to buy new hardware to expand the computing power. * * *

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[FR Doc. 2016–26522 Filed 10–31–16; 4:15 pm]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9792]

RIN 1545–BJ48

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 regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that provide rules 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 final regulations provide rules for determining whether 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), as well as rules for determining whether a CFC holds United States property as a result of certain related party factoring transactions. This document finalizes proposed regulations, and withdraws temporary regulations, published on September 2, 2015. It also finalizes proposed regulations, and withdraws temporary regulations, published on June 14, 1988. The final regulations affect United States shareholders of CFCs.

DATES:

Effective Date: These regulations are effective on November 3, 2016.

Applicability Dates: For dates of applicability, see §§ 1.954–2(i), 1.956–1(g), 1.956–2(h), 1.956–3(d), and 1.956–4(f).

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

SUPPLEMENTARY INFORMATION:

Background

On September 2, 2015, the Department of the Treasury (Treasury Department) and the IRS published final and temporary regulations under sections 954 and 956 (TD 9733) (the 2015 temporary regulations) in the **Federal Register** (80 FR 52976, as corrected at 80 FR 66415 and 80 FR 66416). On the same date, the Treasury Department and the IRS published a notice of proposed rulemaking (REG–155164–09) (the 2015 proposed regulations) in the **Federal Register** (80 FR 53058, as corrected at 80 FR 66485) cross-referencing the temporary regulations and proposing additional regulations under section 956 regarding the treatment as United States property of property held by a CFC in connection with certain transactions involving partnerships. No public hearing was requested or held. Formal written comments were received with respect to the 2015 proposed regulations under section 956 and are available at *www.regulations.gov* or upon request. No comments were received with respect to the 2015 proposed regulations under section 954. This Treasury decision adopts the 2015 proposed regulations, with the changes described in the Summary of Comments and Explanation of Revisions section of this preamble, as final regulations and removes the corresponding temporary regulations. No changes are made to the regulations under section 954.

Additionally, on June 14, 1988, the Treasury Department and the IRS published temporary regulations under sections 304, 864, and 956 (TD 8209) in the **Federal Register** (53 FR 22163), which included guidance under section 956(c)(3) treating as United States property certain trade or service receivables acquired by a CFC from a related United States person in certain factoring transactions (the 1988 temporary regulations). On the same date, the Treasury Department and the IRS published a notice of proposed rulemaking (INTL–49–86, subsequently converted to REG–209001–86) (the 1988 proposed regulations) in the **Federal Register** (53 FR 22186) cross-referencing the 1988 temporary regulations. Although formal written comments were received on the 1988 proposed regulations, none relate to the specific issues addressed in these final regulations. This Treasury decision adopts § 1.956–3 of the 1988 proposed regulations without substantive change as a final regulation (together with the 2015 proposed regulations adopted as final regulations, these final regulations) and removes the corresponding temporary regulations. This preamble does not discuss the formal written comments concerning other rules in the 1988 proposed regulations, which are beyond the scope of these final regulations. The other portions of the 1988 proposed regulations remain in proposed form, except to the extent withdrawn in the partial withdrawal of the notice of proposed rulemaking published in the Proposed Rules section of this issue of the **Federal Register** (REG–122387–16).

The Treasury Department and the IRS published Revenue Ruling 90–112 (1990–2 CB 186) (see § 601.601(d)(2)(ii)(*b*)), on December 31, 1990, before promulgating the rule in § 1.956–2(a)(3) that, prior to modification by this document, addressed the application of section 956 when a CFC is a partner in a partnership that holds property that would be United States property if owned directly by the CFC. This Treasury decision withdraws Revenue Ruling 90–112.

Summary of Comments and Explanation of Revisions

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 of the amounts of United States property held, directly or indirectly, by the CFC at the close of each quarter during its taxable year. For this purpose, in general, the amount taken into account 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.

These final regulations retain the basic approach and structure of the 2015 proposed regulations and the portion of the 1988 proposed regulations that relates to § 1.956–3, with certain revisions, as discussed in this Summary of Comments and Explanation of Revisions.

1. Changes to § 1.956–1 To Conform to the Current Statute

These final regulations take into account certain statutory changes in section 13232(a) of the Revenue Reconciliation Act of 1993 (Pub. L. 103–66, 107 Stat. 312) (the 1993 Act) regarding the methodology for calculating the amount determined under section 956 with respect to a United States shareholder of a CFC. As enacted in section 12 of the Revenue Act of 1962 (Pub. L. 87–834, 76 Stat. 960) (the 1962 Act), and prior to the modification made by the 1993 Act, section 951(a)(1)(B) required a United States shareholder to include an amount in income based on its pro rata share of the CFC's ''increase in earnings invested in United States property'' for the relevant taxable year. Section 956 (as then in effect), in turn, defined the amount of earnings of a CFC invested in United States property at the close of a taxable year and set forth rules for determining a United States shareholder's pro rata share of the CFC's increase in earnings for a taxable year.

The 1993 Act revised the structure and operating rules for determining amounts included in income under sections 951(a)(1)(B) and 956. In general, as revised in 1993, the amount determined under section 956 is based on a United States shareholder's pro rata share of the average amount of United States property held by the CFC as of the close of each quarter of the relevant taxable year. The amendments made by the 1993 Act are effective for tax years of CFCs beginning after September 30, 1993, and for tax years of United States shareholders in which or with which such tax years of CFCs end.

On February 20, 1964, the Treasury Department and the IRS published § 1.956–1 (TD 6704 (29 FR 2599), which was amended by TD 6795 (30 FR 933) in 1965, TD 7712 (45 FR 52373) in 1980, and TD 8209 (53 FR 22163) in 1988) when the section 956 amount was still determined based on the increase of a CFC's earnings invested in United States property during the relevant tax year. Amendments to § 1.956–1 made after 1993 (TD 9402 (73 FR 35580) and TD 9530 (76 FR 36993, corrected at 76 FR 43891)) did not revise the regulation to reflect the changes to section 956(a) made by the 1993 Act. The Treasury Department and the IRS are aware that some taxpayers have attempted to apply parts of § 1.956–1 to tax years for which those parts were superseded by the 1993 Act. In order to avoid confusion, these final regulations revise the section heading of § 1.956–1 (as well as the parallel heading of § 1.956–1T), and the general rules in § 1.956–1(a), to reflect changes made in the 1993 Act. In addition, these final regulations remove the text in paragraphs (b)(1) through (3), (c), and (d) of § 1.956–1 in order to conform § 1.956–1 to the Code and reserve paragraphs (c) and (d). As a result, proposed § 1.956–1(b)(4) is redesignated as § 1.956–1(b) in these final regulations.

2. Section 1.956–1(b) Anti-Avoidance Rule

Prior to the 2015 temporary regulations, § 1.956–1T(b)(4) provided that a CFC would be considered to hold indirectly investments in United States property acquired by any other foreign corporation that is controlled by the foreign corporation if one of the principal purposes for creating, organizing, or funding (thorugh capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the CFC. The 2015 temporary regulations modified the anti-avoidance rule in § 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 and expanded the rule to apply to transactions involving partnerships that are controlled by a CFC.

A. Definition of Funding

In response to the additional guidance on the term funding, a comment suggested that the modification gives rise to uncertainty concerning the application of the anti-avoidance rule and requested that the anti-avoidance rule be revised in these final regulations in one of three alternative ways in order to clarify the application of the rule: (i) Reverting to the language in § 1.956–1T(b)(4) in effect prior to the 2015 temporary regulations; (ii) defining the term funding as either a related CFC contributing capital to or holding debt of the funded entity, or an unrelated person contributing capital to or holding debt of the funded entity, provided that the contribution or loan would not have been made or maintained on the same terms but for the funding CFC contributing capital to or holding debt of the unrelated person; or (iii) clarifying the scope of the term funding with examples that depict when the rule applies and illustrating that common business transactions conducted on arm's-length terms and certain other transactions would not be considered a funding for purposes of the rule.

The Treasury Department and the IRS continue to be concerned about tax planning that is inconsistent with the policy underlying section 956. The policy concerns addressed by the anti-avoidance rule are not limited to fundings by debt or equity; rather, the anti-avoidance rule should apply to all fundings with a principal purpose of avoiding the purposes of section 956, regardless of the form of the funding. The Treasury Department and the IRS have concluded that reverting to the prior formulation of the rule, which applied when there was a ''funding (through capital contributions or debt),'' or adopting the narrow definition of funding proposed in the comment could allow taxpayers to engage in planning that would inappropriately avoid the application of section 956.

In addition, the Treasury Department and the IRS disagree with the view expressed in the comment that the expanded scope of fundings could result in common business transactions being subject to the anti-avoidance rule. Whether a transaction is a ''funding'' does not alone determine whether the transaction is subject to the anti-avoidance rule because the rule applies only when a principal purpose of the funding is to avoid section 956 with respect to the funding CFC. Thus, although the 2015 temporary regulations broaden the funding standard, the ''avoidance'' requirement ensures that ordinary course transactions are not subject to the anti-avoidance rule.

The Treasury Department and the IRS agree, however, that examples illustrating that the anti-avoidance rule should not apply to certain common transactions would be helpful. Accordingly, these final regulations add new examples that address common transactions highlighted by the comment to further illustrate the distinction between funding transactions that are subject to the anti-avoidance rule and common business transactions to which the anti-avoidance rule does not apply. See *Example 4* through *Example 6* of § 1.956–1(b)(4). For example, *Example 5* and *Example 6* illustrate a sale of property for cash in the ordinary course of business and a repayment of a loan, respectively, to which the anti-avoidance rule does not apply. However, *Example 4* illustrates that, consistent with the holding in situation 3 in Revenue Ruling 87–89 (1987–2 CB 195), a CFC may be treated as holding United States property as a result of a deposit with an unrelated bank if the unrelated bank would not have made a loan to another person on the same terms absent the CFC's deposit.

B. Application To Acquisitions of Property by a Partnership Controlled by a CFC

Section 1.956–1(b)(4) of the 2015 proposed regulations expands the anti-avoidance rule to include transactions involving partnerships that are controlled by a CFC that provides funding to the partnership. Proposed § 1.956–1(b)(4)(iii) contains a coordination rule that provides that this new partnership rule 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 proposed § 1.956–4(b). The coordination rule prevents a CFC from being treated as holding duplicative amounts of United States property as a result of a single partnership interest pursuant to the application of proposed §§ 1.956–1(b)(4) and 1.956–4(b). This rule is illustrated by *Example 4* in proposed § 1.956–1(b)(4)(iv), which is included as *Example 7* in § 1.956–1(b)(4) of these final regulations.

A comment recommended that the anti-avoidance rule should not apply in the case of a partnership in which the funding CFC is a partner, as in *Example 4* in proposed § 1.956–1(b)(4)(iv). Noting that proposed § 1.956–4(b) would treat a funding CFC that is a partner in the funded partnership as owning a share of any United States property acquired by the partnership using the funding, the comment asserted that the inclusion resulting from proposed § 1.956–4(b) is sufficient and there is no need for the anti-avoidance rule to apply to create a disproportionate inclusion that would deter taxpayers from entering into transactions in order to avoid the application of section 956. The Treasury Department and the IRS, however, do not agree with the premise of this comment that the anti-avoidance rule results in a disproportionate inclusion in this case. Rather, the Treasury Department and the IRS consider that, in the circumstances in which the anti-avoidance rule would apply, the funded entity, which is controlled by the CFC, essentially serves as a surrogate for the funding CFC with respect to the investment in United States property. Accordingly, the Treasury Department and the IRS have determined that, when a partnership acts as a surrogate for a CFC partner's investment in United States property, the CFC partner's interest in the United States property should not be limited to the CFC's attributable share of the property as determined under § 1.956–4(b). For these reasons, the comment is not adopted.

With respect to the coordination rule in proposed § 1.956–1(b)(4)(iii), another comment noted that a CFC also could be treated as holding duplicative amounts of United States property as a result of a single partnership obligation pursuant to the application of proposed §§ 1.956–1(b)(4) and 1.956–4(c). For example, suppose a domestic corporation (P) wholly owns two controlled foreign corporations (FS1 and FS2), and P is a 40% partner in a foreign partnership (FPRS), while FS1 is a 60% partner. Suppose further that FS2 loans $100x to FPRS, which FPRS uses to acquire $100x of United States property. In these circumstances, FS2 would be treated as holding $40x of United States property under proposed § 1.956–4(c) and existing § 1.956–2(a) (and would not be treated as holding any United States property under proposed § 1.956–4(b)) and could be treated under proposed § 1.956–1(b)(4) and existing § 1.956–2(a) as holding the $100x of United States property acquired by the partnership with its funding. The Treasury Department and the IRS have determined that it is appropriate to limit the amount of United States property that FS2 is treated as holding in the example to $100x, consistent with the result that would apply if FS2 had not funded FPRS's acquisition of United States property and instead had acquired the United States property itself. (Note that, in a case where proposed § 1.956–1(b)(4) would apply, FPRS should not be treated as holding the United States property that would be treated under that rule as held by FS2, and accordingly, FS1 should not be treated as holding United States property under proposed § 1.956–4(b) in this example.) Accordingly, the coordination rule in proposed § 1.956–1(b)(4)(iii) is expanded in final § 1.956–1(b)(3) to prevent a CFC from being treated as holding duplicative amounts of United States property under the anti-avoidance rule as a result of a partnership obligation, and an additional example is added to illustrate this rule. See § 1.956–1(b)(4), *Example 8*.

Further, as noted in the preamble to the 2015 proposed regulations, the references to § 1.956–2(a)(3) in proposed § 1.956–1(b)(4)(iii) and in the examples in proposed § 1.956–1(b)(4)(iv) that illustrate the application of proposed § 1.956–1(b)(4)(i)(C) are supplanted in these final regulations with references to § 1.956–4(b), which replaces § 1.956–2(a)(3) in these final regulations as the applicable rule concerning United States property held indirectly by a controlled foreign corporation through a partnership.

3. Factoring Rules

As noted in the Background section of this preamble, in 1988, the Treasury Department and the IRS proposed § 1.956–3 to address the application of section 956 to property acquired by a CFC in certain related party factoring transactions. No comments were received on these proposed rules. The 2015 proposed regulations proposed revisions to these proposed rules in § 1.956–3(b)(2)(ii) with respect to the application of section 956 to acquisitions of receivables indirectly through a nominee, pass-through entity, or related foreign corporation, and no comments were received on these proposed revisions. These final regulations adopt these portions of the 2015 proposed regulations without change, and also adopt the remainder of the rules in proposed § 1.956–3 that were proposed in the 1988 proposed regulations, with minor revisions to improve clarity and conform to existing regulations.

4. Partnership Property Indirectly Held by a CFC Partner

Under proposed § 1.956–4(b)(1), a CFC partner in a partnership is treated as holding its attributable share of property held by the partnership. In addition, proposed § 1.956–4(b)(1) provides that, for purposes of section 956, a partner's adjusted basis in the property of the partnership equals the partner's attributable share of the partnership's adjusted basis in the property.

Under proposed § 1.956–4(b)(2), a CFC partner's attributable share of partnership property is determined in accordance with the CFC partner's liquidation value percentage with respect to the partnership, unless the partnership agreement contains a special allocation of income (or, where appropriate, gain) with respect to a particular item or items of partnership property that differs from the partner's liquidation value percentage in a particular taxable year. In that case, the partner's attributable share of the property is determined solely by reference to the partner's special allocation with respect to the property, provided the special allocation does not have a principal purpose of avoiding the purposes of section 956.

A. Revenue Ruling 90–112's Outside Basis Limitation

As noted in the Background section of this Preamble, in 1990, the Treasury Department and the IRS published Revenue Ruling 90–112, which addressed the treatment under section 956 of United States property held by a CFC indirectly through a partnership. The holding in the revenue ruling generally is consistent with § 1.956–2(a)(3) (added by TD 9008, 67 FR 58020, in 2002), as well as proposed § 1.956–4(b), in that a CFC that is a partner in a partnership is treated as indirectly holding property held by the partnership when the property would be United States property if the CFC held it directly. However, the revenue ruling includes a limitation on the measurement of United States property that is not included in the final or proposed regulations. Specifically, the revenue ruling provides that the amount of United States property taken into account for purposes of section 956 when a CFC partner indirectly owns property through a partnership is limited by the CFC's adjusted basis in the partnership.

The outside basis limitation in Revenue Ruling 90–112 has resulted in a lack of clarity concerning the determination of the amount of United States property held by a CFC partner through a partnership because neither § 1.956–2(a)(3) nor proposed § 1.956–4(b) include the limitation. A comment requested that proposed § 1.956–4(b)(1) be revised to add the outside basis limitation because the limitation is reflective of the underlying economics and consistent with the policy underlying section 956.

After consideration of the comment, the Treasury Department and the IRS have concluded that the outside basis limitation is not warranted. The rule in proposed § 1.956–4(b)(1) is based on an aggregate approach to partnerships and measures the amount of United States property indirectly held by a CFC partner on a property-by-property basis. An overall limitation on the amount of United States property a CFC partner is considered to indirectly hold through a partnership is inconsistent with this property-by-property aggregate approach to United States property held by the partnership. Additionally, a limitation determined by reference to a CFC partner's basis in its partnership interest is less consistent with section 956(a), which provides that the amount of United States property directly or indirectly held by a CFC is determined by reference to the adjusted basis of the United States property itself. Moreover, the Treasury Department and the IRS are concerned that, under the rules of subchapter K, adjustments may be made to outside basis through the allocation of liabilities pursuant to the regulations under section 752 that are inconsistent with the policy of section 956. Accordingly, the Treasury Department and the IRS have determined that an outside basis limitation should not be incorporated into the rule in proposed § 1.956–4(b)(1). Because proposed § 1.956–4(b)(1) indicates that, for purposes of section 956, a partner's adjusted basis in the property of the partnership equals the partners' attributable share of the partnership's adjusted basis in the property, no revision to the rule is necessary to clarify that there is no outside basis limitation.

Revenue Ruling 90–112 is obsoleted in the Effect on Other Documents section of this preamble. For tax years ending prior to the obsolescence of the revenue ruling, taxpayers may rely on the outside basis limitation provided in the revenue ruling.

B. Consistent Use of Liquidation Value Percentage Method for Purposes of Both § 1.956–4(b) and (c)

In contrast to the rule provided in proposed § 1.956–4(b) providing that a CFC partner's attributable share of partnership property is determined in accordance with the CFC partner's liquidation value percentage, proposed § 1.956–4(c) provided that a partner's share of a partnership obligation is determined in accordance with the partner's interest in partnership profits. The preamble to the 2015 proposed regulations requested comments as to whether a single method should be used as the general rule for determining both a partner's share of partnership assets under proposed § 1.956–4(b) and a partner's share of a partnership obligation under proposed § 1.956–4(c), and, if so, whether the appropriate measure would be a partner's interest in partnership profits, liquidation value percentage, or an alternative measure. Comments suggested that a liquidation value percentage method should be used for purposes of both sets of rules. In accordance with these comments, these final regulations retain the liquidation value percentage method set forth in proposed § 1.956–4(b), and, as discussed in Part 5.B of this Summary of Comments and Explanation of Revisions, revise the general rule in proposed § 1.956–4(c) to implement the liquidation value percentage method.

C. Time for Determining the Liquidation Value Percentage

A comment recommended that the liquidation value percentage of partners in a partnership should be determined on an annual basis, rather than upon formation and upon the occurrence of events described in § 1.704–1(b)(2)(iv)(*f*)(*5*) or § 1.704–1(b)(2)(iv)(*s*)(*1*) (revaluation events) as provided in proposed § 1.956–4(b)(2)(i). The comment noted that partnerships do not necessarily book up (or adjust) partnership capital accounts in connection with revaluation events and suggested that requiring a redetermination of liquidation value percentage regardless of whether a book-up occurs would impose a burden on such partnerships. The comment also noted that partners' relative economic interests in the partnership may change for reasons unrelated to revaluation events, such as when a partnership agreement provides for different profit sharing percentages that apply based on different hurdles.

The Treasury Department and the IRS continue to consider it appropriate for liquidation value percentage to be redetermined upon a revaluation event, which may result in a significant change in the partners' relative economic interests in a partnership. Accordingly, upon a revaluation event, a partnership is required to determine the partnership's capital accounts resulting from a hypothetical book up at such point in time even if the partnership did not actually book up capital accounts in connection with such an event. However, in light of the comment's observation that partners' relative economic interests in the partnership may change significantly as a result of allocations of income or other items under the partnership agreement even in the absence of a revaluation event, § 1.956–4(b)(2)(i) of these final regulations provides that a partner's liquidation value percentage must be redetermined in certain additional circumstances. Specifically, if the liquidation value percentage determined for any partner on the first day of the partnership's taxable year would differ from the most recently determined liquidation value percentage of that partner by more than 10 percentage points, then the liquidation value percentage must be redetermined on that day even in the absence of a revaluation event. For example, if the liquidation value percentage of a partner was determined upon a revaluation event to be 40 percent and, on the first day of a subsequent year before the occurrence of another revaluation event, would be less than 30 percent or more than 50 percent if redetermined on that day, then the liquidation value percentage must be redetermined on that day.

D. Special Allocations

Proposed § 1.956–4(b)(2)(ii) defines a special allocation as an allocation of income (or, where appropriate, gain) from partnership property to a partner under a partnership agreement that differs from the partner's liquidation value percentage in a particular taxable year. In this regard, questions have arisen as to whether allocations pursuant to section 704(c) and the regulations thereunder constitute special allocations. Although a partnership agreement may reference section 704(c) or provide for the adoption of a particular section 704(c) method, allocations under section 704(c) are tax allocations required by operation of the Code and regulations. In response to these questions, the Treasury Department and the IRS have revised the definition of special allocations in final § 1.956–4(b)(2)(ii) to clarify that a special allocation is an allocation of book income or gain, rather than a tax allocation such as the allocations required under section 704(c).

Questions also have arisen as to whether certain allocations of income with respect to all of the property of a partnership, as opposed to allocations of income from a specific item or subset of partnership property, constitute special allocations described in proposed § 1.956–4(b)(2)(i). These final regulations clarify that, for purposes of these regulations, a special allocation means only an allocation of income (or, where appropriate, gain) from a subset of the property of the partnership to a partner other than in accordance with the partner's liquidation value percentage in a particular taxable year.

As noted in this Part 4 of this Summary of Comments and Explanation of Revisions, proposed § 1.956–4(b)(2)(ii) states that a partner's attributable share of an item of partnership property is not determined by reference to a special allocation with respect to the property if the special allocation has a principal purpose of avoiding the purposes of section 956. A comment requested that these final regulations provide guidance on the circumstances in which special allocations are treated as having a principal purpose of avoiding section 956. Specifically, the comment suggested that proposed § 1.956–4(b) be revised to include a presumption that a transaction does not have a principal purpose of avoiding section 956 when the allocation is respected under section 704(b) and is reasonable taking into account the facts and circumstances relating to the economic arrangement of the partners and the characteristics of the property at issue.

The determination of whether a special allocation has a principal purpose of avoiding the purposes of section 956 must take into account all of the relevant facts and circumstances, which include the factors set forth in the comment. However, an allocation adopted with a principal purpose of avoiding the purposes of section 956 could nonetheless be respected under section 704(b), which is not based on, and does not take into account, section 956 policy considerations. In addition, it is not clear what additional clarity would be added by the reasonableness requirement, which itself is necessarily a facts-and-circumstances determination. After consideration of the comment, the Treasury Department and the IRS have determined that the presumption requested by the comment is not appropriate, and the comment is not adopted.

A comment noted that determining a partner's attributable share of an item of property by reference to a special allocation of income or gain with respect to that property could produce results that are inconsistent with the liquidation value percentage approach because of the forward-looking nature of special allocations. The comment described, but did not explicitly recommend, an alternative approach that would limit the effect of a special allocation to the portion of the liquidation value that represents actual appreciation, as opposed to initial book value. The Treasury Department and the IRS recognize the conceptual issue highlighted by the comment but have determined that the alternative approach described by the comment would entail substantial administrative complexity. Additionally, the Treasury Department and the IRS continue to consider it appropriate, in cases in which special allocations are economically meaningful, to determine a partner's attributable share of property in accordance with such special allocations, since such allocations replicate the effect of owning, outside of the partnership, an interest in the property that is proportional to the special allocation.

However, the Treasury Department and the IRS have determined that special allocations with respect to a partnership controlled by a U.S. multinational group (a controlled partnership) and its CFCs are unlikely to have economic significance for the group as a whole and can facilitate inappropriate tax planning. Accordingly, the Treasury Department and the IRS are proposing a new rule in a notice of proposed rulemaking in the Proposed Rules section of this issue of the **Federal Register** (REG–114734–16) under which a partner's attributable share of property of a controlled partnership is determined solely in accordance with the partner's liquidation value percentage, without regard to any special allocations.

5. Obligations of Foreign Partnerships

A. Use of an Aggregate Approach as the General Rule

Pursuant to section 956(c), United States property includes an obligation of a United States person. In addition, under section 956(d) and § 1.956–2(c), a CFC is treated as holding an obligation of a United States person if the CFC is a pledgor or guarantor of the obligation. Therefore, if a CFC makes or guarantees a loan to a United States person, an income inclusion may be required with respect to the CFC under sections 951(a)(1)(B) and 956. Under the general rule in proposed § 1.956–4(c)(1), an obligation of a foreign partnership would be treated as an obligation of its partners in proportion to the partners' interest in partnership profits, unless the exception in proposed § 1.956–4(c)(2) (for obligations of partnerships in which neither the lending CFC nor any person related to the lending CFC is a partner) or the special rule in proposed § 1.956–4(c)(3) (regarding certain partnership distributions) applies. Thus, the general rule adopts an aggregate approach that would treat an obligation of a foreign partnership as an obligation of its partners.

A comment asserted that taking the aggregate approach to a foreign partnership for this purpose is overly broad and inconsistent with the policy underlying section 956. The comment states that a CFC loan to a foreign partnership results in a repatriation of CFC earnings to the United States partners in the partnership only when the loan proceeds either are used to acquire United States property or are distributed to the partners, which, according to the comment, are adequately addressed in § 1.956–1T(b)(4) and (5). Accordingly, the comment requested that the rules in § 1.956–1T(b)(4) and (5) be finalized, but that the general rule in § 1.956–4(c)(1) be removed. Thus, the comment generally advocates for the treatment of a foreign partnership as an entity, with anti-abuse rules to address certain situations. In contrast, another comment indicated that the concerns identified in the preamble to the 2015 proposed regulations ''constitute an appropriate basis for the general aggregate approach of [proposed § 1.956–4(c)(1)]''.

After consideration of the comments, the Treasury Department and the IRS have concluded that it is appropriate to retain the aggregate approach of the general rule in proposed § 1.956–4(c). The Treasury Department and the IRS disagree with the assertion that the aggregate approach is not supported by the policy of section 956. As discussed in the preamble to the 2015 proposed regulations, failing to treat an obligation of a foreign partnership as an obligation of its partners could allow for the deferral of U.S. taxation of CFC earnings and profits in a manner that is inconsistent with the purpose of section

956. As discussed in that preamble, the legislative history provides that Congress intended section 956 to apply when deferred CFC earnings are made available to a United States shareholder, which occurs when a United States shareholder conducts operations through a foreign partnership that are funded by deferred CFC earnings, without regard to whether there is any distribution from the partnership to the United States shareholder. In addition, as described in Section C of this Part 5 of this Summary of Comments and Explanation of Revisions, there are exceptions from the treatment of obligations as United States property under § 1.956–4(c) that the Treasury Department and the IRS have determined mitigate some of the concerns about the breadth of the general rule raised by the comment. Accordingly, the final regulations do not adopt the recommendation to abandon the aggregate approach.

B. Liquidation Value Percentage Method

The preamble to the 2015 proposed regulations requested comments on whether the liquidation value percentage method or another method would be a more appropriate basis for determining a partner's share of a foreign partnership's obligation. In addition, as noted in Part 4.B of this Summary of Comments and Explanation of Revisions, the 2015 proposed regulations solicited comments on whether a single method should be used for determining both a partner's share of partnership assets under proposed § 1.956–4(b) and a partner's share of partnership obligations under proposed § 1.956–4(c).

Comments highlighted a number of issues related to applying a rule based on a partner's interest in partnership profits and noted the lack of guidance in the 2015 proposed regulations for applying this standard for purposes of proposed § 1.956–4(c). The comments stated that a partner's interest in partnership profits would be a difficult standard to apply for partnerships other than simple partnerships, because a partner's interest in partnership profits can fluctuate significantly from year to year, as well as during a taxable year. The comments noted that the proposed rule did not address whether the determination would be made based solely on the partnership's profits in the current year or whether the determination would take into account the expected profits over the term of the partnership. Moreover, under section 956(a), the amount of United States property held by a CFC as a result of being treated as holding an obligation of a related United States person under proposed § 1.956–4(c) would be the average of the amounts held by the CFC at the close of each quarter of its taxable year. Thus, under proposed § 1.956–4(c), taxpayers would need to determine a CFC partner's interest in partnership profits on a quarterly basis when a relevant partnership obligation is outstanding throughout a taxable year. As a result, calculating the amount of United States property held by a CFC in a taxable year could be complicated when a partner's interest in partnership profits is not known until the end of the taxable year (such as when there are one or more tiers of allocations of partnership profits based on various internal rate of return hurdles). Furthermore, the requirement to determine a CFC's interest in United States property on a quarterly basis could result in the calculation of a section 956 amount that is inconsistent with the annual profit allocated to the partner from the partnership for that year.

After consideration of these comments, the Treasury Department and the IRS have determined that the liquidation value percentage method should be used to determine a partner's share of a foreign partnership's obligation because of the potential for complexity in calculating a partner's interest in partnership profits for purposes of proposed § 1.956–4(c) as well as the uncertainty inherent in the method. The liquidation value percentage method is a sound indicator of a partner's interest in a partnership. Moreover, the objective rules provided in proposed § 1.956–4(b) for determining the liquidation value percentage provide more certainty than the rule in proposed § 1.956–4(c). In addition, using the same standard for determining a partner's share of partnership property and a partner's share of partnership obligations reduces complexity for taxpayers that must apply both sets of rules for purposes of section 956 with respect to a single partnership. Accordingly, these final regulations provide that an obligation of a foreign partnership is treated as an obligation of its partners in proportion to the partners' liquidation value percentage with respect to the partnership. As described in Part 4.C of this Summary of Comments and Explanation of Revisions, a partner's liquidation value percentage must be determined upon formation of a partnership and any revaluation events and in certain other circumstances in which redetermination of the liquidation value percentage would result in a significant change from the previously determined liquidation value percentage.

C. Exceptions From General Rule of Aggregate Treatment

Proposed § 1.956–4(c)(2) provides an exception from the aggregate treatment of proposed § 1.956–4(c)(1) that applies if neither the CFC that holds the obligation (or is treated as holding the obligation) nor any person related to the CFC (within the meaning of section 954(d)(3)) is a partner in the partnership on the CFC's quarterly measuring date on which the treatment of the obligation as United States property is being determined. A comment suggested an additional exception from the general rule in proposed § 1.956–4(c)(1) providing for aggregate treatment of partnership obligations. The comment requested that an obligation of a foreign partnership not be treated as an obligation of its partners to the extent that the obligation arises from a routine, ordinary course transaction between the lending CFC and the foreign partnership.

The comment highlighted a fact pattern involving an obligation arising from a deposit by a CFC with a foreign partnership that acts as a coordination center for a taxpayer's cash pooling system. In this case, the comment asserted that any United States partners in the partnership should not be considered to have accessed the deferred earnings of the CFC deposited with the partnership and that, accordingly, the aggregate approach to partnership obligations should not apply to treat the CFC as holding an obligation of the United States partners for purposes of section 956. Regarding this fact pattern, the Treasury Department and the IRS observe that the short-term obligation exception in § 1.956–2T(d)(2)(iv), which applies when a CFC holds obligations of a United States person for a limited period of time during a taxable year, generally would prevent an inclusion under section 956 in the fact pattern described in the comment if the CFC had a net deposit with the partnership only for the limited period of time described in that exception. The Treasury Department and the IRS have concluded that there is no reason to provide a more expansive exception from United States property treatment for obligations of a foreign partnership with certain United States persons as partners than would apply with respect to obligations incurred directly by those same United States persons.

Another comment recommended adding a new *de minimis* exception that would provide that an obligation of a foreign partnership is not treated as an obligation of a United States person that is a partner if the United States person and its related persons own less than a specified percentage, 10% or 20%, of the profits and capital interests in the foreign partnership. The comment noted that a U.S. partner with a relatively small interest in a partnership may lack the ability to cause the partnership to make a distribution to the U.S. partner.

Although a U.S. partner with a relatively small partnership interest may not be able to compel a distribution from the partnership, the potential to directly access partnership assets is not, as the comment acknowledges, the sole or overriding consideration motivating the aggregate approach to partnerships under the proposed regulations and these final regulations. Even if the other partners in a partnership in which a United States shareholder of a CFC is a minority partner are unrelated to the United States shareholder, the United States shareholder would still benefit from the funding of the partnership's business with deferred earnings of the CFC to the extent of its interest in the partnership. Additionally, as noted in the preamble to the 2015 proposed regulations, a standard based on whether the funding CFC or a related person is a partner in the partnership, rather than whether such persons own a certain minimum interest in the partnership, is consistent with the relevant exception adopted by Congress in section 956(c)(2)(L).

Accordingly, the Treasury Department and the IRS have determined that the additional exceptions to aggregate treatment suggested in the comments are not warranted.

D. Special Obligor Rule in the Case of Certain Distributions

The 2015 proposed regulations include a special funded distribution rule that increases the amount of a foreign partnership obligation that is treated as United States property when the following requirements are satisfied: (i) A CFC lends funds (or is a pledgor or guarantor with respect to a loan) to a foreign partnership whose obligation is, in whole or in part, United States property with respect to the CFC pursuant to proposed § 1.956–4(c)(1) and existing § 1.956–2(a); (ii) the partnership distributes an amount of money or property to a partner that is related to the CFC (within the meaning of section 954(d)(3)) and whose obligation would be United States property if held (or treated as held) by the CFC; (iii) the foreign partnership would not have made the distribution but for a funding of the partnership through an obligation held (or treated as held) by the CFC; and (iv) the distribution exceeds the partner's share of the partnership obligation as determined in accordance with the partner's interest in partnership profits. When these requirements are satisfied, proposed § 1.956–4(c)(3) provided that the amount of the partnership obligation that is treated as an obligation of the distributee partner (and thus as United States property held by the CFC) is the lesser of the amount of the distribution that would not have been made but for the funding of the partnership and the amount of the partnership obligation.

Comments suggested that taxpayers might take the position that the ''but for'' requirement in proposed § 1.956–4(c)(3) is not satisfied in certain situations in which CFC earnings are effectively repatriated to a partner that is a related United States person. For example, taxpayers might take the position that a partnership distribution could have been made without the funding by the CFC merely by establishing that a third party would have loaned the funds needed for the partnership to make the distribution. The Treasury Department and the IRS have determined that this position is inconsistent with the purposes of this rule. Accordingly, these final regulations clarify the funded distribution rule by providing with respect to the ''but for'' requirement in proposed § 1.956–4(c)(3) that a foreign partnership will be treated as if it would not have made a distribution of liquid assets but for a funding of the partnership through obligations held (or treated as held) by a CFC to the extent the foreign partnership did not have sufficient liquid assets to make the distribution immediately prior to the distribution, without taking into account the obligations. When a CFC holds (or is treated as holding) multiple obligations of the foreign partnership to which this rule could potentially apply, its applicability is determined first with respect to the obligation acquired (or treated as acquired) closest in time to the distribution, and then successively to other obligations further in time from the distribution until the distribution is fully accounted for.

6. Comments Concerning Multiple Inclusions

Comments were received in response to the request for comments included in the preamble to the 2015 proposed regulations concerning whether the Treasury Department and the IRS should exercise the authority granted under section 956(e) to prescribe regulations concerning situations in which multiple CFCs serve, or are treated, as pledgors or guarantors of a single obligation for purposes of section 956(d) in order to limit the aggregate inclusions of a United States shareholder with respect to a CFC under sections 951(a)(1)(B) and 956 to the unpaid principal amount of the obligation. The Treasury Department and the IRS continue to study the comments concerning multiple inclusions under section 956(d), which do not impact any of the proposed regulations adopted by this Treasury decision.

Effective/Applicability Dates

The rules in § 1.954–2(c)(1)(i) and (d)(1)(i) (regarding the active development test) apply to rents or royalties, as applicable, received or accrued during 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, 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 September 1, 2015. The rules in § 1.954–2(c)(1)(iv), (c)(2)(ii), (d)(1)(ii), and (d)(2)(ii) (regarding the active marketing test), as well as the rules in § 1.954–2(c)(2)(iii)(E), (c)(2)(viii), (d)(2)(iii)(E), and (d)(2)(v) (regarding cost-sharing arrangements), apply to rents or royalties, as applicable, received or accrued during 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, to the extent that such rents or royalties are received or accrued on or after September 1, 2015. The section 956 anti-avoidance rules in § 1.956–1(b) 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, 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 September 1, 2015. The rules regarding factoring transactions in § 1.956–3 (other than § 1.956–3(b)(2)(ii)) apply to trade or service receivables acquired (directly or indirectly) after March 1, 1984.

The remaining rules in these final regulations apply to taxable years of CFCs ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end. In general, these remaining rules apply to property acquired, or pledges or guarantees entered into, on or after September 1, 2015, including property considered acquired, and pledges and guarantees considered entered into, on or after September 1, 2015, as a result of a deemed exchange pursuant to section 1001. See § 1.956–4(c) (dealing with obligations of foreign partnerships); §§ 1.956–2(c), 1.956–4(d), and 1.956–1(e)(2) (dealing with pledges and guarantees, including pledges and guarantees by a partnership and with respect to obligations of a foreign partnership); and § 1.956–3(b)(2)(ii) (dealing with trade and service receivables acquired from related United States persons indirectly through nominees, pass-through entities, or related foreign corporations). Two rules, however, apply to all obligations held on or after November 3, 2016. See §§ 1.956–2(a)(3) and 1.956–4(e) (dealing with obligations of disregarded entities and domestic partnerships, respectively). Finally, § 1.956–4(b) (dealing with partnership property indirectly held by a CFC) applies to property acquired on or after November 3, 2016. No inference is intended as to the application of the provisions amended by these final regulations under prior law, including in transactions involving obligations of foreign partnerships. The IRS may, where appropriate, challenge transactions under the Code, regulatory provisions under prior law, or judicial doctrines.

Effect on Other Documents

Rev. Rul. 90–112 (1990–2 CB 186) is obsolete as of November 3, 2016.

Special Analyses

Certain IRS regulations, including these regulations, 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 also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. Chapter 5) does not apply to these regulations, and because the regulations do 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), the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel of Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is 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.

Adoption of 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 * * *

Section 1.956–1 also issued under 26 U.S.C. 956(d) and 956(e).

Section 1.956–2 also issued under 26 U.S.C. 956(d) and 956(e).

Section 1.956–3 also issued under 26 U.S.C. 864(d)(8) and 956(e).

Section 1.956–4 also issued under 26 U.S.C. 956(d) and 956(e).

* * * * *

■ **Par. 2.** Section 1.954–2 is amended by:

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

■ 2. Removing the word ''and'' at the end of paragraph (c)(2)(iii)(C).

■ 3. Removing the period at the end of paragraph (c)(2)(iii)(D) and adding in its place a semicolon and the word ''and''.

■ 4. Revising paragraphs (c)(2)(iii)(E) and (c)(2)(viii).

■ 5. Revising paragraphs (d)(1)(i), (d)(1)(ii), and (d)(2)(ii).

■ 6. Removing the word ''and'' at the end of paragraph (d)(2)(iii)(C).

■ 7. Removing the period at the end of paragraph (d)(2)(iii)(D), and adding in its place a semicolon and the word ''and''.

■ 8. Revising paragraphs (d)(2)(iii)(E) and (d)(2)(v).

■ 9. Revising paragraph (i).

The revisions and additions read as follows:

§ 1.954–2 Foreign personal holding company income.

* * * * *

(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;

* * * * *

(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.

(2) * * *

(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.

(iii) * * *

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

* * * * *

(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.

* * * * *

(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.

(2) * * *

(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.

(iii) * * *

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

* * * * *

(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.

* * * * *

(i) *Effective/applicability dates*—(1) *Paragraphs (c)(2)(v) through (vii).* Paragraphs (c)(2)(v) through (vii) of this section and *Example 6* of paragraph (c)(3) of this section apply to taxable years of controlled foreign corporations beginning on or after May 2, 2006, and for taxable years of United States shareholders with or within which such taxable years of the controlled foreign corporations end. Taxpayers may elect to apply paragraphs (c)(2)(v) through (vii) to taxable years of controlled foreign corporations beginning after December 31, 2004, and for taxable years of United States shareholders with or within which such taxable years of the controlled foreign corporations end. If an election is made to apply § 1.956–2(b)(1)(vi) to taxable years beginning after December 31, 2004, then the election must also be made for paragraphs (c)(2)(v) through (vii) of this section.

(2) *Other paragraphs.* 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 September 1, 2015, 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 September 1, 2015. 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 September 1, 2015, 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 September 1, 2015. 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 September 1, 2015.

* * * * *

§ 1.954–2T [Removed]

■ **Par. 3.** Section 1.954–2T is removed.

■ **Par. 4.** Section 1.956–1 is amended by:

■ 1. Revising the section heading and paragraphs (a) and (b).

■ 2. Removing and reserving paragraphs (c) and (d).

■ 3. Revising paragraphs (e)(2) and (g).

The revisions read as follows:

§ 1.956–1 Shareholder's pro rata share of the average of the amounts of United States property held by a controlled foreign corporation.

(a) *In general.* Subject to the provisions of section 951(a) and the regulations thereunder, a United States shareholder of a controlled foreign corporation is required to include in gross income the amount determined under section 956 with respect to the shareholder for the taxable year but only to the extent not excluded from gross income under section 959(a)(2) and the regulations thereunder.

(b) *Amount of United States property held indirectly by a controlled foreign corporation*—(1) *General rule.* For purposes of section 956, United States property held indirectly by a controlled foreign corporation includes—

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

(ii) 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

(iii) 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.

(2) *Control.* For purposes of paragraphs (b)(1)(ii) and (iii) 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 section 267(b) or section 707(b). For this purpose, in determining whether two corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned for the purposes of section 1563(e)(1), and stock owned with the application of section 267(c).

(3) *Coordination rule.* Paragraph (b)(1)(iii) of this section applies only to the extent that the amount of United States property that is treated under that paragraph as held indirectly by a

controlled foreign corporation through the partnership exceeds the sum of—

(i) The amount of United States property described in paragraph (b)(1)(iii) of this section that is treated as held by the controlled foreign corporation as a result of the application of § 1.956–4(b) with respect to the partnership; and

(ii) The amount of United States property that is treated as held by the controlled foreign corporation as a result of the application of § 1.956–4(c) with respect to any portion of an obligation attributable to the funding described in paragraph (b)(1)(iii) of this section of the partnership by the controlled foreign corporation.

(4) *Examples.* The following examples illustrate the rules of this paragraph (b). In each example, 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) 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* of this paragraph (b)(4), 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) and § 1.956–2(a) 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 $100x 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)(1)(ii) 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 deposits $100x with BK, an unrelated foreign financial institution. FS2 subsequently borrows $100x from BK. BK would not have loaned the $100x to FS2 on the same terms absent FS1's deposit. FS2 loans the $100x borrowed from BK to P. FS2 has no earnings and profits, and FS1 has substantial accumulated earnings and profits. A principal purpose for the transactions is to avoid the application of section 956 with respect to FS1.

(ii) *Result.* FS1 is considered to hold indirectly United States property under this paragraph (b) and § 1.956–2(a) because FS1's deposit with BK, which facilitates BK's loan to FS2, is considered a funding by FS1 of FS2, a principal purpose of which was to avoid the application of section 956 with respect to FS1.

Example 5. (i) *Facts.* FS1 sells inventory to FS2 in exchange for $100x. The sale occurred in the ordinary course of FS1's trade or business and FS2's trade or business, and the terms of the sale are consistent with terms that would be observed among parties dealing at arm's length. FS1 makes a $100x loan to P. FS2 has no earnings and profits, and FS1 has substantial accumulated earnings and profits.

(ii) *Result.* FS2 will not be considered to indirectly hold United States property under this paragraph (b) because a sale in the ordinary course of business for cash on terms that are consistent with those that would be observed among parties dealing at arm's length does not constitute a funding.

Example 6. (i) *Facts.* In Year 1, FS2 loans $100x to FS1 to finance FS1's trade or business. The terms of the loan are consistent with those that would be observed among parties dealing at arm's length. In Year 2, FS1 repays the loan in accordance with the terms of the loan. Immediately after the repayment by FS1, FS2 loans $100x to P. FS2 has no earnings and profits, and FS1 has substantial accumulated earnings and profits.

(ii) *Result.* FS1 will not be considered to indirectly hold United States property under this paragraph (b) because a repayment of a loan that has terms that are consistent with those that would be observed among parties dealing at arm's length and that is repaid consistent with those terms does not constitute a funding.

Example 7. (i) *Facts.* FS1 has substantial earnings and profits. P and FS1 are the only partners in FPRS, a foreign partnership. 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 § 1.956–4(b) and § 1.956–2(a), 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)(3) 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)(1)(iii) 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)(3) of this section, FS1 is treated as holding United States property under paragraph (b)(1)(iii) only to the extent the amount held indirectly under paragraph (b)(1)(iii) of this section exceeds the sum of the amount of the United States property that FS1 is treated as holding as a result of the application of § 1.956–4(b) with respect to FPRS. The amount of United States property that FS1 is treated as indirectly holding under paragraph (b)(1)(iii) of this section and § 1.956–2(a) ($100x) exceeds the amount determined under § 1.956–4(b) ($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 § 1.956–4(b) and $40x under paragraphs (b)(1)(iii) and (b)(3) of this section).

Example 8. (i) *Facts.* FS1 and FS2 have substantial earnings and profits. P and FS1 are the only partners in FPRS, a foreign partnership. There are no special allocations in the FPRS partnership agreement. P's liquidation value percentage with respect to FPRS is 40%, and FS1's liquidation value percentage with respect to FPRS is 60%. FS2 lends $100x to FPRS, and FPRS lends $100x to P. Under § 1.956–4(c) and § 1.956–2(a), FS2 is treated as holding United States property of $40x (40% x $100x) as a result of its loan to FPRS. A principal purpose of funding FPRS is to avoid the application of section 956 with respect to FS2.

(ii) *Result.* Before taking into account paragraph (b)(3) of this section, because FS2 controls FPRS and a principal purpose of funding FPRS was to avoid the application of section 956 with respect to FS2, FS2 is considered under paragraph (b)(1)(iii) of this section to indirectly hold the $100x obligation of P that would be United States property if held directly by FS2. However, under paragraph (b)(3) of this section, FS2 is treated as holding United States property under paragraph (b)(1)(iii) only to the extent the amount held indirectly under paragraph (b)(1)(iii) of this section exceeds the amount of United States property that FS2 is treated as holding as a result of the application of § 1.956–4(c) with respect to the obligation with which FS2 funds FPRS. The amount of United States property that FS2 is treated as indirectly holding under paragraph (b)(1)(iii) of this section and § 1.956–2(a) ($100x) exceeds the amount determined under § 1.956–4(c) ($40x) by $60x. Thus, FS2 is considered to hold United States property within the meaning of section 956(c) in the amount of $100x ($40x under § 1.956–4(c) and $60x under paragraphs (b)(1)(iii) and (b)(3) of this section). P does not have an income inclusion under sections 951(a)(1)(B) and 956 with respect to FS1 related to the P obligation held by FPRS.

(c)–(d) [Reserved]

(e) * * *

(2) *Rule for pledges and guarantees.* For purposes of this section, the amount of an obligation treated as held (before application of § 1.956–4(b)) as a result of a pledge or guarantee described in § 1.956–2(c) is the unpaid principal amount of the obligation on the applicable determination date.

* * * * *

(g) *Effective/applicability date.* (1) Paragraph (a) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and to taxable years of United States shareholders in which or with which such taxable years end.

(2) Paragraph (b) of this section applies to taxable years of controlled foreign corporations ending on or after September 1, 2015, 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 September 1, 2015. 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 September 1, 2015, and property acquired before September 1, 2015. For purposes of this paragraph (g)(2), a deemed exchange of property pursuant to section 1001 on or after September 1, 2015 constitutes an acquisition of the property on or after that date.

(3) Paragraph (e)(2) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to pledges or guarantees entered into on or after September 1, 2015. For purposes of this paragraph (g)(3), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

* * * * *

■ **Par. 5.** Section 1.956–1T is revised to read as follows:

§ 1.956–1T Shareholder's pro rata share of the average of the amounts of United States property held by a controlled foreign corporation.

(a) through (e)(4) [Reserved]

(5) Exclusion for certain recourse obligations. For purposes of § 1.956–1(e)(1) of the regulations, in the case of an investment in United States property consisting of an obligation of a related person, as defined in section 954(d)(3) and paragraph (f) of § 1.954–1, a liability will not be recognized as a specific charge if the liability representing the charge is with recourse with respect to the general credit or other assets of the investing controlled foreign corporation.

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

(f) Effective/applicability date. Paragraph (e)(5) of this section applies to investments made on or after June 14, 1988.

(g)–(h) [Reserved]

■ **Par. 6.** Section 1.956–2 is amended by:

■ 1. Revising paragraphs (a)(3), (c)(1), and (c)(2).

■ 2. Adding *Example 4* to paragraph (c)(3).

■ 3. Adding paragraph (h).

The revisions and addition read as follows:

§ 1.956–2 Definition of United States property.

(a) * * *

(3) *Treatment of disregarded entities.* For purposes of section 956, an obligation of a business entity (as defined in § 301.7701–2(a) of this chapter) that is disregarded as an entity separate from its owner for federal tax purposes under §§ 301.7701–1 through 301.7701–3 of this chapter is treated as an obligation of its owner.

* * * * *

(c) *Treatment of pledges and guarantees*—(1) *General rule.* Except as provided in paragraph (c)(4) of this section, for purposes of section 956, any obligation of a United States person with respect to which a controlled foreign corporation or a partnership is a pledgor or guarantor will be considered to be held by the controlled foreign corporation or the partnership, as the case may be. See § 1.956–1(e)(2) for rules that determine the amount of the obligation treated as held by a pledgor or guarantor under this paragraph (c). For rules that treat an obligation of a foreign partnership as an obligation of the partners in the foreign partnership for purposes of section 956, see § 1.956–4(c).

(2) *Indirect pledge or guarantee.* If the assets of a controlled foreign corporation or a partnership serve at any time, even though indirectly, as security for the performance of an obligation of a United States person, then, for purposes of paragraph (c)(1) of this section, the controlled foreign corporation or partnership will be considered a pledgor or guarantor of that obligation. If a partnership is considered a pledgor or guarantor of an obligation, a controlled foreign corporation that is a partner in the partnership will not also be treated as a pledgor or guarantor of the obligation solely as a result of its ownership of an interest in the partnership. For purposes of this paragraph, a pledge of stock of a controlled foreign corporation representing at least 66⅔ percent of the total combined voting power of all classes of voting stock of such corporation will be considered an indirect pledge of the assets of the controlled foreign corporation if the pledge is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion to dispose of assets and/or incur liabilities other than in the ordinary course of business. See § 1.956–4(d) for guidance on the treatment of indirect pledges or guarantees of an obligation of a partnership attributed to its partners under § 1.956–4(c).

(3) * * *

Example 4. (i) *Facts.* USP, a domestic corporation, owns 70% of the stock of FS, a controlled foreign corporation, and a 90% interest in FPRS, a foreign partnership. X, an unrelated foreign person, owns 30% of the stock of FS. Y, an unrelated foreign person, owns a 10% interest in FPRS. There are no special allocations in the FPRS partnership agreement. FPRS borrows $100x from Z, an unrelated person. FS pledges its assets as security for FPRS's performance of its obligation to repay the $100x loan. USP's share of the $100x FPRS obligation, determined in accordance with its liquidation value percentage, is $90x. Under § 1.956–4(c), $90x of the FPRS obligation is treated as an obligation of USP for purposes of section 956.

(ii) *Result.* For purposes of section 956, under paragraph (c)(1) of this section, FS is considered to hold an obligation of USP in the amount of $90x, and thus is treated as holding United States property in the amount of $90x.

* * * * *

(h) *Effective/applicability date.* (1) Paragraph (a)(3) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations held on or after November 3, 2016.

(2) Paragraphs (c)(1), (c)(2), and *Example 4* of paragraph (c)(3) of this section apply to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which

such taxable years end, with respect to pledges and guarantees entered into on or after September 1, 2015. For purposes of this paragraph (h)(2), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

* * * * *

■ **Par. 7.** Section § 1.956–3 is added to read as follows:

§ 1.956–3 Certain trade or service receivables acquired from United States persons.

(a) *In general.* For purposes of section 956(a) and § 1.956–1, the term ''United States property'' also includes any trade or service receivable if the trade or service receivable is acquired (directly or indirectly) from a related person who is a United States person (as defined in section 7701(a)(30)) (a *related United States person*) and the obligor under the receivable is a United States person. A trade or service receivable described in this paragraph is considered to be United States property notwithstanding the exceptions (other than subparagraph (H)) contained in section 956(c)(2). The terms ''trade or service receivable'' and ''related person'' have the respective meanings given to the terms by section 864(d) and the regulations thereunder, including § 1.864–8T(b). For purposes of this section, the exception in § 1.956–2T(d)(2)(ii) does not apply to trade or service receivables described in this paragraph.

(b) *Acquisition of a trade or service receivable*—(1) *General rule.* The rules of § 1.864–8T(c)(1) apply to determine whether a controlled foreign corporation has acquired a trade or service receivable.

(2) *Indirect acquisitions*—(i) *Acquisition through unrelated person.* A trade or service receivable is considered acquired from a related person when it is acquired from an unrelated person who acquired (directly or indirectly) the receivable from a person who is a related person to the acquiring person.

(ii) *Acquisition by nominee, pass-through entity, or related foreign corporation.* A controlled foreign corporation is treated as holding a trade or service receivable that is held by a nominee on its behalf, or by a simple trust or other pass-through entity (other than a partnership) to the extent of its direct or indirect ownership or beneficial interest in such simple trust or other pass-through entity. See §§ 1.956–1(b) and 1.956–4(b) for rules that may treat a controlled foreign corporation as indirectly holding a trade or service receivable held by a foreign corporation or partnership. A controlled foreign corporation that is treated as holding a trade or service receivable held by another person (the *direct holder*) (or that would be treated as holding the receivable if the receivable were United States property or would be United States property if held directly by the controlled foreign corporation) is considered to have acquired the receivable from the person from whom the direct holder acquired the receivable. This paragraph (b)(2)(ii) does not limit the application of paragraph (b)(2)(iii) of this section. The following examples illustrate the application of this paragraph (b)(2)(ii):

Example 1. (i) *Facts.* A domestic corporation, P, wholly owns a controlled foreign corporation, FS, with substantial earnings and profits. FS contributes $200x of cash to a partnership, PRS, in exchange for an 80% partnership interest. An unrelated foreign person contributes real estate located in a foreign country with a fair market value of $50x to PRS for the remaining 20% partnership interest. There are no special allocations in the PRS partnership agreement. PRS uses the $200x of cash received from FS to purchase trade receivables from P. The obligors with respect to the trade receivables are United States persons that are not related to any partner in PRS. The liquidation value percentage, as determined under § 1.956–4(b), for FS with respect to PRS is 80%. A principal purpose of funding PRS (through FS's cash contribution) is to avoid the application of section 956 with respect to FS.

(ii) *Result.* Under § 1.956–4(b)(1), FS is treated as holding 80% of the trade receivables acquired by PRS from P, with a basis equal to $160x (80% × $200x, PRS's basis in the trade receivables). However, because FS controls PRS and a principal purpose of FS funding PRS was to avoid the application of section 956 with respect to FS, under § 1.956–1(b), if the trade receivables would be United States property if held directly by FS, FS additionally would be treated as holding the trade receivables to the extent that they exceed the amount of the receivables it holds under § 1.956–4(b), which is $40x ($200x − $160x). Accordingly, under this paragraph (b)(2)(ii), FS is treated as having acquired from P, a related United States person, the trade receivables that it is treated as holding with a basis equal to $200x ($160x + $40x). Thus, FS is treated as holding United States property with a basis of $200x under paragraph (a) of this section.

Example 2. (i) *Facts.* A domestic corporation, P, wholly owns a controlled foreign corporation, FS1, that has earnings and profits of at least $300x. FS1 organizes a foreign corporation, FS2, with a $200x cash contribution. FS2 uses the cash contribution to purchase trade receivables from P. The obligors with respect to the trade receivables are unrelated United States persons. A principal purpose of funding FS2 (through FS1's cash contribution) is to avoid the application of section 956 with respect to FS1.

(ii) *Result.* Under § 1.956–1(b), if the trade receivables held by FS2 were United States property, FS1 would be treated as holding the trade receivables held by FS2 because FS1 controls FS2 and a principal purpose of FS1 funding FS2 was to avoid the application of section 956 with respect to FS1. Accordingly, under this paragraph (b)(2)(ii), FS1 is treated as having acquired from P, a related United States person, the trade receivables that it would be treated as holding with a basis equal to $200x. Thus, FS1 is treated as holding United States property with a basis of $200x under paragraph (a) of this section.

(iii) *Swap or pooling arrangements.* A trade or service receivable of a United States person is considered to be a trade or service receivable acquired from a related United States person and subject to the rules of this section when it is acquired in accordance with an arrangement that involves two or more groups of related persons, if the groups are unrelated to each other and the effect of the arrangement is that one or more persons in each group acquire (directly or indirectly) trade or service receivables from one or more unrelated United States persons who are also parties to the arrangement in exchange for reciprocal purchases of receivables from related United States persons. The following example illustrates the application of this paragraph (b)(2)(iii):

Example. (i) *Facts.* Controlled foreign corporations A, B, C, and D are wholly-owned subsidiaries of domestic corporations M, N, O, and P, respectively. M, N, O, and P are not related persons. According to a prearranged plan, A, B, C, and D each acquire trade or service receivables from M, N, O, and/or P. The obligors under some or all of the receivables acquired by each of A, B, C, and D are United States persons.

(ii) *Result.* The effect of the prearranged plan is that each of A, B, C, and D acquires trade or service receivables of United States persons from one or more unrelated United States persons who are also parties to the arrangement, in exchange for reciprocal purchases of receivables from a related United States person. Accordingly, each of A, B, C, and D is treated as holding a trade or service receivable acquired from a related United States person and is subject to the rules of this section. As a result, each of A, B, C, and D is treated as holding an amount of United States property equal to its adjusted basis in the receivables acquired pursuant to the arrangement with respect to which the obligors are United States persons.

(iv) *Financing arrangements.* If a controlled foreign corporation participates (directly or indirectly) in a lending transaction that results in a loan to a United States person who purchases property described in section 1221(a)(1) (*inventory property*) or services from a related United States person, or to any person who purchases from a related United States person trade or service receivables under which the obligor is a United States person, or to a person who is a related person with respect to the purchaser, and if the loan would not have been made or maintained on the same terms but for the corresponding purchase, then the controlled foreign corporation is considered to have indirectly acquired a trade or service receivable described in paragraph (a) of this section. For purposes of this paragraph (b)(2)(iv), it is immaterial that the sums lent are not, in fact, the sums used to finance the purchase of the inventory property or services or trade or service receivables from a related United States person. The amount to be taken into account with respect to the United States property treated as held by a controlled foreign corporation as a result of the application of this paragraph (b)(2)(iv) is the lesser of the amount lent pursuant to a lending transaction described in this paragraph (b)(2)(iv) and the purchase price of the inventory property, services, or trade or service receivables. The following examples illustrate the application of this paragraph (b)(2)(iv):

Example 1. (i) *Facts.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation. P sells inventory property for $200x to X, an unrelated United States person. FS1 makes a $100x short-term loan to X, which loan would not have been made or maintained on the same terms but for X's purchase of P's inventory property.

(ii) *Result.* FS1 directly participates in a lending transaction described in this paragraph (b)(2)(iv). Thus, FS1 is considered to have acquired a trade or service receivable described in paragraph (a) of this section. That is, FS1 is considered to have acquired a trade or service receivable of a United States person from a related United States person. As a result, FS1 is treated as holding United States property in the amount of $100x.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (b)(2)(iv), except that instead of loaning money to X directly, FS1 deposits $300x with an unrelated financial institution that loans $200x to X in order for X to purchase P's inventory property. The loan would not have been made or maintained on the same terms but for the corresponding deposit.

(ii) *Result.* FS1 is considered to have acquired a trade or service receivable described in paragraph (a) of this section because FS1 indirectly participates in a lending transaction described in this paragraph (b)(2)(iv). See Rev. Rul. 87–89, 1987–2 CB 195. That is, FS1 is considered to have acquired a trade or service receivable of a United States person from a related United States person. Thus, FS1 is treated as holding United States property in the amount of $200x.

Example 3. (i) *Facts.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation. FS1 makes a $300x loan to U, an unrelated foreign corporation, in connection with U's purchase from P of receivables from the sale of inventory property by P to United States obligors for $200x.

(ii) *Result.* FS1 is considered to have acquired a trade or service receivable described in paragraph (a) of this section because FS1 directly participates in a lending transaction described in this paragraph (b)(2)(iv). That is, FS1 is considered to have acquired a trade or service receivable of a United States person from a related United States person. Thus, FS1 is treated as holding United States property in the amount of $200x.

(c) *Substitution of obligor.* For purposes of this section, the substitution of another person for a United States obligor is disregarded, unless it can be demonstrated by the parties to the transaction that the primary purpose for the arrangement was not the avoidance of section 956. The following example illustrates the application of this paragraph (c):

Example. (i) *Facts.* P, a domestic corporation, owns all of the outstanding stock of FS1, a controlled foreign corporation with substantial accumulated earnings and profits. P sells inventory property to X, a domestic corporation unrelated to P. To pay for the inventory property, X arranges for a foreign financing entity to issue a note to P. P then sells the note to FS1. P and X cannot demonstrate that the primary purpose for X's assignment of the payment obligation to the foreign financing entity was not the avoidance of section 956.

(ii) *Result.* The substitution of the foreign financing entity for X is disregarded, and FS1 is treated as holding an obligation of a United States person acquired from a related United States person. Thus, FS1 is treated as holding United States property in the amount of the purchase price of the note.

(d) *Effective/applicability date*—(1) Except as provided in paragraph (d)(2) of this section, this section applies to trade or service receivables acquired (directly or indirectly) after March 1, 1984.

(2) Paragraph (b)(2)(ii) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to trade or service receivables acquired on or after September 1, 2015. For purposes of this paragraph (d), a significant modification, within the meaning of § 1.1001–3(e), of a trade or service receivable on or after September 1, 2015, constitutes an acquisition of the trade or service receivable on or after that date.

§ 1.956–3T [Removed]

■ **Par. 8.** Section 1.956–3T is removed.

■ **Par. 9.** Section 1.956–4 is added to read as follows:

§ 1.956–4 Certain rules applicable to partnerships.

(a) *Overview.* This section provides rules concerning the application of section 956 to certain obligations of and property held by a partnership. Paragraph (b) of this section provides rules concerning United States property held indirectly by a controlled foreign corporation through a partnership. Paragraph (c) of this section provides rules that generally treat obligations of a foreign partnership as obligations of the partners in the foreign partnership, as well as a special rule that treats a partner that is a United States person as owing additional amounts of a partnership obligation in certain circumstances. Paragraph (d) of this section sets forth a rule concerning the application of the indirect pledge or guarantee rule to obligations of partnerships. Paragraph (e) of this section provides that obligations of a domestic partnership are obligations of a United States person. Paragraph (f) of this section provides effective and applicability dates. See §§ 1.956–1(b) and 1.956–2(c) for additional rules applicable to partnerships.

(b) *Property held indirectly through a partnership*—(1) *General rule.* For purposes of section 956, a partner in a partnership is treated as holding its attributable share of any property held by the partnership (including an obligation that the partnership is treated as holding as a result of the application of § 1.956–2(c)). A partner's attributable share of partnership property is determined under the rules set forth in paragraph (b)(2) of this section. An upper-tier partnership's attributable share of the property of a lower-tier partnership is treated as property of the upper-tier partnership for purposes of applying this paragraph (b)(1) to the partners of the upper-tier partnership. For purposes of section 956, a partner's adjusted basis in the property of the partnership equals the partner's attributable share of the partnership's adjusted basis in the property, as determined under the rules set forth in paragraph (b)(2) of this section, taking into account any adjustments to basis under section 743(b) (with respect to the partner) or section 734(b) or any similar adjustments to basis. The rules in § 1.956–1(e)(2) apply to determine the amount of an obligation treated as held by a partnership as a result of the application of § 1.956–2(c). See § 1.956–

1(b) for special rules that may treat a controlled foreign corporation as holding a greater amount of United States property held by a partnership than the amount determined under this section.

(2) *Methodology*—(i) *Liquidation value percentage*—(A) *Calculation.* Except as otherwise provided in paragraph (b)(2)(ii) of this section, for purposes of paragraph (b)(1) of this section, a partner's attributable share of partnership property is determined in accordance with the partner's liquidation value percentage. For purposes of this paragraph (b)(2)(i) and paragraph (c)(1) of this section, the liquidation value of a partner's interest in a partnership is the amount of cash the partner would receive with respect to the interest if, on the applicable determination date, as provided in paragraph (b)(2)(i)(B) of this section, the partnership sold all of its assets for cash equal to the fair market value of such assets (taking into account section 7701(g)), satisfied all of its liabilities (other than those described in § 1.752–7), paid an unrelated third party to assume all of its § 1.752–7 liabilities in a fully taxable transaction, and then liquidated. A partner's liquidation value percentage is the ratio (expressed as a percentage) of the liquidation value of the partner's interest in the partnership divided by the aggregate liquidation value of all of the partners' interests in the partnership.

(B) *Determination date.* The *determination date* with respect to a partnership is the most recent of—

(*1*) The formation of the partnership;

(*2*) An event described in § 1.704–1(b)(2)(iv)(*f*)(*5*) or § 1.704–1(b)(2)(iv)(*s*)(*1*) (a *revaluation event*), irrespective of whether the capital accounts of the partners are adjusted in accordance with § 1.704–1(b)(2)(iv)(*f*); or

(*3*) The first day of the partnership's taxable year, as determined under section 706, provided the liquidation value percentage determined for any partner on that day would differ from the most recently determined liquidation value percentage of that partner by more than 10 percentage points.

(ii) *Special allocations.* For purposes of paragraph (b)(1) of this section, if a partnership agreement provides for the allocation of book income (or, where appropriate, book gain) from a subset of the property of the partnership to a partner other than in accordance with the partner's liquidation value percentage in a particular taxable year (a *special allocation*), then the partner's attributable share of that property is determined solely by reference to the partner's special allocation with respect to the property, provided the special allocation does not have a principal purpose of avoiding the purposes of section 956.

(3) *Examples.* The following examples illustrate the rule of this paragraph (b):

Example 1. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, which, in turn, owns an interest in FPRS, a foreign partnership. The remaining interest in FPRS is owned by an unrelated foreign person. FPRS holds non-depreciable property with an adjusted basis of $100x (the ''FPRS property'') that would be United States property if held by FS directly. At the close of quarter 1 of year 1, the liquidation value percentage, as determined under paragraph (b)(2) of this section, for FS with respect to FPRS is 25%. There are no special allocations in the FPRS partnership agreement.

(ii) *Result.* Under paragraph (b)(1) of this section, for purposes of section 956, FS is treated as holding its attributable share of the property held by FPRS with an adjusted basis equal to its attributable share of FPRS's adjusted basis in such property. Under paragraph (b)(2) of this section, FS's attributable share of property held by FPRS is determined in accordance with FS's liquidation value percentage, which is 25%. Thus, FS's attributable share of the FPRS property is 25%, and its attributable share of FPRS's basis in the FPRS property is $25x. Accordingly, for purposes of determining the amount of United States property held by FS as of the close of quarter 1 of year 1, FS is treated as holding United States property with an adjusted basis of $25x.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (b)(3), except that the FPRS partnership agreement, which satisfies the requirements of section 704(b), specially allocates 80% of the income with respect to the FPRS property to FS. The special allocation does not have a principal purpose of avoiding the purposes of section 956.

(ii) *Result.* Under paragraph (b)(1) of this section, for purposes of section 956, FS is treated as holding its attributable share of property held by FPRS with an adjusted basis equal to its attributable share of FPRS's adjusted basis in such property. In general, FS's attributable share of property held by FPRS is determined in accordance with FS's liquidation value percentage. However, because the special allocation does not have a principal purpose of avoiding the purposes of section 956, under paragraph (b)(2)(ii) of this section, FS's attributable share of the FPRS property is determined by reference to its special allocation. FS's special allocation percentage for the FPRS property is 80%, and thus FS's attributable share of the FPRS property is 80% and its attributable share of FPRS's basis in the FPRS property is $80x. Accordingly, for purposes of determining the amount of United States property held by FS as of the close of quarter 1 of year 1, FS is treated as holding United States property with an adjusted basis of $80x.

Example 3. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, which, in turn, owns an interest in FPRS, a foreign partnership. USP owns the remaining interest in FPRS. FPRS holds property (the ''FPRS property'') that would be United States property if held by FS directly. The FPRS property has an adjusted basis of $100x and is anticipated to appreciate in value but generate relatively little income. The FPRS partnership agreement, which satisfies the requirements of section 704(b), specially allocates 80% of the income with respect to the FPRS property to USP and 80% of the gain with respect to the disposition of FPRS property to FS. The special allocation does not have a principal purpose of avoiding the purposes of section 956.

(ii) *Result.* Because the special allocation does not have a principal purpose of avoiding the purposes of section 956, under paragraph (b)(2)(ii) of this section, FS's attributable share of the FPRS property is determined by reference to a special allocation with respect to the FPRS property. Given the income and gain anticipated with respect to the FPRS property, it is appropriate to determine FS's attributable share of the property in accordance with the special allocation of gain. Accordingly, for purposes of determining the amount of United States property held by FS in each year that FPRS holds the FPRS property, FS's attributable share of the FPRS property is 80% and its attributable share of FPRS's basis in the FPRS property is $80x. Thus, FS is treated as holding United States property with an adjusted basis of $80x.

(c) *Obligations of a foreign partnership*—(1) *In general.* Except as provided in paragraphs (c)(2) and (c)(3) of this section, for purposes of section 956, an obligation of a foreign partnership is treated as a separate obligation of each of the partners in the partnership to the extent of each partner's share of the obligation. A partner's share of the partnership's obligation is determined in accordance with the partner's liquidation value percentage, as determined under the rules set forth in paragraph (b)(2)(i) of this section, without regard to the rules set forth in paragraph (b)(2)(ii) of this section. An upper-tier partnership's share of an obligation of a lower-tier partnership is treated as an obligation of the upper-tier partnership for purposes of applying this paragraph (c)(1) to the partners of the upper-tier partnership.

(2) *Exception for obligations of partnerships in which neither the lending controlled foreign corporation nor any person related to the lending controlled foreign corporation is a partner.* For purposes of applying section 956 with respect to a controlled foreign corporation, an obligation of a foreign partnership is treated as an obligation of a foreign partnership, and not as an obligation of its partners, if neither the controlled foreign corporation nor any person related to

the controlled foreign corporation within the meaning of section 954(d)(3) is a partner in the partnership. For purposes of section 956, an obligation treated as an obligation of a foreign partnership pursuant to this paragraph (c)(2) is not an obligation of a United States person.

(3) *Special obligor rule in the case of certain partnership distributions*—(i) *General rule.* For purposes of determining a partner's share of a foreign partnership's obligation under section 956, if the foreign partnership distributes an amount of money or property to a partner that is related to a controlled foreign corporation within the meaning of section 954(d)(3) and whose obligation would be United States property if held (or if treated as held) by the controlled foreign corporation, and the foreign partnership would not have made the distribution but for a funding of the partnership through an obligation held (or treated as held) by a controlled foreign corporation, notwithstanding § 1.956–1(e), the partner's share of the partnership obligation is the greater of—

(A) The partner's share of the partnership obligation as determined under paragraph (c)(1) of this section; and

(B) The lesser of the amount of the distribution to the partner that would not have been made but for the funding of the partnership and the amount of the obligation (as determined under § 1.956–1(e)).

(ii) *Deemed treatment*—(A) For purposes of applying paragraph (c)(3)(i) of this section, in the case of a distribution of liquid assets by a foreign partnership to a partner, the foreign partnership is treated as if it would not have made the distribution of liquid assets to the partner but for the funding of the partnership through an obligation or obligations held (or treated as held) by the controlled foreign corporation to the extent the foreign partnership does not have sufficient liquid assets to make the distribution immediately prior to the distribution, without taking into account the obligation or obligations.

(B) If the controlled foreign corporation holds (or is treated as holding) multiple obligations of the foreign partnership, paragraph (c)(3)(ii)(A) of this section applies to the obligations in reverse chronological order starting with the obligation that was acquired (or the obligation with respect to which a pledge or guarantee was entered into) closest in time to the distribution. Paragraph (c)(3)(ii)(A) of this section applies to an obligation only to the extent that the full amount of the distribution is not otherwise treated, pursuant to paragraph (c)(3)(ii)(A) of this section, as if it would not have been made but for the funding of the partnership through one or more other obligations.

(C) For purposes of paragraph (c)(3)(ii) of this section, a significant modification, within the meaning of § 1.1001–3(e), of an obligation constitutes an acquisition of the obligation on or after that date, and a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor.

(D) For purposes of paragraph (c)(3)(ii) of this section, liquid assets means cash or cash equivalents, marketable securities within the meaning of section 453(f)(2), or an obligation owed by a related person (within the meaning of section 954(d)(3)).

(4) *Examples.* The following examples illustrate the rules of this paragraph (c):

Example 1. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation, and owns an interest in FPRS, a foreign partnership. At the close of quarter 1 of year 1, the liquidation value percentage, as determined under paragraph (b)(2)(i) of this section, for USP with respect to FPRS is 90%. X, a foreign person that is unrelated to USP or FS, owns the remaining interest in FPRS. FPRS borrows $100x from FS. FS's basis in the FPRS obligation is $100x.

(ii) *Result.* Under paragraph (c)(1) of this section, for purposes of section 956, the obligation of FPRS is treated as obligations of its partners (USP and X) in proportion to each partner's liquidation value percentage with respect to FPRS. Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), the exception in paragraph (c)(2) of this section does not apply. Based on its liquidation value percentage, USP's share of the FPRS obligation is $90x. Accordingly, for purposes of section 956, $90x of the FPRS obligation held by FS is treated as an obligation of USP and is United States property within the meaning of section 956(c). Therefore, on the date the loan is made, FS is treated as holding United States property of $90x.

Example 2. (i) *Facts.* The facts are the same as in *Example 1* of this paragraph (c)(4), except that USP owns 40% of the stock of FS and is not a related person (as defined in section 954(d)(3)) with respect to FS. Y, a United States person that is unrelated to USP or X, owns the remaining 60% of the stock of FS.

(ii) *Result.* Because neither FS nor any person related to FS within the meaning of section 954(d)(3) is a partner in FPRS, the exception in paragraph (c)(2) of this section applies to treat the FPRS obligation as an obligation of a foreign partnership and not an obligation of a United States person. Therefore, paragraph (c)(1) of this section does not apply, and FS is not treated as holding United States property.

Example 3. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation. USP and FS own interests in FPRS, a foreign partnership. USP's liquidation value percentage with respect to FPRS is 60%, and FS's liquidation value percentage with respect to FPRS is 30%. U.S.C., a domestic corporation that is unrelated to USP and FS, also owns an interest in FPRS; its liquidation value percentage is 10%. FPRS borrows $100x from an unrelated person. FS guarantees the FPRS obligation.

(ii) *Result.* Under paragraph (c)(1) of this section, for purposes of section 956, the obligation of FPRS is treated as obligations of its partners (USP, FS, and U.S.C.) in proportion to each partner's liquidation value percentage. Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), and because FS is a partner in FPRS, the exception in paragraph (c)(2) of this section does not apply. Based on their liquidation value percentages, USP's share of the FPRS obligation is $60x, and U.S.C.'s share of the FPRS obligation is $10x. For purposes of section 956, $60x of the FPRS obligation is treated as an obligation of USP, and $10x of the FPRS obligation is treated as an obligation of U.S.C. Under § 1.956–2(c)(1), FS is treated as holding the obligations of USP and U.S.C. that FS guaranteed. All of the exceptions to the definition of United States property contained in section 956 and § 1.956–2 must be considered to determine whether the obligations of USP and U.S.C. that are treated as held by FS constitute United States property. Accordingly, the obligation of U.S.C. is not United States property under section 956(c)(2)(F) and § 1.956–2(b)(1)(viii). The obligation of USP, however, is United States property within the meaning of section 956(c). Therefore, on the date the guarantee is made, FS is treated as holding United States property of $60x.

Example 4. (i) *Facts.* USP, a domestic corporation, wholly owns FS, a controlled foreign corporation. USP owns an interest in FPRS, a foreign partnership; its liquidation value percentage with respect to FPRS is 70%. A domestic corporation that is unrelated to USP and FS owns the remaining interest in FPRS; its liquidation value percentage is 30%. FPRS borrows $100x from FS and makes a distribution of $80x to USP. FPRS would not have made the distribution to USP but for the funding of FPRS by FS.

(ii) *Result.* Because USP, a partner in FPRS, is related to FS within the meaning of section 954(d)(3), the exception in paragraph (c)(2) of this section does not apply. Moreover, an obligation of USP held by FS would be United States property. USP's share of the FPRS obligation as determined under paragraph (c)(1) of this section in accordance with USP's liquidation value percentage is $70x. Under paragraph (c)(3) of this section, USP's share of the FPRS obligation is the greater of (i) USP's attributable share of the obligation, $70x, or (ii) the lesser of the amount of the distribution, $80x, or the amount of the obligation, $100x. For purposes of section 956, therefore, $80x of the FPRS obligation is treated as an obligation of USP and is United States property within the meaning of section 956(c). Thus, on the date the loan is made, FS is treated as holding United States property of $80x.

(d) *Limitation on a partner's indirect pledge or guarantee.* For purposes of section 956 and § 1.956–2(c), a controlled foreign corporation that is a partner in a partnership is not considered a pledgor or guarantor of the portion of an obligation of the partnership attributed to its partners that are United States persons under paragraph (c) of this section solely as a result of the attribution of a portion of the partnership's assets to the controlled foreign corporation under paragraph (b) of this section.

(e) *Obligations of a domestic partnership.* For purposes of section 956, an obligation of a domestic partnership is an obligation of a United States person. See section 956(c)(2)(L) for an exception from the treatment of such an obligation as United States property.

(f) *Effective/applicability dates.* (1) Paragraph (b) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to property acquired on or after November 3, 2016. For purposes of this paragraph (f)(1), a deemed exchange of property pursuant to section 1001 on or after November 3, 2016, constitutes an acquisition of the property on or after that date. See § 1.956–2(a)(3), as contained in 26 CFR part 1 revised as of April 1, 2016, for the rules applicable to taxable years of a controlled foreign corporation beginning on or after July 23, 2002, and ending before November 3, 2016, and with respect to property acquired before November 3, 2016, to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(2) Except as otherwise provided in this paragraph (f)(2), paragraph (c) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations acquired, or pledges or guarantees entered into, on or after September 1, 2015, and, for purposes of paragraph (c)(3) of this section, in the case of distributions made on or after September 1, 2015. Paragraph (c)(3)(ii) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations acquired, or pledges or guarantees entered into, on or after September 1, 2015, and distributions made on or after November 3, 2016. For purposes of this paragraph (f)(2), a significant modification, within the meaning of § 1.1001–3(e), of an obligation on or after September 1, 2015 constitutes an acquisition of the obligation on or after that date. Furthermore, for purposes of this paragraph (f)(2), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015. See § 1.956–1T(b)(5), as contained in 26 CFR part 1 revised as of April 1, 2016, for rules applicable to taxable years of controlled foreign corporations ending on or after September 1, 2015, and before November 3, 2016, 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 September 1, 2015.

(3) Paragraph (d) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and taxable years of United States shareholders in which or with which such taxable years end, with respect to pledges or guarantees entered into on or after September 1, 2015. For purposes of this paragraph (f)(3), a pledgor or guarantor is treated as entering into a pledge or guarantee when there is a significant modification, within the meaning of § 1.1001–3(e), of an obligation with respect to which it is a pledgor or guarantor on or after September 1, 2015.

(4) Paragraph (e) of this section applies to taxable years of controlled foreign corporations ending on or after November 3, 2016, and to taxable years of United States shareholders in which or with which such taxable years end, with respect to obligations held on or after November 3, 2016.

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: October 17, 2016.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2016–26425 Filed 11–2–16; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF HOMELAND SECURITY

Coast Guard

33 CFR Part 117

[Docket No. USCG–2016–0966]

Drawbridge Operation Regulation; Harlem River, New York City, NY

AGENCY: Coast Guard, DHS.

ACTION: Notice of deviation from drawbridge regulation.

SUMMARY: The Coast Guard has issued a temporary deviation from the operating schedule that governs the Spuyten Duyvil Bridge across the Harlem River, mile 7.9, New York City, New York. This deviation is necessary to allow the bridge owner to perform a test of the submarine cables at the bridge.

DATES: This deviation is effective from 10 p.m. on December 9, 2016 to 7 a.m. on December 11, 2016.

ADDRESSES: The docket for this deviation, [USCG–2016–0966] is available at *http://www.regulations.gov.* Type the docket number in the ''SEARCH'' box and click ''SEARCH''. Click on Open Docket Folder on the line associated with this deviation.

FOR FURTHER INFORMATION CONTACT: If you have questions on this temporary deviation, call or email Judy Leung-Yee, Project Officer, First Coast Guard District, telephone (212) 514–4330, email *judy.k.leung-yee@uscg.mil.*

SUPPLEMENTARY INFORMATION: The Spuyten Duyvil Bridge, mile 7.9, across the Harlem River, has a vertical clearance in the closed position of 5 feet at mean high water and 9 feet at mean low water. The existing bridge operating regulations are found at 33 CFR 117.789(d).

The waterway is transited by commercial vessels.

The bridge owner, National Railroad Passenger Corporation (Amtrak), requested a temporary deviation from the normal operating schedule to perform a test of the submarine cables at the bridge.

Under this temporary deviation, the Spuyten Duyvil Bridge shall remain in the closed position from 10 p.m. on December 9, 2016 to 7 a.m. on December 11, 2016.

Vessels able to pass under the bridge in the closed position may do so at any time. The bridge will be able to open for emergencies and there is an alternate route for vessels to pass.

The Coast Guard will inform the users of the waterways through our Local and Broadcast Notices to Mariners of the