CFC2 is a related person with respect to CFC1. Thus, with respect to CFC1, the sales income is deemed to be derived from the purchase of personal property from a related person. Because the property purchased is both manufactured and



sold for use outside of Country A, CFC1's country of organization, CFC1's distributive share of the sales income is foreign base company sales income.

(ii) For purposes of determining whether CFC2's distributive share of Partnership's sales income is foreign base company sales income, CFC2 is treated as if it directly sold Product A to third parties within Country B. Therefore, Product A is both manufactured and sold for use within CFC2's country of organization. Thus, CFC2's distributive share of Partnership's sales income is not foreign base company sales income.

Par. 5. In §1.954-2, paragraph (a)(5) and (a)(6) are added to read as follows:

§1.954-2 Foreign personal holding company income.

(a) \* \* \*

(5) Special rules applicable to distributive share of partnership income--(i) [The text of the proposed paragraph (a)(5)(i) is the same as the text of §1.954-2T(a)(5) published elsewhere in this issue of the **Federal Register**].

(ii) Certain other exceptions applicable to foreign personal holding company income. To determine the extent to which a controlled foreign corporation's distributive share of an item of income of a partnership is foreign personal holding company income, the exceptions contained in sections 954(c)(2) and §1.954-2(b)(2) and (6), (e)(1)(ii), (f)(1)(ii), (g)(2)(ii), and (h)(3)(ii), shall apply only if any such exception would have applied to exclude the income from foreign personal holding company income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign

corporation or any other person.

(iii) [The text of the proposed paragraph (a)(5)(iii) is the same as the text of §1.954-2T(a)(5)(iii) published elsewhere in this issue of the **Federal Register**].

(6) Special rules applicable to exceptions from foreign personal holding company income treatment in circumstances involving hybrid branches--(i) [The text of the proposed paragraph (a)(6)(i) is the same as the text of §1.954-2T(a)(6) published elsewhere in this issue of the **Federal Register**].

\* \* \* \* \*

Par. 6. Section 1.954-3 is amended as follows:

1. The second sentence of paragraph (a)(4)(i) is revised.
2. The first sentence of paragraph (a)(4)(ii) is revised.
3. Paragraph (a)(6) is added.

The revisions and addition read as follows:

§1.954-3 Foreign base company sales income.

(a) \* \* \*

(4) \* \* \*

(i) \* \* \* A controlled foreign corporation (selling corporation) will be considered, for purposes of this paragraph (a)(4), to have manufactured, produced, or constructed personal property that it sells if, as a result of the operations conducted by such selling corporation in connection with the property that it purchased and sold, the property sold is in effect not the property that it purchased. \* \* \*

(ii) \* \* \* If, prior to its sale of property that it has

purchased, a selling corporation substantially transforms the property, the selling corporation will be treated as having manufactured, produced, or constructed such property. \* \* \*  
\* \* \* \* \*

(6) Special rule applicable to distributive share of partnership income--(i) In general. To determine the extent to which a controlled foreign corporation's distributive share of any item of gross income of a partnership would have been foreign base company sales income if received by it directly, under §1.952-1(b), the property sold will be considered to be manufactured, produced or constructed by the controlled foreign corporation within the meaning of paragraph (a)(4) of this section only if the manufacturing exception of paragraph (a)(4) of this section would have applied to exclude the income from foreign base company sales income if the controlled foreign corporation had earned the income directly, determined by taking into account only the activities of, and property owned by, the partnership and not the separate activities or property of the controlled foreign corporation or any other person.

\* \* \* \* \*

Par. 7. In §1.954-4, paragraph (b)(2)(iii) is added to read as follows:

§1.954-4 Foreign base company services income.

\* \* \* \* \*

(b) \* \* \*

(2) \* \* \*

(iii) Special rule applicable to distributive share of partnership income. A controlled foreign corporation's distributive share of a partnership's services income will be deemed to be derived from services performed for or on behalf of a related person, within the meaning of section 954(e)(1)(A), if the partnership is a related person with respect to the controlled foreign corporation, under section 954(d)(3), and, in connection with the services performed by the partnership, the controlled foreign corporation provided assistance that would have constituted substantial assistance contributing to the performance of such services, under paragraph (b)(2)(ii) of this section, if furnished to the controlled foreign corporation by a related person.

\* \* \* \* \*

Par. 8. Section 1.954-9 is added to read as follows:

§1.954-9 Hybrid branches.

[The text of this proposed section is the same as the text of §1.954-9T published elsewhere in this issue of the **Federal Register.**]

Par. 9. In §1.956-2, paragraph (a)(3) is added to read as follows:

§1.956-2 Definition of United States property.

(a) \* \* \*

(3) For purposes of section 956, if a controlled foreign corporation is a partner in a partnership that owns property that would be United States property, within the meaning of paragraph

(a)(1) of this section, if owned directly by the controlled foreign corporation, the controlled foreign corporation will be treated as holding an interest in the property equal to its ownership interest in the partnership and such ownership interest will be treated as an interest in United States property.

\* \* \* \* \*

PART 301--PROCEDURE AND ADMINISTRATION

Par. 10. The authority citation for 26 CFR part 301 continues to read in part as follows:

Authority: 26 U.S.C. 7805 \* \* \*

Par. 11. Section 301.7701-3 is amended as follows:

1. Paragraph (a) is amended by adding a sentence at the end of the paragraph.

2. Paragraph (c)(1)(iv) is amended by adding a sentence at the end of the paragraph.

The additions read as follows:

§301.7701-3 Classification of certain business entities.

(a) [The text of the proposed paragraph (a) of this section is the same as the text of §301.7701-3T(a) published elsewhere in this issue of the **Federal Register**.]

\* \* \* \* \*

(c) \* \* \*

(1) \* \* \*

(iv) [The text of the proposed paragraph (c)(1)(iv) of this section is the same as the text of §301.7701-3T(c)(1)(iv) published elsewhere in this issue of the **Federal Register**.]

\* \* \* \* \*

/s/ Michael P. Dolan

Deputy Commissioner of Internal Revenue