No. 18-1862

IN THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

SIH PARTNERS LLLP, EXPLORER CORPORATION, TAX MATTERS PARTNER

Petitioner-Appellant,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellee.

ON APPEAL FROM THE UNITED STATES TAX COURT

OPENING BRIEF FOR PETITIONER-APPELLANT

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CORPORATE DISCLOSURE STATEMENT

Pursuant to Federal Rule of Appellate Procedure 26.1 and Third Circuit L.A.R. 26.1, SIH Partners, LLLP, Explorer Partner Corp., Tax Matters Partner makes the following disclosure:

The following are parent corporations of SIH Partners, LLLP, Explorer Partner Corp., Tax Matters Partner: Colombus International Holdings, Inc.; Balboa International Holdings, Inc.; Coronado International Holdings, Inc.; Cortes International Holdings, Inc.; LaSalle International Holdings, Inc.; Explorer Partner Corp.

No publicly held companies hold 10% or more of the party's stock.

No publicly held corporation which is not a party to the proceeding before this Court has a financial interest in the outcome of the proceeding.

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INTRODUCTION

The IRS wants to have it both ways in this case. It seeks to treat a loan guarantee by a foreign corporation as a dividend, while simultaneously denying application of the lower tax rate that generally applies to dividends. Both positions cannot be correct—and in fact both are wrong.

In general, a shareholder of a corporation does not pay tax on the income of the corporation. Instead, the corporation pays tax on its own income and its shareholders are taxed on dividends they receive out of the corporation's earnings. These dividends typically were taxed at a reduced rate of 15 percent in the years at issue.

In subpart F of the Internal Revenue Code, Congress identified certain situations in which U.S. taxpayers could make use of a foreign corporation's earnings without formally declaring a dividend, and provided that in these situations U.S. shareholders should be taxed on the corporation's earnings in advance of a formal dividend.

Section 956, the section of subpart F that is relevant here, imposes tax on U.S. shareholders of a controlled foreign corporation ("CFC") when the CFC makes specified investments in U.S. property that

effectively repatriate the CFC's income and so are substantially equivalent to a dividend.[1] A quintessential example, directly addressed by section 956, is when a CFC makes a loan to a related U.S. person. In this situation, Congress determined that a loan is akin to a dividend and therefore required the CFC's U.S. shareholder to include the loan amount in its income, to the extent of the CFC's previously untaxed earnings.

Section 956(d) separately addresses loan guarantees. This separate treatment recognizes that the benefit a U.S. shareholder receives from a loan guarantee differs from the benefit the shareholder receives from a direct loan (addressed in section 956(c)). To deal with the unique aspects of loan guarantees, Congress assigned Treasury responsibility for drafting regulations to govern their treatment as investments in U.S. property. Treasury has failed to adequately carry out its responsibilities. Indeed, there are three reasons to reverse the Tax Court's decision.

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[1] Unless otherwise specified, all references to the Code refer to the Internal Revenue Code of 1986. Changes to the Code enacted in 2017, Pub. L. 115-97, 131 Stat. 2054 (Dec. 22, 2017), do not apply to this case.

First, there is no evidence that Treasury undertook the reasoned analysis necessary to determine when, and to what extent, a guarantee should be deemed a repatriation of a CFC's earnings. Instead, the regulations treat every CFC guarantor of a U.S. person's loan as investing the entire unpaid principal amount of that loan, and thus repatriating all of their earnings up to the full amount of the loan. This is essentially the same treatment that would apply under section 956(c) if the CFCs had loaned the funds directly. Treasury failed to address any of the characteristics of guarantees that led Congress to treat them differently from direct loans. The regulations take no account of whether the CFC's guarantee had any impact on the U.S. person's ability to receive the guaranteed loan, and apply without regard to whether the CFC is one of several guarantors of the loan. When there are multiple guarantors, as in this case, the guarantees can result in the repatriation of many times the amount of the loan. The regulations thus ignore the actual economic impact, if any, of the guarantee. Rather than providing a reasoned explanation for these rules as required by law, Treasury said only that they were issued "to conform"

to section 956. The rules thus reflect a failure of reasoned decisionmaking, and do not support the imposition of tax.

Second, perhaps recognizing the shortcomings of Treasury's regulations and the absurdities they can produce, the IRS issued precedential guidance requiring that, in applying section 956, the facts and circumstances of each case must be reviewed to determine whether there has been a repatriation of CFC earnings. In this case, the IRS refused to follow its own precedent and incorrectly concluded that a repatriation of earnings occurred.

Third, the IRS compounded its mistake by imposing tax on the CFCs' earnings at the ordinary income rate (35 percent), rather than the qualified dividend income ("QDI") rate (15 percent). Three years after the guarantees, and before the IRS ever questioned the taxation of the CFCs' earnings, the CFCs distributed their earnings, and tax was paid at the QDI rate of 15 percent. The IRS argues that taxation of those earnings should have been accelerated under section 956 *as if* they were dividends while also arguing that the earnings should be taxed at the higher ordinary rate because, when they were deemed to be repatriated by virtue of the guarantees under the section 956(d)

regulations, they were not *actually* dividends. But this argument ignores the fact that income inclusions under section 956 are dividends by their very nature. Accelerating income recognition does not change the character of that income.

In short, the government cannot have it both ways. It cannot treat CFC guarantees as substantially the equivalent of a dividend for purposes of inclusion in current income while also arguing that the same guarantees are *not* substantially equivalent to a dividend for purposes of the applicable tax rate.

The Tax Court erroneously concluded that, because Congress did not expressly state in a statute that earnings made taxable under section 956 "*are* dividends for general purposes of the Code," J.A. 55 (emphasis in original), Congress must not have intended to tax them as dividends. This conclusion disregards the structure and history of section 956, ignores Supreme Court precedent, is contradicted by the IRS' own guidance, and violates the purpose of the QDI rules.

The Tax Court's decision should be reversed.

STATEMENT OF JURISDICTION

The Tax Court had jurisdiction under 26 U.S.C. § 6213. It entered its final order on January 18, 2018. J.A. 3. Appellant filed a timely notice of appeal on April 16, 2018. J.A. 1-2. This Court has jurisdiction under 26 U.S.C. § 7482(a)(1).

STATEMENT OF ISSUES

1. Whether Treasury regulations governing CFC guarantees and pledges, 26 C.F.R. §§ 1.956-2(c)(1) and 1.956-1(e)(2), are unreasonable and inadequately explained. J.A. 19-46 (Tax Ct. 16-43).

2. Whether, even if the regulations are valid, the Tax Court should have applied a fact-specific analysis to determine whether the CFCs' earnings were repatriated in substance. J.A. 46-47 (Tax Ct. 43-44).

3. Whether, if any CFC earnings are taxed under section 956, the QDI rate applies. J.A. 51-56 (Tax Ct. 48-53).

STATEMENT OF RELATED CASES

Appellant is aware of one related case, *SIH Partners, LLLP, Explorer Partner Corp., Tax Matters Partner v. Commissioner of Internal Revenue*, No. 026531-16 (Tax Ct. filed Dec. 12, 2016).

STATEMENT OF THE CASE

A. Statutory Framework

A CFC is not subject to U.S. income tax on foreign income unless it engages in a U.S. trade or business. *See* 26 U.S.C. § 882(a). However, U.S. shareholders are taxed on dividends they receive from a CFC. Congress enacted subpart F of the Code to limit the ability of U.S. shareholders to avoid U.S. tax by (i) causing CFCs to earn certain "mobile" income that would otherwise be earned by the U.S. shareholders or (ii) making use of CFC earnings without formally declaring a dividend. 26 U.S.C. §§ 951(a)(1)(A), 951(a)(1)(B), 956.

The provision at issue here, section 956, addresses the second situation. Under section 956, U.S. shareholders must pay U.S. tax when a CFC, instead of formally declaring a dividend, invests its earnings in specified "United States property."[2] If those earnings are later formally distributed as dividends, no further U.S. tax is due. Thus, section 956 effectively accelerates U.S. tax (*i.e.*, ends a deferral of

[2] In this brief, "section 956 inclusion" refers to the amount of a CFC's earnings that a U.S. shareholder is required to include in income under section 951(a)(1)(B), as computed under section 956.

tax) on CFC earnings by treating those earnings as if they were distributed to the CFC's U.S. shareholders.

Congress determined that CFC investments in U.S. property should trigger tax to a CFC's U.S. shareholder because they are "substantially the equivalent of a dividend." J.A. 21 (Tax Ct. 18) (quoting S. Rep. 87-1881 at 88 (1962)). Absent section 956, if a CFC invested its income in U.S. property, "the income would be effectively repatriated in a manner that would escape current tax." Dep't of the Treasury, "The Deferral of Income Earned Through U.S. Controlled Foreign Corporations: A Policy Study" at xv (Dec. 2000), *available at* https://www.treasury.gov/resource-center/tax-policy/Documents/Report-SubpartF-2000.pdf. To counteract this, under section 956 "the U.S. shareholder must include in income an amount calculated by reference to the amount invested in the U.S. property." *Id.*

With limited exceptions not relevant here, section 956 applies a categorical rule whenever a CFC invests in "tangible property located in the United States," "stock of a domestic corporation," "an obligation of a United States person," and certain types of intellectual property. 26 U.S.C. § 956(c)(1). When a CFC makes such an investment, its U.S.

shareholders must include a specified amount of the CFC's previously untaxed earnings in their income.

The amount of the CFC's earnings that a U.S. shareholder must include in its income as a result of a CFC's investment in U.S. property is generally measured by the CFC's "basis" in the property, *i.e.*, the amount the CFC has invested in that property. Specifically, a U.S. shareholder must include in income the CFC's basis in the property up to the amount of the CFC's previously untaxed earnings. *Id.* § 956(a)(1).

A guarantee of a U.S. person's loan is not an asset of the CFC—it is a contingent liability. However, in some circumstances a guarantee may enable a U.S. shareholder to obtain a loan that it could not otherwise obtain, and thus can be viewed as an indirect repatriation of funds. *See, e.g.*, *Ludwig v. Commissioner*, 68 T.C. 979, 990 (1977) ("[T]he controlling stockholders could derive nearly identical benefits by borrowing funds from another source and having the loan guaranteed by the [CFC] or secured by a pledge of such corporation's assets. Such use of the credit or assets of the [CFC] indirectly effects a repatriation of available earnings.").

Rather than listing pledges and guarantees among the investments in property that automatically trigger U.S. tax according to a set statutory formula, Congress addressed pledges and guarantees in a separate subsection of section 956 and assigned Treasury responsibility for promulgating rules to govern their treatment. Specifically, section 956(d) provides: "[A] controlled foreign corporation shall, *under regulations prescribed by the Secretary*, be considered as holding an obligation of a United States person if such controlled foreign corporation is a pledgor or guarantor of such obligation." (emphasis added).[3] Because guarantees do not otherwise constitute investments in U.S. property, and a CFC guarantor does not have an adjusted basis in its guarantee or the guaranteed loan, absent valid regulations no CFC guarantee would trigger taxation under section 956. *See* J.A. 19 (Tax Ct. 16) (no dispute that section 956(d) is not self-executing).

[3] The provisions of section 956(c) and (d) were originally enacted as section 956(b) and (c), but were later renumbered. *See* Pub. L. 103-66, 107 Stat. 312, § 13232(a)(1) (1993). For convenience, we refer to these provisions using their current numbering.

B. Regulatory Framework

In response to section 956(d), the Treasury Department promulgated regulations (the "section 956(d) regulations") governing the treatment of pledges and guarantees. As relevant here, those regulations address two issues: (1) *When* is a CFC that provides a pledge or guarantee of a U.S. person's obligation considered to hold an obligation of a U.S. person, and thus to have made an investment in U.S. property? and (2) *How much* of the guaranteed obligation should be viewed as an investment by the CFC in U.S. property that triggers taxation of the CFC's earnings? Section 1.956-2(c)(1) answers the first question by adopting a categorical rule that *any* CFC pledge or guarantee causes the CFC to hold "an obligation of a U.S. person." 26 C.F.R. § 1.956-2(c)(1). Section 1.956-1(e)(2) answers the second question by adopting a categorical rule that "the amount taken into account with respect to any pledge or guarantee … shall be the unpaid principal amount … of the obligation with respect to which the controlled foreign corporation is a pledgor or guarantor." *Id.* § 1.956-1(e)(2).

The section 956(d) regulations thus treat every CFC that guarantees a loan to its U.S. shareholder as if the CFC itself had loaned *all* the borrowed funds to the U.S. shareholder. They impose this result without regard to whether, or to what extent, a CFC guarantee actually enabled the U.S. shareholder to borrow funds that it would otherwise not have received but for the benefit of such guarantee. For example, the regulations do not consider factors such as whether the CFC guarantor had enough assets to support the entire amount of the loan, or whether the CFC was the sole guarantor or one of many parties guaranteeing the loan. Under the regulations, every CFC guarantor, except for those subject to a conduit financing exception that is not applicable here, is treated as making the entire amount of the guaranteed loan, up to the amount of its previously untaxed earnings. Where multiple CFC guarantors are involved, the regulations treat each guarantor as making the full amount of the loan—for example, ten CFC guarantors would result in ten times the loan amount being treated as invested in U.S. property (with the inclusion capped by the CFCs' unrepatriated earnings). The only explanation Treasury provided for all of its section 956 regulations (including many having

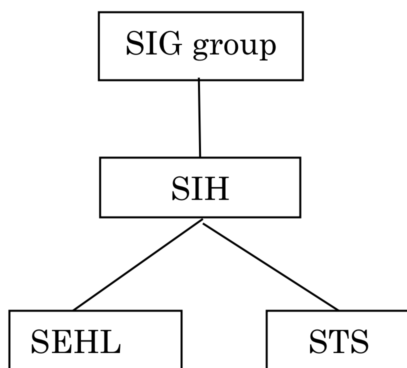
nothing to do with pledges or guarantees) was a single sentence stating that they were issued to "conform" to section 956. 29 Fed. Reg. 2,599, 2,599 (Feb. 20, 1964).

After the regulations were promulgated, Treasury and the IRS recognized that the rules can produce strange results, particularly as applied to multiple guarantors. *See* Notice of Proposed Rulemaking, 80 Fed. Reg. 53,058, 53,061-68 (Sept. 2, 2015) ("[I]n cases in which there are, with respect to a single obligation, multiple pledgors or guarantors that are CFCs … , the aggregate amount of United States property treated as held by CFCs may exceed the unpaid principal amount of the obligation."); FSA 200216022 (Jan. 8, 2002) (recognizing that a literal application of section 1.956-2(c)(1) "could produce strange results"), *available at* https://www.irs.gov/pub/irs-wd/0216022.pdf. Yet the IRS has failed to fix these problems.

C. The Facts of This Case

This appeal involves the IRS's application of its section 956(d) regulations to the earnings of two CFCs: Susquehanna Europe Holdings

Limited ("SEHL")[4] and Susquehanna Trading Services, Inc. ("STS," and, together with SEHL, "the CFCs"). The CFCs are owned by appellant SIH, which is commonly controlled with Susquehanna International Group, LLP ("SIG") and its affiliates (the "SIG group"). J.A. 8-10 (Tax Ct. 5-7).



In 2007, Merrill Lynch loaned $1.485 billion to SIG. J.A. 11-12 (Tax Ct. 8-9). In connection with the loans, numerous SIG affiliates, including the two CFCs at issue here, entered into an Amended and Restated Guarantee and Security Agreement with Merrill Lynch ("ARGSA") and several ancillary agreements. J.A. 12 (Tax Ct. 9). Through these agreements, the SIG affiliates guaranteed the loans, and some non-CFC guarantors pledged their assets in support of the loans. *Id.* At the time the loans were issued, SIG and the non-CFC guarantors

[4] SEHL is the successor entity to Susquehanna Ireland Holdings Limited, which SEHL acquired in December 2007.

had over $2.7 billion in liquid net assets on deposit with Merrill Lynch, nearly twice the amount of the loans. J.A. 72-74 (Harley Decl. ¶¶7-10). By contrast, the combined net assets of both CFC guarantors were approximately $240 million, less than ten percent of the non-CFC guarantors' combined liquid net assets on deposit with Merrill Lynch. *Id.*

SIH presented uncontroverted testimony that Merrill Lynch requested that the two CFCs serve as guarantors not to provide collateral support for the loans but rather to ensure that Merrill Lynch could still obtain access to the assets of SIG and its U.S. affiliates if SIG transferred assets to the CFCs. *See* J.A. 65-67 (Greenberg Decl. ¶¶9-13). The terms of the ARGSA reflect this purpose, as each guarantor had a right to contribution from the other guarantors that was calculated by reference to the funds that each guarantor had received from other SIG affiliates. J.A. 76, 100 (Harley Decl. ¶18; Stipulation ¶61).

SIG repaid the loans by December 2011. J.A. 13 (Tax Ct. 10). No SIG affiliate was required to pay any amount under the guarantee. *Id.*

Prior to the repayment of the loans, SEHL distributed earnings to SIH of $250 million (in 2010) and $25 million (in 2011), and in 2010 STS distributed earnings to SIH of approximately $74 million. J.A. 108 (Stipulation ¶¶80, 82, 85). Because the CFCs qualified for benefits under U.S. income tax treaties in those years, those distributed earnings were reported as QDI and taxed at the 15-percent rate. It is these same earnings that the IRS, under the section 956(d) regulations, claims should have been taxed in earlier taxable years, and at a higher rate.

D. Procedural History

The IRS determined that the CFC earnings distributed in 2010 and 2011 should have been taxed in 2007 and 2008 under the section 956(d) regulations, because the CFCs had served as co-guarantors of SIG's borrowing from Merrill Lynch. J.A. 4 (Tax Ct. 1). Having concluded that the CFCs' earnings were taxable to their U.S. shareholder *as if* distributed as a dividend, the IRS further determined that these earnings were not an *actual* dividend and thus should have been taxed at the ordinary income tax rate of 35 percent, rather than

the QDI rate of 15 percent then applicable to dividends received from certain CFCs.[5] J.A. 51 (Tax Ct. 48).

SIH petitioned the Tax Court for review, arguing that (1) the CFCs' earnings were not subject to accelerated taxation in 2007 and 2008, but that (2) if they were, the QDI rate should apply.[6] J.A. 5-7, 58 (Dkt. 1, Tax. Ct. 2-4). SIH and the IRS subsequently filed cross-motions for summary judgment. J.A. 6 (Tax Ct. 3).

SIH argued that the section 956(d) regulations are arbitrary and capricious, and thus could not support the asserted tax deficiency. J.A. 19 (Tax Ct. 16). Alternatively, SIH contended that the IRS was required by its own administrative practice to examine whether there had been a repatriation in substance. J.A. 7 (Tax Ct. 4). SIH further argued that, even if SIH had been required to include some amount in income in 2007 and 2008, any income from SEHL's earnings should have been taxed at the QDI rate, rather than the ordinary income rate,

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[5] The U.S. entities in the SIG group, including SIH, are generally "passthroughs" for U.S. tax purposes, so their income is subject to U.S. tax at the rate of the group's individual owners.

[6] A dividend from a foreign corporation may qualify as QDI only if the payor company is eligible for benefits under certain tax treaties. 26 U.S.C. § 1(h)(11)(C). Because only SEHL qualified for benefits under a tax treaty in 2007-2008, only its earnings would receive QDI treatment in those years.

because any such tax was imposed on CFC earnings that were deemed to have been distributed to SIH by virtue of the guarantees, which would be qualified dividend income. J.A. 51-56 (Tax Ct. 48-53).

The Tax Court granted the IRS's motion for summary judgment and denied SIH's motion. J.A. 3 (Order). The Tax Court upheld the validity of the section 956(d) regulations, and affirmed the IRS's determination that the QDI rate did not apply. J.A. 45-46. The Tax Court also held that, given the language of the regulations, the proffered facts and circumstances demonstrating that the CFC guarantees did not constitute a repatriation in substance were irrelevant. J.A. 47-51.

SIH filed a timely appeal.

SUMMARY OF THE ARGUMENT

1. The section 956(d) regulations are invalid. Section 956 taxes U.S. shareholders on CFC earnings that are repatriated to the United States through investments in U.S. property, including direct loans from a CFC to its U.S. shareholder. In section 956(d), Congress provided that pledges and guarantees would be considered investments in U.S. property "under regulations prescribed by the Secretary."

Treasury's section 956(d) regulations treat every CFC guarantor of a U.S. person's loan as though it has made the full amount of the guaranteed loan. These broad-brush rules do not reflect a reasonable policy choice made in light of the statutory purpose. Moreover, Treasury failed to give any explanation for its policy choice or even any indication that it considered important aspects of the issues.

By treating each CFC guarantor as lending the entire guaranteed loan, the section 956(d) regulations ignore both congressional intent and economic reality. Although some CFC guarantees may repatriate CFC earnings by making possible a U.S. person's receipt of a loan that otherwise would not be obtainable on the same terms, that is not true of all guarantees. And it certainly is not true that all guarantees repatriate the full amount of the underlying loan. The actual value of a given guarantee, and thus its repatriating effect, depends on real-world factors such as the terms of the obligation and guarantee, the creditworthiness of the obligor and the guarantor, and whether there are multiple guarantors. The section 956(d) regulations, without reasoned explanation, ignore all these issues and instead treat all guarantees exactly like direct loans. If that were Congress' intent, it

could simply have left guarantees in the section 956(c) list, and not provided a separate grant of regulatory authority.

The section 956(d) regulations are particularly arbitrary as applied to a CFC guarantor that is one of several guarantors of a loan, as is the case here. Treasury gave no indication that it considered the issues raised by multiple guarantors when it promulgated the section 956(d) regulations. By treating every CFC guarantor of a single loan as having made an investment equal to the full amount of the loan, the regulations can easily treat CFC guarantors as having repatriated far more earnings than would have been deemed repatriated if they had jointly loaned the money themselves. That is contrary to both congressional intent and common sense, as well as to the approach Treasury took in regulations applying section 956 to partnerships.

The IRS has recognized that its rules lead to strange results. And despite the categorical language of the rules, the IRS for decades followed binding guidance that required it to examine the facts and circumstances of each case to determine whether, in substance, there had been a repatriation of the CFC's earnings. *See, e.g.*, Rev. Rul. 89-73 (May 22, 1989). Having abandoned a wooden approach to the

application of the section 956 regulations decades ago, the IRS belatedly seeks to adopt such an approach here.

The Tax Court erroneously concluded that the regulations are both valid and should be applied literally, finding that, because CFC guarantees "clearly benefit the U.S. shareholder," it was reasonable for Treasury to "choose a broad baseline rule for pledges and guarantees" J.A. 42, 45. But neither the IRS nor the Tax Court explained how *this* broad baseline rule is consistent with the statutory purpose, and Treasury provided no reasoned explanation for the rule it adopted.

Because the section 956(d) regulations are contrary to congressional intent, at odds with economic reality, and were promulgated without a reasoned explanation, they do not provide a valid basis for imposing additional tax on SIH.

2. If the Court concludes that the section 956(d) regulations are valid, it should at a minimum vacate and remand to the Tax Court for proceedings consistent with precedential IRS guidance that examines the facts and circumstances of each case to determine whether, in substance, there was a repatriation of CFC earnings. Such an analysis would show that there was no repatriation in substance here, because

the CFC guarantees merely prevented the *ex*patriation of SIG's U.S. assets, rather than the *re*patriation of CFC earnings.

3. Having argued that the CFCs' earnings should be taxed on an accelerated basis because they made an investment in U.S. property that is substantially equivalent to a dividend, the IRS reverses course and argues that the earnings should not be taxed as a dividend, but rather as ordinary income. The IRS cannot have it both ways: it cannot accelerate tax on the ground that the guarantees are substantially equivalent to a dividend while simultaneously arguing that they are *not* substantially equivalent to a dividend for purposes of the applicable rate.

The IRS argues that section 956 accelerated the year in which SIH is taxed on the CFCs' earnings, from the year in which the earnings were actually distributed to an earlier year in which the earnings are deemed to have been repatriated through an investment in U.S. property as a result of the loan guarantee. The IRS position is that CFC earnings that were *in fact* distributed in 2010 and 2011 and taxed at a rate of 15 percent, should be *deemed* distributed in 2007 and 2008

and taxed at a rate of 35 percent. But the acceleration of income does not change its character.

If, contrary to SIH's analysis, this Court determines that the section 956(d) regulations are valid and require that SIH be taxed in 2007 and 2008 on the CFCs' earnings, it should hold that any income derived from SEHL's earnings was taxable at the QDI rate, rather than at the ordinary income rate.

The Tax Court erred in adopting the IRS's contrary analysis, which relies on a purported distinction between amounts that are treated "as" dividends versus those treated "as if" they were dividends. The court concluded that, because Congress did not expressly state in the statute that earnings made taxable under section 956 "*are* dividends for general purposes of the Code," J.A. 55 (emphasis in original), Congress did not intend to tax them as dividends. This conclusion is not only contrary to the purpose of section 956, its legislative history, and general tax principles, but ignores numerous instances in which the IRS has done exactly what the Tax Court said was prohibited by its crabbed reading of the statute—that is, in numerous regulations and rulings the IRS has treated section 956

repatriations as dividends. That precedent supports treating section 956 inclusions as qualified dividend income, and should be followed here.

STANDARD OF REVIEW

This Court reviews the Tax Court's legal conclusions de novo and its factual findings for clear error. *See Anderson v. C.I.R.*, 698 F.3d 160, 164 (3d Cir. 2012). Agency action is unlawful if it is "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law." 5 U.S.C. § 706(2)(A).

ARGUMENT

I. TREASURY'S SECTION 956(D) REGULATIONS ARE UNREASONABLE AND ARBITRARY

The undisputed purpose of section 956 is to tax transactions that repatriate CFC earnings to the United States. In section 956(d), Congress provided that pledges and guarantees would be considered investments in U.S. property "under regulations prescribed by the Secretary." Treasury's regulations under section 956(d) address two questions: (1) when does a CFC guarantee constitute an investment in U.S. property for purposes of section 956? and (2) how much of the CFC's earnings should be taxed based on such guarantees? Treasury's

mechanical answers to those questions are unreasonable and arbitrary because they impose tax without regard to whether, and to what extent, the CFC has in fact repatriated earnings by entering into a guarantee.

A. Treasury Regulations Must Be Reasonable, Non-Arbitrary, and Reasonably Explained

This Court reviews Treasury's regulations under the familiar *Chevron* framework. *See Chevron, U.S.A., Inc. v. Nat. Res. Def. Council, Inc.*, 467 U.S. 837, 842-43 (1984); *Mayo Found. for Med. Educ. & Research v. United States*, 562 U.S. 44, 48 (2011). Where, as here, the statute leaves gaps for the agency to fill, the question is "whether the agency's answer is based on a permissible construction of the statute" – that is, whether it represents a "reasonable policy choice for the agency to make" in light of the statute and its purpose. *Chevron*, 467 U.S. at 843-45. The agency's construction is permissible if, but only if, the agency "operate[s] within the bounds of reasonable interpretation." *Util. Air Regulatory Grp. v. E.P.A.*, 134 S. Ct. 2427, 2442 (2014); *see also Mayo*, 562 U.S. at 58.

In "reviewing the reasonableness of a regulation," courts "may consider the plain language of the statute, its origin, and purpose," and must ensure that the regulation "harmonize[s] with the statute" and is

"reasonable in light of the legislature's revealed design." *See Si Men Cen v. Attorney General*, 825 F.3d 177, 186-87 (3d Cir. 2016). A regulation receives no deference if it is arbitrary, capricious, or "contrary to clear congressional intent," *Torretti v. Main Line Hosps., Inc.*, 580 F.3d 168, 174 (3d Cir.), *amended*, 586 F.3d 1011 (3d Cir. 2009). In addition, a regulation that lacks a reasoned explanation is arbitrary and thus unlawful. *See Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2125 (2016) ("[W]here the agency has failed to provide [a reasoned explanation], its action is arbitrary and capricious and so cannot carry the force of law.").

As the Supreme Court has explained, analysis under the "arbitrary [or] capricious" standard, 5 U.S.C. § 706(2)(A); *Motor Vehicle Mfrs. Assn. of United States, Inc. v. State Farm Mut. Automobile Ins. Co.*, 463 U.S. 29, 43 (1983), is the "same" as in *Chevron* step two because, for both, courts "ask whether an agency interpretation is 'arbitrary or capricious in substance,'" *Judulang v. Holder*, 565 U.S. 42, 52 n.7 (2011) (quoting *Mayo*, 562 U.S. at 48). *See also Michigan v. EPA*, 135 S. Ct. 2699, 2706-07 (2015); *Good Fortune Shipping SA v. Commissioner*, 897 F.3d 256, 263 (D.C. Cir. 2018) ("[IRS] must …

engage in reasoned analysis sufficient to command our deference under *Chevron*." (internal quotation marks omitted)).

For the reasons that follow, the regulations under section 956(d) are unreasonable and arbitrary, inadequately explained, and reflect a failure of reasoned decision making.

B. The Regulations Are Inconsistent with the Purpose and Structure of Section 956

1. Section 956 Taxes Investments in Property That Are "Substantially The Equivalent Of A Dividend"

The purpose of section 956 is undisputed. As the Tax Court recognized, Congress acted "'to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation.'" J.A. 21 (quoting H.R. Rep. 87-1447 at 52 (1962)). Congress recognized that "untaxed CFC earnings invested in United States property" "'generally'" provide a benefit to U.S. shareholders "'which is substantially the equivalent of a dividend being paid to them.'" *Id.* (quoting S. Rep. 87-1881 at 88). The IRS has long recognized the purpose of section 956 is "to prevent the repatriation of income to the United States in a manner which does not subject it to U.S. taxation." Rev. Rul. 89-73.

To achieve its purpose, Congress carefully considered both the *types* of CFC investments in U.S. property that trigger a repatriation of earnings and the *amount* of earnings repatriated by such transactions. In section 956(c), Congress listed specific types of U.S. property that trigger a repatriation. And in section 956(a), Congress provided that the amount of a CFC's investment in such U.S. property, and thus the amount of earnings considered repatriated, is generally the CFC's adjusted basis in the property—*i.e.*, the amount the CFC has actually invested. Under these provisions, when a CFC directly loans money to related U.S. persons, Congress considers the amount of the loan to have been repatriated.

Congress also recognized that a CFC's guarantee of a third-party loan may serve to repatriate earnings indirectly by enabling a U.S. shareholder to receive funds that the U.S. shareholder would not have otherwise been able to receive on the same terms. But loan guarantees differ from direct loans in important ways: a guarantee is not an investment in property, and a guarantor has no tax basis in a guarantee. Moreover, guarantees arise in a wide range of

circumstances and do not necessarily make additional funds available to a U.S. shareholder.

Congress clearly recognized that guarantees present special issues. Although the House version of what became section 956 included pledges and guarantees in the list of CFC transactions that automatically trigger U.S. tax, *see* Revenue Act of 1962, H.R. 10650, 87th Cong., § 13(a), the statute as enacted removed pledges and guarantees from that list.[7] Instead, Congress separately addressed pledges and guarantees in section 956(d), which provides that "under regulations prescribed by the Secretary," a CFC "shall be considered as holding an obligation of a United States person if such [CFC] is a pledgor or guarantor of such obligation." It is undisputed that section 956(d) is not self-executing, as it applies only "under regulations." J.A. 19 (Tax Ct. 16).

Congress's decisions to (i) limit section 956(c) categorical inclusions to the amount of a CFC's actual investments in U.S. property, and (ii) accord separate treatment to guarantees and pledges

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[7] During the legislative process, public comments criticized the breadth and ambiguity of the guarantee rule. *See* Hearings on H.R. 10650 before the Senate Committee on Finance: Pt. 11 (1962) (Comm. Print), at 4487, 4492.

"under regulations," reflect the fundamental principle that taxation should reflect economic reality. *See, e.g., Gregory v. Helvering*, 293 U.S. 465, 470 (1935) (in tax statutes, Congress does not intend to "exalt artifice above reality"); *Merck & Co. v. United States*, 652 F.3d 475, 483 (3d Cir. 2011) (noting "tax code's general insistence on the controlling effect of economic reality"). That is, the statute seeks to tax U.S. shareholders on an amount of CFC earnings equal to the CFC's actual investments in U.S. property, nothing more.

2. The Regulations Implementing Section 956(d) Are Unreasonable

The section 956(d) regulations are inconsistent with the structure and purpose of section 956, as well as economic reality, because they impose shareholder-level tax without regard to whether and to what extent CFC earnings have been repatriated. The regulations treat every CFC that guarantees a U.S. person's loan as if it had made the full amount of the underlying loan directly to the U.S. shareholder. This effectively reinstates the rejected House version of the legislation, ignoring Congress's decision to remove guarantees from the list of items treated categorically as investments in U.S. property. If Congress had intended to apply a categorical rule to guarantees, it could simply have

left guarantees in the section 956(c) list, and not provided the separate grant of regulatory authority.

The regulations ignore the features of guarantees that led Congress to grant Treasury regulatory authority in the first place. Although some CFC guarantees may effectively repatriate CFC earnings by making additional funds available to a U.S. person, that is not true of all guarantees. And even among CFC guarantees that have some repatriating effect, very few can plausibly be seen as repatriating the full amount of a guaranteed loan. U.S. tax law generally provides that guarantees may be recharacterized as a direct loan only when a lender looks primarily to the guarantor, and not the borrower, for expected repayment. *See, e.g., Plantation Patterns, Inc. v. Commissioner*, 462 F.2d 712 (5th Cir. 1972) (addressing when a guarantee can be recharacterized as a direct loan). Yet the section 956(d) regulations recharacterize *every* CFC guarantee as a direct loan, by treating every CFC guarantor as though it invested the full loan amount in U.S. property.

The section 956(d) regulations are particularly unreasonable when applied, as they were in this case, to multiple guarantors. When a loan

is guaranteed by multiple parties, no one guarantor can plausibly be viewed as making the entire amount of the loan available to the U.S. shareholder. Yet under the section 956(d) regulations, each CFC guarantor is treated as making the full amount of the loan, and as repatriating funds up to the limit of its untaxed earnings, regardless of the guarantees' economic effect. Thus, when more than one CFC guarantees a given loan, the regulations deem the guarantors to have made multiple loans, and may tax the U.S. shareholder on *multiples* of the entire amount of the actual loan. For example, if all 39 guarantors in this case had been CFCs, a single $1.485 billion loan could have resulted in more than $57.9 billion of deemed loans from the CFCs. This absurd result demonstrates the irrationality of treating CFC guarantors as investing in the full amount of a loan regardless of the actual effects of the guarantee.

3. IRS Practice Shows that the Regulations Are Unreasonable

The IRS's own administrative practice confirms the unreasonableness of its regulations. For decades the IRS repeatedly declined to apply its section 956 regulations in accordance with their rigid language. The IRS formalized this approach in binding IRS

guidance stating that, in applying section 956, "[t]he facts and circumstances of *each* case must be reviewed to determine if, in substance, there has been a repatriation of the earnings of the controlled foreign corporation." Rev. Rul. 89-73 (emphasis added). Unlike the categorical language of the section 956(d) regulations, this case-by-case analysis reflects the bedrock principle that "tax classifications … turn on the objective economic realities of a transaction rather than … the particular form the parties employed." *Boulware v. United States*, 552 U.S. 421, 429 (2008). *See also PPL Corp. v. C.I.R.*, 569 U.S. 329, 340 (2013) (rejecting IRS's categorical, form-driven interpretation of a tax provision as contrary to "the black-letter principle that 'tax law deals in economic realities'" (citation omitted)).

The IRS argued below that only the government, and not taxpayers, can benefit from this facts-and-circumstances analysis in Revenue Ruling 89-73. But the IRS's other rulings are to the contrary.[8] In a 1980 Technical Advice Memorandum involving a U.S. parent's

[8] *See, e.g.*, Rev. Rul. 67-130 (Jan. 1, 1967) (finding no repatriation even though CFC held tangible property located in the United States, because the property was only passing through the United States); Rev. Rul. 71-373 (Jan. 1, 1971), obsoleted by Rev. Rul. 89-12 (Jan. 23, 1989) (finding no repatriation despite CFC's acquisition of a U.S. person's note because investment was part of a broader series of transactions that did not result in repatriated earnings).

pledge of CFC stock to secure its obligations under a guarantee, the IRS concluded—despite the categorical language of the section 956(d) regulations—that, "[v]iewing the substance of the transaction," there was "no evidence of a controlled foreign corporation's earnings being directly or indirectly repatriated to the U.S." T.A.M. 8042001 (Mar. 18, 1980). As the IRS explained, "a proper interpretation of the statute is reached when one focuses not on the highly technical meaning of the terms 'pledge' and 'guarantor' as used in commercial transactions, but instead on the purpose of section [956(d)] of the Code"—which is "to prevent a United States shareholder from being able to repatriate directly or indirectly the controlled foreign corporation's earnings without the United States shareholder being taxed on such earnings as a dividend." *Id.*; *see also* T.A.M. 8101012 (Oct. 7, 1980) (U.S. parent's obligation as guarantor of CFC's bank borrowing held not an "obligation" of a U.S. person within the meaning of section 956, consistent with the reality that the guarantee of such obligation worked no repatriation of CFC earnings).[9]

[9] Many other IRS documents similarly reject literal applications of section 956 when no repatriation in substance occurred. *See, e.g.*, P.L.R. 8746050 (Aug. 19, 1987) (effectively inventing a tracing rule (continued…)

Conversely, the IRS has found a repatriation in substance in circumstances where the literal terms of section 956 and its regulations do *not* apply.[10] In conducting this facts-and-circumstances analysis, the IRS historically has not adopted an all-or-nothing approach to repatriation, but instead has assessed the amount that the CFC repatriated in a given transaction. For example, in Revenue Ruling 90-112 the IRS applied section 956 to a CFC that invested in U.S. property through a partnership, and concluded, under "the general principle that section 956 is concerned with the substance of a transaction and not merely its form," that the CFC at issue only repatriated the amount

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under export property provisions to avoid creating an inappropriate application of section 956 to a transaction that worked no repatriation); 1995 FSA Lexis 392 (although in form there was an investment in U.S. property, transactions were recharacterized as a loan between two CFCs, preventing the application of section 956). *See also* Notice 88-108 (providing administrative exception for certain short-term obligations that otherwise constituted investments in U.S. property). Notice 88-108, which was promulgated in anticipation of a rule-making that did not occur until 28 years later, was relied upon in the same manner as a revenue ruling. Private Letter Rulings and similar IRS documents are not precedential, 26 U.S.C. §6110(b)(1), (k)(3), but they are "evidence" of the IRS's approach to an issue, *Rowan Cos. v. United States*, 452 U.S. 247, 261 n.17 (1981).

[10] *See, e.g.*, Rev. Rul. 76-125 (Jan. 1, 1976) (relying on the "intent of section 956" to find that "use of the assets or credit of a [CFC] as collateral for an obligation of a United States person shall be considered a repatriation of earnings"); Rev. Rul. 76-192 (Jan. 1, 1976) (applying section 956 to a U.S. shareholder loan routed through bank and affiliate); Rev. Rul. 87-89 (Aug. 31, 1987) (loan from CFC to bank, and then from bank to U.S. parent, treated as direct loan from CFC to parent if the bank loan would not have been made on the same terms but for the CFC loan to the bank).

proportional to its partnership interest and not the full amount of the underlying investment.

Indeed, the IRS has directly acknowledged some of the problems with its section 956(d) regulations, but has failed to fix them. *See* 80 Fed. Reg. 53058 (noting that in the case of multiple guarantors "the aggregate amount of United States property treated as held by CFCs may exceed the unpaid principal amount of the obligation," and soliciting comments regarding potential solutions to the anomaly); FSA 200216022 (recognizing that a literal application of guarantee regulations "could produce strange results"); *cf. Good Fortune*, 897 F.3d at 263 (finding the IRS's regulations "all the more inexplicable" because the IRS recognized, after promulgating the regulations at issue, that one of their main premises was incorrect).

The Tax Court acknowledged the arguments "concerning economic reality" and "strange results," but dismissed them with an observation that "'[r]egulation, like legislation, often requires drawing lines.'" J.A. 44 (citation omitted). Congress authorized Treasury to draw lines to implement section 956(d), but that authorization does not extend to lines that are "unmoored from the purposes and concerns" of the

statute. *Judulang*, 565 U.S. at 64. For example, Treasury could have drawn a line that treats all CFC guarantees as investments in U.S. property but measures the amount of the investment as the value of the guarantee. As another example, Treasury itself has suggested that the investment in U.S. property mechanically deemed to occur by virtue of CFC guarantees under the section 956(d) regulations could at least be allocated among multiple CFC guarantors, 80 Fed. Reg. at 53,062, which is similar to what Treasury has done in the context of CFC investments made through partnerships, *see supra* p. 35. Under that regulation, if the 39 guarantors of the Merrill Lynch loan had joined together to directly make the loan, the CFCs would be considered to have invested in only their pro rata share of the loan. Yet the section 956(d) regulations would treat the CFCs, as guarantors, the same as if they had each made the entire amount of the loan. In the section 956(d) regulations, Treasury drew lines that cannot be squared with the purpose of section 956, and it has declined to correct the anomalies created by its rules. *See Woodall v. Fed. Bureau of Prisons*, 432 F.3d 235, 249 (3d Cir. 2005) (holding that regulations are "not reasonable in light of the legislature's revealed design" (citation omitted)).

C. Treasury Did Not Provide a Reasoned Explanation for the Regulations

"When an administrative agency sets policy, it must provide a reasoned explanation for its action." *Judulang*, 565 U.S. at 45. A regulation that lacks a reasoned explanation "is itself unlawful and receives no *Chevron* deference." *Encino*, 135 S. Ct. at 2126. Thus, "a 'reasonable' explanation of how an agency's interpretation serves the statute's objectives is the stuff of which a 'permissible' construction is made." *Northpoint Tech. Ltd. v. FCC*, 412 F.3d 145, 151 (D.C. Cir. 2005).

Treasury provided no reasoned explanation for its guarantee regulations. Instead, it said only that all of the section 956 regulations were issued to "to conform" to section 956. 29 Fed. Reg. at 2,599; 28 Fed. Reg. 3,541, 3,541 (Apr. 11, 1963). When an agency makes a policy choice, a conclusory statement that the agency's choice "conforms" to the statute is no explanation at all. Such a statement says nothing about *why* the chosen approach conforms to the statute, let alone why it is preferable to other approaches. As this Court has noted, "conclusory remarks ... do not equip ... a court to review the [agency's] reasoning." *Nat'l Parks Conservation Ass'n v. E.P.A.*, 803 F.3d 151, 166 (3d Cir.

2015). Such an explanation "could be used to justify any [determination] at all," which "demonstrates its arbitrariness." *Id.*

Even on its own terms, Treasury's statement cannot withstand scrutiny. Rather than merely "conforming" to the statute, the section 956(d) regulations reflect Treasury's recognition that policy choices needed to be made. For example, they create an exception for guarantees related to "conduit financing arrangements." *See* 26 C.F.R. § 1.956-2(c)(4). If Treasury's categorical rules actually were necessary to "conform" to the statute, such extra-statutory rules would be impermissible.

Notwithstanding the lack of any explanation for Treasury's policy choices in the section 956(d) regulations, the Tax Court was persuaded that "[t]he agency's path 'may reasonably be discerned'" because the "proposed and final rules concerning CFC pledges and guaranties sought to implement the clear wording of the statute and to equate the treatment of these transactions with the treatment of items of United States property under the statute." J.A. 33. But as explained above, and as the Tax Court itself acknowledged, the statutory language does not require Treasury to treat all CFC guarantees as investments in U.S.

property equal to the full value of the loan. Congress assigned Treasury responsibility for making policy choices, and the reasons for Treasury's choice cannot be discerned from its one-sentence "explanation."

Treasury's conclusory statement gives no indication that it even considered the issues presented by the fact that not all guarantees effect a repatriation of earnings or the presence of multiple guarantors, let alone why it resolved them as it did. *See State Farm*, 463 U.S. at 43 (agency regulation is "arbitrary and capricious if the agency has ... entirely failed to consider an important aspect of the problem"); *Dominion Resources, Inc. v. United States*, 681 F.3d 1313, 1318 (Fed. Cir. 2012) (holding Treasury regulation "violates the *State Farm* requirement that Treasury provide a reasoned explanation for adopting a regulation"); *Pub. Citizen v. Steed*, 733 F.2d 93, 99 (D.C. Cir. 1984) ("[W]e will demand that the [agency] consider reasonably obvious alternative[s] ... and explain its reasons for rejecting alternatives in sufficient detail to permit judicial review.").

The D.C. Circuit recently held that a categorical tax regulation supported by a single-sentence explanation was unreasonable. *See Good Fortune*, 897 F.3d 256. Treasury, in construing a statutory

provision concerning the types of stock ownership that permit a foreign shipping corporation to qualify for a tax exemption, adopted a blanket regulation excluding bearer shares as a permissible form of stock ownership, based on a one-sentence explanation that invoked "the difficulty of reliably demonstrating the true ownership of bearer shares." *Id.* at 260 (quoting 68 Fed. Reg. 51,394, 51,399). The court held that this "single, undeveloped statement" was inadequate. *Id.* at 262.

Treasury's one-sentence "explanation" for its section 956(d) regulations is even more unreasonable than the inadequate one-sentence explanation in *Good Fortune*. In *Good Fortune*, Treasury at least addressed the issue and stated, in a conclusory fashion, why it adopted a categorical rule—it simply failed to adequately explain why it adopted the particular rule it chose. Here, Treasury did not even state why it adopted a categorical rule. Indeed, Treasury's statement was not even tied specifically to section 956(d), as it applied to every provision of section 956 addressed in the rulemaking. By "cho[osing] to paint with such a broad brush," the IRS "failed adequately to justify its categorical rule." *Id.* at 266 (internal quotation marks omitted).

D. The Facts of this Case Highlight the Unreasonableness of the Regulations

This case exemplifies the problems with section 956(d) regulations. After entering into the guarantees, SEHL and STS distributed earnings of nearly $350 million to SIH. All these distributions were subject to U.S. taxation, and all taxes were paid at the dividend rate. Nevertheless, Treasury invoked the section 956(d) regulations to accelerate taxation of those earnings and more than double the tax rate. But applying those regulations here highlights their unreasonableness.

First, by joining with 37 other affiliates to guarantee SIG's loans in 2007, SEHL and STS did not cause SIG to obtain a loan it would not have otherwise obtained on the same terms, and thus did not provide a benefit to their shareholders that was "substantially the equivalent of a dividend being paid to them." J.A. 21 (Tax Ct. 18). SIG and its U.S. affiliates had far more assets in the United States than were needed to obtain the loans, with or without the CFC guarantors. J.A. 66-67 (Greenberg Decl. ¶13). Merrill Lynch requested that SIG's foreign affiliates serve as guarantors to prevent the potential *expatriation* of funds from the United States. These transactions were not a

repatriation, and are far removed from the type of tax avoidance schemes that prompted Congress to enact subpart F.

Second, it is particularly unrealistic for the IRS to assert that, by serving as two of 39 guarantors on SIG's loans, the CFCs each invested $1.485 billion in U.S. property. The Tax Court concluded that this anomaly is excusable given that "[t]he amounts determined under section 956 are capped by the statute at the CFCs' applicable earnings for the tax years in issue," and that, in this case, those amounts "do not exceed the value of the underlying obligations." J.A. 49. This explanation misses the point. The fact that the CFCs' earnings happen to be less than their purported investments in U.S. property is a fortuity that does not cure the basic problem with the section 956(d) regulations, which is that they treat each CFC guarantor as having invested an amount in U.S. property that is divorced from the amount of any actual repatriation of earnings provided to U.S. shareholders by a guarantee.

* * * *

In sum, Treasury's guarantee regulations are inconsistent with the purpose of section 956, detached from economic reality, and

virtually unexplained. Accordingly, they cannot support the imposition of additional tax on SIH.

II. EVEN IF THE REGULATIONS WERE VALID, THE IRS'S OWN PRECEDENTIAL GUIDANCE WOULD REQUIRE A REVIEW OF THE FACTS

As noted in Part I above, the IRS's own guidance states that "[t]he facts and circumstances of *each* case must be reviewed to determine if, in substance, there has been a repatriation of the earnings of the controlled foreign corporation." Rev. Rul. 89-73 (emphasis added). This statement in a revenue ruling is a binding "concession" by the IRS, *see Rauenhorst v. Commissioner*, 119 T.C. 157, 171-73 (2002) (describing revenue rulings "as concessions by the Commissioner"); *Dover Corp. v. Commissioner*, 122 T.C. 324 (2004) (applying *Rauenhorst*). Accordingly, even if this Court determines (despite the analysis in Part I) that the section 956(d) regulations can stand, it should vacate and remand with instructions to employ the standard required by the IRS's own precedent.

The facts and circumstances of this case show that there was no repatriation in substance. SIG's U.S. affiliates had sufficient assets on deposit with Merrill Lynch to fully collateralize the entire amount of the

borrowing. *See* J.A. 66-67 (Greenberg Decl. ¶13). The guarantees thus did not enable SIG to borrow a greater amount than it otherwise could have borrowed. *Id.* Instead, the guarantees prevented SIG from restricting Merrill Lynch's access to SIG's U.S. assets, which SIG otherwise could have accomplished by transferring those assets to the CFCs absent the guarantees.

The IRS never analyzed these facts to determine whether there was a repatriation in substance. Nor did it explain why it was departing from its longstanding approach requiring that the facts and circumstances of each case must be reviewed. This "[u]nexplained inconsistency" is itself a "reason for holding [its new] interpretation to be an arbitrary and capricious change from agency practice." *Encino*, 136 S. Ct. at 2125-26; *see also id.* ("When an agency changes its existing position, it … must at least 'display awareness that it is changing position'" and "'show that there are good reasons for the new policy.'" (quoting *FCC v. Fox Television Stations, Inc.*, 556 U.S. 502, 515 (2009)).

The Tax Court, for its part, did not address Revenue Ruling 89-73 or the other IRS authorities calling for an analysis of the facts of each case. Instead, the Tax Court simply observed that SIG could have

avoided the entire problem by refusing to provide Merrill Lynch with the CFC guarantees. J.A. 50. But the issue is not whether SIG could have undertaken a different transaction, it is whether the transaction SIG undertook resulted in a repatriation, and therefore is properly subject to tax under section 956.[11]

Accordingly, if the Court determines that the guarantee regulations are valid, it should remand this case with instructions to undertake the analysis required by the IRS's binding guidance.

III. SECTION 956 INCLUSIONS SHOULD BE TAXED AS DIVIDENDS

The IRS compounds its error by arguing that any inclusions arising under section 956 must be taxed at the ordinary rate of 35 percent rather than the 15-percent rate applicable to qualified dividends. A conclusion that the section 956(d) regulations are valid and require SIH to be taxed on a deemed repatriation of the CFC's

[11] The IRS also argued that a taxpayer "must accept the tax consequences of his choice, … and may not enjoy the benefit of some other route he might have chosen to follow but did not." *Commissioner v. Nat'l Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974). But SIH does not seek to recharacterize the guarantees as different, hypothetical transactions. Instead, SIH's position is that the CFC guarantees do not come within section 956 because they are not repatriations in substance.

earnings would logically foreclose the IRS position that the 35-percent rate applies to such earnings. That is so because:

- Congress enacted section 956 to tax U.S. shareholders on transactions that are substantially the equivalent of a dividend.

- Transactions that do not effectively "dividend" value from a CFC to a U.S. shareholder fall outside section 956.

- Thus, if the Court determines that the guarantee regulations are valid and apply here, it follows that the CFCs' guarantees were substantially the equivalent of a dividend.

Put simply, the government cannot claim that CFC guarantees are substantially the equivalent of a dividend for purposes of inclusion in current income while also arguing that the same guarantees are *not* substantially equivalent to a dividend for purposes of the applicable rate.

The IRS position also leads to irrational results. It is undisputed that:

- If SEHL had paid a formal dividend to its U.S. shareholders during the years in question in lieu of guaranteeing the loan, the QDI rate would have applied.

- If SEHL had paid a formal dividend *and* had made the loan guarantee in the *same* year, the QDI rate would have applied.

- If SEHL had paid a formal dividend and then made the loan guarantee in a *subsequent* year, the QDI rate would have applied with respect to any earnings distributed in the formal dividend.

Each of those scenarios produces economic results identical to the transactions in this case. But the IRS nevertheless argues that the exact same transactions result in tax at more than double the QDI rate simply because the taxpayer undertook them in the wrong order: the guarantee preceded the formal dividend.

That arbitrary result is not supported by the statute for several reasons. First, the QDI rules apply to constructive dividends. Second, section 956 and the structure of subpart F demonstrate that section 956 inclusions are dividends. Third, multiple IRS authorities, ignored by the IRS and the Tax Court, treat section 956 inclusions as dividends. Fourth, not treating section 956 inclusions as dividends creates timing anomalies that are contrary to Supreme Court precedent. Accordingly, any additional amounts that SIH was required to include in income in 2007 and 2008 under section 956 based on SEHL's guarantee should receive QDI treatment.[12]

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[12] The government's position on the applicable tax rate has not been adopted as a regulation, and therefore is not entitled to *Chevron*
(continued…)

A. The QDI Rules Apply to Constructive Dividends

The QDI provisions in section 1(h)(11) apply to "dividends." Because Congress did not adopt a special definition of "dividends" for purposes of section 1(h)(11), the Code's general definition of "dividends" for income tax purposes applies. *See* 26 U.S.C. § 316(a) (defining "dividends" as "any distribution of property made by a corporation to its shareholders … out of its earnings and profits of the taxable year … .").

It is well established that "dividends" include not only formally declared distributions, but also "disguised" and "constructive" dividends. As a leading treatise explains, "[t]he hallmark of a constructive distribution is value passing from a corporation to, or a specific economic benefit conferred by a corporation on, its shareholder without receiving equivalent value in return." Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders, ¶8.06 (2018). Thus, "[a] shareholder, even if the corporation has dispensed with the formalities of declaration, may be charged with a disguised or

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deference. *See United States v. Mead Corp.*, 533 U.S. 218, 234 (2001) (agency's ruling letters not entitled to *Chevron* deference). Accordingly, the courts in *Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *aff'd*, 722 F.3d 306 (5th Cir. 2013), gave no deference to IRS Notice 2004-70, which articulates the IRS position that section 956 inclusions are not eligible for the QDI rate.

constructive dividend if the corporation confers a direct benefit on him from available earnings and profits without expectation of repayment." *Neonatology Assocs., P.A. v. Commissioner*, 299 F.3d 221, 231-32 (3d Cir. 2002). For example, where shareholders use corporate property—like the company car—for a personal purpose, there is a benefit, and thus a constructive dividend. *Melvin v. C.I.R.*, 88 T.C. 63, 79 (1987), *aff'd,* 894 F.2d 1072 (9th Cir. 1990). These results follow not from particular Code provisions that define disguised or constructive dividends, but rather from the principle that "tax classifications like 'dividend' ... turn on 'the objective economic realities of a transaction rather than ... the particular form the parties employed.'" *Boulware*, 552 U.S. at 429.

Because disguised or constructive dividends are, in economic reality, dividends, they are taxed as dividends. Both the IRS and the courts have recognized that constructive dividends are eligible to be taxed at the QDI rate. *See Luczaj & Associates v. Commissioner*, Nos. 25541-14, 25542-14, 2017 WL 923522, at *8 n.3 (T.C. Mar. 8, 2017) (noting apparent IRS concession that "constructive dividends constitute 'qualified dividends' within the meaning of section 1(h)(11)"); *Avrahami*

v. Commissioner, Nos. 17594-13, 18274-13, 2017 WL 3610601, at *32, 34 (T.C. Aug. 21, 2017) (constructive dividend failed to qualify as QDI only because not paid by treaty-eligible CFC); *Schank v. Commissioner*, Nos. 16641-14, 16642-14, 2015 WL 8477305, at *8 (T.C. Dec. 9, 2015) (stating petitioners could potentially benefit from QDI rate under constructive dividend theory). *Cf. Smith v. Commissioner*, Dkt. No. 14900-15, 151 T.C. No. 5, at 53 n.12 (T.C. Sept. 18, 2018) (not reaching the issue because it was not addressed by the parties).[13]

Taxing constructive dividends at the QDI rate furthers the purpose of the QDI rules. Because corporations pay tax on their earnings, the shareholder-level tax that is imposed when corporate earnings are distributed results in double taxation. Congress enacted the QDI provisions in section 1(h)(11) to reduce the double taxation of corporate earnings, with the goal of spurring economic activity by encouraging distribution of earnings to shareholders. *See* H.R. Rep. 108-94 at 31 (2003) ("[T]he Committee finds that present law, by taxing

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[13] Similarly, the IRS has acknowledged that QDI rates can apply to "consent dividends," which are hypothetical distributions that shareholders consent to include in their taxable income for purposes of, *inter alia*, the personal holding company tax. *See* 26 U.S.C. § 565; IRS CCA 201653017 n.3 (Sept. 8, 2016).

dividend income at a higher rate … , encourages corporations to retain earnings rather than to distribute them as taxable dividends.”). The purpose of section 1(h)(11), which expressly applies to CFCs, is thus furthered by applying the QDI rate to constructive dividends as well as formal dividends, since both promote economic activity through shareholder access to corporate earnings.

B. Section 956 and the Structure of Subpart F Confirm that Section 956 Inclusions Are Taxable as Dividends

1. Section 956 Inclusions Are Statutory Constructive Dividends

The rationale of section 956 is that “earnings brought back to the United States are taxed to the shareholders [under section 956] on the grounds that this is substantially the equivalent of a dividend being paid to them.” S. Rep. 87-1881 at 88; *see also* H.R. Rep. 87-1447 at 52 (provisions “deny tax deferral where funds are brought back and invested in the United States in a manner which does not otherwise subject them to U.S. taxation”). In short, section 956 adopts a “statutory constructive dividend doctrine.” *Dougherty v. Commissioner*, 60 T.C. 917, 930 (1973); *see also* Bittker & Eustice, *supra*, ¶ 15.62[4][a] (section 956 inclusions are “deemed” or “constructive” dividends).

Indeed, the Code itself refers to section 956 inclusions (and other section 951(a) inclusions) as "[c]onstructive dividends" in the title of 26 U.S.C. § 6501(e)(1)(C). Notably, Congress amended this Code section in 2004, one year after it enacted the QDI rules, without changing the provision's title, confirming its understanding that section 956 inclusions are constructive dividends.[14]

2. The Structure of Subpart F Demonstrates That Congress Intended Section 956 Inclusions to be Treated as Dividends

The structure of subpart F confirms that section 956 inclusions are properly taxed as dividends. As explained above, subpart F applies to two broad categories of undistributed CFC earnings: (1) subpart F income, which is immediately taxable to U.S. shareholders under section 951(a)(1)(A); and (2) income not otherwise subject to subpart F (and thus normally taxable at the shareholder level only when formally distributed as dividends) that was invested in U.S. property, which was taxable under section 951(a)(1)(B), in the amount determined by section

[14] Although the titles of Code sections are not given "legal effect," 26 U.S.C. § 7806(b), courts and the IRS look to such descriptive matter "as an aid to interpretation," *El v. Commissioner*, 144 T.C. 140, 147 n.10 (2015); P.L.R. 9040045 (July 10, 1990); *see also Maguire v. Commissioner*, 313 U.S. 1, 9 (1941).

956. The Staff of the Committee on Ways and Means described these two categories of income as follows:

> The amounts on which the U.S. person is taxed may be classified as: (1) subpart F income, and (2) *profits considered as being distributed. … The amount treated as having been distributed is the profit accumulated after 1962 to the extent that it is invested in certain prohibited types of property which include … most assets situated in the United States*.

H.R. Comm. on Ways and Means, Brief Summary of Provisions in H.R. 10650 the "Revenue Act of 1962", at 9 (1962) (emphasis added), *available at* https://www.finance.senate.gov/imo/media/doc/87PrtRevwm.pdf.

In the case of non-subpart F income, section 956 determines when deferral of U.S. taxation should end based on Congress's judgment that certain investments in U.S. property are functionally equivalent to dividends that repatriate earnings to the United States. Like formal dividends, section 956 deemed dividends permit a U.S. shareholder to access otherwise-deferred CFC earnings. In both situations, the U.S. shareholder obtains the use of the CFC's earnings, and therefore Congress treated both situations as repatriation events justifying taxation.

Moreover, once a CFC's earnings are taxed under section 956, they are not taxed again when they are formally distributed as dividends. 26 U.S.C. § 959. Instead, section 956 *accelerates* the tax on dividends that otherwise would have attached to those earnings. Thus, the structure and purpose of section 956—taxing disguised distributions of otherwise-deferred foreign earnings—confirms the dividend equivalence of section 956 inclusions.

In short, section 956 addresses the *timing* of U.S. taxation. It applies to business earnings of a CFC that have been properly deferred from U.S. taxation, ending that deferral when earnings are made available to a U.S. shareholder, just as deferral would end if those earnings were paid out as a formal dividend. Nothing about this *timing* provision suggests altering the *character* of the income recognized by denying dividend treatment.

In reaching a contrary result, the Tax Court looked to whether there was an actual distribution of CFC earnings, and found none. J.A. 54-55 (*citing Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *aff'd*, 722 F.3d 306, 309-10 (5th Cir. 2013)). But a narrow focus on *actual* distributions disregards the constructive dividend doctrine and the

structure and purpose of section 956. *See Neonatology*, 299 F.3d at 231-32. The Tax Court thus failed to give sufficient weight to decades of constructive dividend authorities, including those recognizing that constructive dividends qualify under the QDI rules.

C. The IRS Regularly Treats Section 956 Inclusions as Dividends Even When No Statute Expressly Provides for Such Treatment

Directly contradicting its position here, the IRS has repeatedly issued interpretive guidance that treats section 956 inclusions as dividends for purposes of multiple Code provisions, even when no statute expressly requires such treatment. For example, four tax regulations require that section 956 inclusions be treated as dividends for purposes of four different substantive rules that turn on the payment or receipt of a dividend:

1. 26 C.F.R. § 1.338-8(h)(4) ("treating any reference to a dividend" as including "[a]n amount included in income under section 951(a)(1)(B)").
2. *Id.* § 1.385-3(c)(3)(i)(C)(3)(ii) ("the term dividend includes inclusions with respect to stock (for example, inclusions under sections 951(a) and 1293)").

3. *Id.* § 1.865-2(d)(2) (defining "dividend recapture amount" to encompass "an inclusion described in section 951(a)(1)(B)").

4. *Id.* § 1.904-5(m)(4) (dividend "includ[es] an amount included in gross income under section 951(a)(1)(B)").

A fifth regulation permits taxpayers to elect such treatment. *Id.* § 1.1411-10(c), (g). Thus, five regulations require or permit dividend treatment of section 956 inclusions in the absence of a statutory provision expressly providing for such treatment.

Similarly, twenty IRS letter rulings treat subpart F inclusions, including section 956 inclusions, as dividends for purposes of the rules that tax the "unrelated business taxable income" ("UBTI") of tax-exempt organizations.[15] Indeed, Congress has tacitly endorsed the IRS treatment of subpart F income as a dividend for UBTI purposes. *See* H.R. Rep. 104-737 at 294 (1996) (citing with approval IRS rulings treating subpart F inclusions as dividends, and criticizing one ruling that adopted a different analysis).

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[15] *See, e.g.*, P.L.R. 9507007 (Nov. 10, 1994); P.L.R. 9024086 (Mar. 22, 1990); P.L.R. 8922047 (Mar. 6, 1989); P.L.R. 8836037 (Jun. 14, 1988).

The IRS has explained why it requires dividend treatment of subpart F inclusions in the absence of a statutory rule:

> Subpart F income is taxed in largely the same manner as a dividend. The mere fact that the timing of income recognition is accelerated under the Subpart F provisions … does not result in treating the Subpart F inclusion any differently than distribution of an actual dividend in the absence of these rules, unless specifically provided elsewhere in the Code.

P.L.R. 9024026 (Mar. 15, 1990). *See also* T.D. 8916 (Jan. 3, 2001) (explaining that "like an actual dividend," 956 inclusions are "treated as paid pro rata out of all of the CFC's earnings and profits"). Moreover, the IRS routinely refers to section 956 inclusions as deemed dividends. *See, e.g.*, GCM 36965 (Dec. 22, 1976) (stating that "under Code § 951 U.S. shareholders are deemed to have received dividends from controlled foreign corporations attributable … to the increase in earnings invested in U.S. property, as defined in Code § 956"); P.L.R. 9217039 (Jan. 28, 1992) (stating that "amounts included under section 951(a)(1)(A) and (B) are treated as deemed dividend payments").

The IRS's longstanding treatment of section 956 inclusions as dividends for a variety of analogous Code purposes should be followed here.

D. The Tax Court Placed Undue Reliance on Statutory Provisions Expressly Providing for Dividend Treatment in Certain Circumstances

The Tax Court recognized that "section 951 in operation treats a CFC's investment in United States property 'as if it were a dividend.'" J.A. 55. It nevertheless held that, because no Code provision expressly provides that section 956 inclusions are treated as dividends for QDI purposes, Congress intended them to be taxed at ordinary income tax rates. The Tax Court relied on *Rodriguez*, which similarly concluded that "when Congress decides to treat certain inclusions as dividends, it explicitly states as much, and Congress has not so designated the inclusions at issue here." 722 F.3d at 311. This conclusion is incorrect, for several reasons.

First, neither the Tax Court in this case nor the courts in *Rodriguez* considered the multiple IRS regulations and rulings that treat section 956 inclusions as dividends in the absence of a specific statutory provision to that effect. If the reasoning of those courts is correct, all of those regulations and rulings are invalid.

Second, neither the Tax Court in this case nor the *Rodriguez* courts recognized that the established rules governing constructive

dividends, as well as the structure and history of subpart F, support treating section 956 inclusions as dividends even without a specific statutory provision to that effect. *See supra* pp. 52-55.

Third, it is not correct that statutory provisions designating certain section 951 inclusions as dividends for specified purposes would become meaningless "surplusage" unless all other section 951 inclusions are taxed as ordinary income. *Rodriguez*, 722 F.3d at 311. In *Rodriguez*, the Tax Court pointed to six Code sections (26 U.S.C. §§ 54A(g), 302(a), 304(a), 305(c), 551(b), and 1248) as showing that Congress knows how to provide for dividend treatment when that is what it intends. *See Rodriguez*, 137 T.C. at 178-79. But the court read far too much into those provisions. Many are rules that change the characterization of a transaction, or the character of a taxpayer's income. For example, under section 1248 a shareholder's gain on the sale of stock is treated as dividend income, even though it does not involve a distribution of a company's earnings and profits, actual, constructive, or deemed. Other cited provisions involve similar transformations. *See* 26 U.S.C. §§ 302(a), 304(a), 305(c) (deeming certain transactions with respect to corporate stock to be distributions).

By contrast, in section 956, Congress addressed a timing issue, accelerating the taxation of otherwise-deferred earnings when shareholders accessed those earnings through an investment in U.S. property. Regardless of when that income is recognized by the U.S. shareholder, it is dividend income by its very nature. For that reason, the IRS authorities addressing other provisions that simply apply to "dividends" have routinely treated section 956 inclusions as dividends notwithstanding the absence of a statutory rule requiring such treatment.

Similarly, the *Rodriguez* courts misread the significance of four Code provisions that address the dividend treatment of subpart F inclusions.[16] All four provisions clarify the treatment of section 951(a)(1)(A) inclusions, which as noted above are not covered by the dividend-equivalence rationale of section 956. Three of the provisions

[16] Those provisions are: (1) 26 U.S.C. § 851(b) (permitting dividend treatment of a section 951(a)(1)(A) inclusion, but only if the earnings are actually distributed by the CFC); (2) *id.* § 959(a)(1) (providing that once a CFC's earnings have been taxed under subpart F, they cannot be taxed *again* when the earnings are *actually* distributed); (3) *id.* § 960(a)(1) (providing that all section 951(a) inclusions are treated as dividends for indirect foreign tax credit purposes); (4) *id.* § 904(d)(3)(G) (for foreign tax credit limitation purposes, confirming both the dividend treatment of section 956 inclusions and the non-dividend treatment of section 951(a)(1)(A) inclusions).

extend dividend treatment to such inclusions and one confirms non-dividend treatment, for purposes of particular specialized Code rules. These specialized rules should not be read to reject the general dividend equivalence of section 956 inclusions. One of the cited provisions does not address section 956 inclusions at all, and thus has limited relevance. 26 U.S. § 851(b). If anything, the absence of a specific reference to section 956 inclusions in a rule extending dividend treatment to section 951(a)(1)(A) inclusions suggests that Congress understood it did not need to expressly mention section 956 inclusions to confirm that they are subject to dividend treatment.

Two of the other cited provisions broadly apply dividend treatment to section 951(a)(1) inclusions, and thus extend such treatment to section 951(a)(1)(A) inclusions for specified purposes, while also confirming that treatment of section 956 inclusions. *Id.* §§ 959(a)(1), 960(a)(1). This type of broad cross-reference should not be read to contradict the general dividend equivalence of section 956 inclusions. The fourth provision simply confirms, in the foreign tax credit limitation context, that section 951(a)(1)(A) inclusions are not dividends while section 956 inclusions are. *Id.* § 904(d)(3)(G).

In sum, these specialized rules either confirm or do not address the general dividend equivalence of section 956 inclusions. They should not be read as prohibiting the dividend treatment of such amounts, as otherwise established by the structure and history of section 956.

Over and above these points, the "canon against surplusage is not an absolute rule," because "[r]edundancies across statutes are not unusual events in drafting." *Marx v. Gen. Revenue Corp.*, 568 U.S. 371, 385 (2013). Here, the strong reasons for according dividend treatment to section 956 inclusions—including the constructive dividend doctrine, the purpose, structure, and history of section 956, and the numerous IRS regulations and rulings treating section 956 inclusions as dividends—all support the conclusion that the QDI rate applies.

Finally, there is a particularly strong reason to apply dividend treatment with respect to section 956 inclusions related to guarantees of loans to U.S. persons. The *Rodriguez* courts considered only investments in tangible U.S. property that did not result in any distribution to the U.S. shareholders. But here, the U.S. shareholders received cash, in the form of loans from Merrill Lynch. The IRS position treats the cash received by SIG as actually coming from CFC

earnings. Thus, under the IRS position, that distribution of cash from corporate earnings is a dividend.

E. Failing to Treat Section 956 Inclusions as Dividends Leads to Timing-Based Anomalies Contrary to Supreme Court Precedent

Taxing section 956 inclusions as if they are ordinary income, rather than dividend income, also produces arbitrary results. The applicable tax rate is more than doubled, based not on any substantive distinction, but solely on the timing and manner of repatriating CFC income. This result violates Supreme Court precedent addressing the timing of income recognition.

First, the Supreme Court has held that merely accelerating the recognition of income should not alter the character of the income to the taxpayer. *See, e.g., Commissioner v. P.G. Lake, Inc.*, 356 U.S. 260, 265 (1958) (holding that a taxpayer's sale of an oil payment right was taxable as ordinary income because the "lump sum consideration seems essentially a substitute for what would otherwise be received at a future time as ordinary income"). When a treaty-eligible CFC distributes its earnings to an individual shareholder, the dividend unquestionably is taxed at the QDI rate. When section 956 requires a shareholder-level

income inclusion with respect to the earnings of the CFC, that inclusion merely accelerates the taxation of those earnings. This acceleration is "essentially a substitute for what would otherwise be received at a future time" as dividends, *id.*, and thus should not alter the character the income would have if it had been received in due course.

Second, the Supreme Court has likewise instructed that when closely related events occur in different taxable years, the tax treatment of those events must take into account the treatment that would apply if all the relevant events occurred in the same taxable year—that is, the tax characterization of the related events must be consistent across the years, under a "relation back" principle. *See Arrowsmith v. Commissioner*, 344 U.S. 6, 8-9 (1952); *United States v. Skelly Oil Co.*, 394 U.S. 678 (1969). Courts have applied this doctrine "in favor of both the taxpayer and the Government in a myriad of factual settings." *Freedom Newspapers, Inc. v. Commissioner*, 36 T.C.M. 1755 (1977).

Here, SEHL distributed its earnings and profits in 2010, after having entered into the guarantee at issue long before there was any suggestion from the IRS that the guarantee could have triggered a section 956 inclusion. When SEHL distributed its earnings and profits

in 2010, all taxes due were paid at the QDI rate. Now, solely because SEHL is *deemed* to have distributed *those same earnings* in 2007 and 2008, the IRS contends that the shareholders should have paid taxes earlier and at more than double the dividend rate. By contrast, as discussed above, it is undisputed that if SEHL had provided the guarantees *and* paid a formal dividend of an equivalent amount in the same year, the QDI rate would apply to the CFC's earnings thus repatriated. Under the *Arrowsmith* doctrine, merely separating the two events into different taxable years should not generate the dramatically different tax result the IRS seeks.

There is no indication in statutory text or legislative history that Congress intended to override tax doctrines that require consistent tax treatment of income regardless of whether it is accelerated or otherwise spread across multiple tax years. And there certainly is no indication that Congress intended to impose the anomalous and arbitrary result that the IRS seeks to impose here.

CONCLUSION

The judgment of the Tax Court should be reversed.

Respectfully submitted,

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ADDENDUM

CERTIFICATE OF BAR MEMBERSHIP

I hereby certify that, pursuant to Third Circuit L.A.R. 46.1 (2011), I am admitted to and a member in good standing of the Bar of the United States Court of Appeals for the Third Circuit.

CERTIFICATE OF COMPLIANCE

This brief complies with the type-volume limitations of Federal Rule of Appellate Procedure 32(a)(7)(B) because it contains 12,997 words, excluding the parts of the brief exempted by Rule 32(f) and Third Circuit L.A.R. 32.2(c). This brief complies with the typeface requirements of Rule 32(a)(5) and the type style requirements of Rule 32(a)(6) because it has been prepared in a proportionally spaced typeface using Microsoft Word 2016 in Century Schoolbook and 14 point font.

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I hereby certify that this brief complies with Third Circuit L.A.R. 31.1(c) because the virus detection program Symantec Endpoint Protection, Version 14.0, has been run on the file and no virus was detected.

s/ Robert A. Long, Jr.
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September 19, 2018

CERTIFICATE OF SERVICE

I hereby certify that I electronically filed the foregoing with the Clerk of the Court for the United States Court of Appeals for the Third Circuit by using the appellate CM/ECF system on September 19, 2018.

I certify that all participants in the case are registered CM/ECF users and that service will be accomplished by the appellate CM/ECF system.

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September 19, 2018

ADDENDUM OF STATUTES AND REGULATIONS

U.S. Code

26 U.S.C. § 1(h)(11) (eff. to Jan. 1, 2013)... 1a

26 U.S.C. § 54A (eff. to Dec. 21, 2017).. 3a

26 U.S.C. § 302(a) (eff. to Dec. 21, 2010).. .... 4a

26 U.S.C. § 304(a) (eff. to Aug. 9, 2010)... 5a

26 U.S.C. § 305(c) (eff. to Mar. 22, 2018)... 7a

26 U.S.C. § 316(a).. .... 8a

26 U.S.C. § 551 (eff. to Dec. 31, 2004)... 9a

26 U.S.C. § 851(b) (eff. to Dec. 21, 2017).. .... 10a

26 U.S.C. § 904(d)(3) (eff. to Feb. 16, 2009).. 12a

26 U.S.C. § 951 (eff. Dec. 29, 2007 to Dec. 21, 2017). 15a

26 U.S.C. § 951 (eff. Jan. 1, 2005 to Dec. 28, 2007). 19a

26 U.S.C. § 956 (eff. Dec. 29, 2007 to Mar. 22, 2018).......................... 22a

26 U.S.C. § 956 (eff. Jan. 1, 2005 to Dec. 28, 2007). 29a

26 U.S.C. § 959(a) (eff. to Dec. 21, 2017).. .... 36a

26 U.S.C. § 960(a) (eff. to Aug. 9, 2010)... 37a

26 U.S.C. § 1248(a) (eff. to Dec. 21, 2017). 39a

26 U.S.C. § 6501... 40a

26 U.S.C. § 7806... 41a

Code of Federal Regulations

26 C.F.R. § 1.338-8(h)(4)(i) 42a

26 C.F.R. § 1.385-3(c)(3)(i)(C)(3)(ii)..43a

26 C.F.R. § 1.865-2(d)(2)..44a

26 C.F.R. § 1.904-5(m)(4)...45a

26 C.F.R. § 1.956-1 (eff. to June 23, 2008)..46a

26 C.F.R. § 1.956-1 (eff. June 24, 2008 to June 23, 2011). 53a

26 C.F.R. § 1.956-2 (eff. to July 2, 2008)..60a

26 C.F.R. § 1.956-2 (eff. July 3, 2008 to May 5, 2011)……………………73a

26 C.F.R. § 1.1411-10(c), (g) 86a

26 U.S.C. § 1(h)(11) (eff. to Jan. 1, 2013). Tax imposed.

. . .

(11) Dividends taxed as net capital gain.--

(A) In general.--For purposes of this subsection, the term "net capital gain" means net capital gain (determined without regard to this paragraph) increased by qualified dividend income.

(B) Qualified dividend income.--For purposes of this paragraph--

(i) In general.--The term "qualified dividend income" means dividends received during the taxable year from--

(I) domestic corporations, and
(II) qualified foreign corporations.

(ii) Certain dividends excluded.--Such term shall not include--

(I) any dividend from a corporation which for the taxable year of the corporation in which the distribution is made, or the preceding taxable year, is a corporation exempt from tax under section 501 or 521,
(II) any amount allowed as a deduction under section 591 (relating to deduction for dividends paid by mutual savings banks, etc.), and
(III) any dividend described in section 404(k).

(iii) Coordination with section 246(c).--Such term shall not include any dividend on any share of stock--

(I) with respect to which the holding period requirements of section 246(c) are not met (determined by substituting in section 246(c) "60 days" for "45 days" each place it appears and by substituting "121-day period" for "91-day period"), or

(II) to the extent that the taxpayer is under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.

(C) Qualified foreign corporations.--

(i) In general.--Except as otherwise provided in this paragraph, the term "qualified foreign corporation" means any foreign corporation if--

(I) such corporation is incorporated in a possession of the United States, or
(II) such corporation is eligible for benefits of a comprehensive income tax treaty with the United States which the Secretary determines is satisfactory for purposes of this paragraph and which includes an exchange of information program.

(ii) Dividends on stock readily tradable on United States securities market.--A foreign corporation not otherwise treated as a qualified foreign corporation under clause (i) shall be so treated with respect to any dividend paid by such corporation if the stock with respect to which such dividend is paid is readily tradable on an established securities market in the United States.

(iii) Exclusion of dividends of certain foreign corporations. Such term shall not include any foreign corporation which for the taxable year of the corporation in which the dividend was paid, or the preceding taxable year, is a passive foreign investment company (as defined in section 1297).

(iv) Coordination with foreign tax credit limitation.--Rules similar to the rules of section 904(b)(2)(B) shall apply with respect to the dividend rate differential under this paragraph.

. . . .

26 U.S.C. § 54A. (eff. to Dec. 21, 2017). Credit to holders of qualified tax credit bonds

. . .

(g) S corporations and partnerships.--In the case of a tax credit bond held by an S corporation or partnership, the allocation of the credit allowed by this section to the shareholders of such corporation or partners of such partnership shall be treated as a distribution.

. . . .

26 U.S.C. § 302(a) (eff. to Dec. 21, 2010). Distributions in redemption of stock.

(a) General rule.--If a corporation redeems its stock (within the meaning of section 317(b)), and if paragraph (1), (2), (3), or (4) of subsection (b) applies, such redemption shall be treated as a distribution in part or full payment in exchange for the stock.

. . . .

26 U.S.C. § 304(a) (eff. to Aug. 9, 2010). Redemption through use of related corporations.

(a) Treatment of certain stock purchases.--

(1) Acquisition by related corporation (other than subsidiary).--For purposes of sections 302 and 303, if--

(A) one or more persons are in control of each of two corporations, and

(B) in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control,

then (unless paragraph (2) applies) such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock. To the extent that such distribution is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation shall be treated in the same manner as if the transferor had transferred the stock so acquired to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.

(2) Acquisition by subsidiary.--For purposes of sections 302 and 303, if--

(A) in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and

(B) the issuing corporation controls the acquiring corporation,

then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.

. . . .

26 U.S.C. § 305(c) (eff. to Mar. 22, 2018). Distributions of stock and stock rights.

. . .

(c) Certain transactions treated as distributions.--For purposes of this section and section 301, the Secretary shall prescribe regulations under which a change in conversion ratio, a change in redemption price, a difference between redemption price and issue price, a redemption which is treated as a distribution to which section 301 applies, or any transaction (including a recapitalization) having a similar effect on the interest of any shareholder shall be treated as a distribution with respect to any shareholder whose proportionate interest in the earnings and profits or assets of the corporation is increased by such change, difference, redemption, or similar transaction. Regulations prescribed under the preceding sentence shall provide that--

> (1) where the issuer of stock is required to redeem the stock at a specified time or the holder of stock has the option to require the issuer to redeem the stock, a redemption premium resulting from such requirement or option shall be treated as reasonable only if the amount of such premium does not exceed the amount determined under the principles of section 1273(a)(3),
>
> (2) a redemption premium shall not fail to be treated as a distribution (or series of distributions) merely because the stock is callable, and
>
> (3) in any case in which a redemption premium is treated as a distribution (or series of distributions), such premium shall be taken into account under principles similar to the principles of section 1272(a).

. . . .

26 U.S.C. § 316(a). Dividend defined.

(a) General rule.--For purposes of this subtitle, the term “dividend” means any distribution of property made by a corporation to its shareholders--

> (1) out of its earnings and profits accumulated after February 28, 1913, or
>
> (2) out of its earnings and profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof, and from the most recently accumulated earnings and profits. To the extent that any distribution is, under any provision of this subchapter, treated as a distribution of property to which section 301 applies, such distribution shall be treated as a distribution of property for purposes of this subsection.

. . . .

26 U.S.C. § 551(b) (eff. to Dec. 31, 2004). Foreign personal holding company income taxed to United States shareholders.

. . .

(b) Amount included in gross income.-- Each United States shareholder, who was a shareholder on the day in the taxable year of the company which was the last day on which a United States group (as defined in section 552(a)(2)) existed with respect to the company, shall include in his gross income, as a dividend, for the taxable year in which or with which the taxable year of the company ends, the amount he would have received as a dividend (determined as if any distribution in liquidation actually made in such taxable year had not been made) if on such last day there had been distributed by the company, and received by the shareholders, an amount which bears the same ratio to the undistributed foreign personal holding company income of the company for the taxable year as the portion of such taxable year up to and including such last day bears to the entire taxable year.
. . . .

26 U.S.C. § 851(b) (eff. to Dec. 21, 2017). Definition of regulated investment company.

(b) Limitations.--A corporation shall not be considered a regulated investment company for any taxable year unless--

(1) it files with its return for the taxable year an election to be a regulated investment company or has made such election for a previous taxable year;

(2) at least 90 percent of its gross income is derived from--

(A) dividends, interest, payments with respect to securities loans (as defined in section 512(a)(5)), and gains from the sale or other disposition of stock or securities (as defined in section 2(a)(36) of the Investment Company Act of 1940, as amended) or foreign currencies, or other income (including but not limited to gains from options, futures or forward contracts) derived with respect to its business of investing in such stock, securities, or currencies, and

(B) net income derived from an interest in a qualified publicly traded partnership (as defined in subsection (h)); and

(3) at the close of each quarter of the taxable year--

(A) at least 50 percent of the value of its total assets is represented by--

(i) cash and cash items (including receivables), Government securities and securities of other regulated investment companies, and
(ii) other securities for purposes of this calculation limited, except and to the extent provided in subsection (e), in respect of any one issuer to an amount not greater in value than 5 percent of the value of the total assets of the taxpayer and to

not more than 10 percent of the outstanding voting securities of such issuer, and

(B) not more than 25 percent of the value of its total assets is invested in--

(i) the securities (other than Government securities or the securities of other regulated investment companies) of any one issuer,
(ii) the securities (other than the securities of other regulated investment companies) of two or more issuers which the taxpayer controls and which are determined, under regulations prescribed by the Secretary, to be engaged in the same or similar trades or businesses or related trades or businesses, or
(iii) the securities of one or more qualified publicly traded partnerships (as defined in subsection (h)).

For purposes of paragraph (2), there shall be treated as dividends amounts included in gross income under section 951(a)(1)(A)(i) or 1293(a) for the taxable year to the extent that, under section 959(a)(1) or 1293(c) (as the case may be), there is a distribution out of the earnings and profits of the taxable year which are attributable to the amounts so included. For purposes of paragraph (2), the Secretary may by regulation exclude from qualifying income foreign currency gains which are not directly related to the company's principal business of investing in stock or securities (or options and futures with respect to stock or securities). For purposes of paragraph (2), amounts excludable from gross income under section 103(a) shall be treated as included in gross income. Income derived from a partnership (other than a qualified publicly traded partnership as defined in subsection (h)) or trust shall be treated as described in paragraph (2) only to the extent such income is attributable to items of income of the partnership or trust (as the case may be) which would be described in paragraph (2) if realized by the regulated investment company in the same manner as realized by the partnership or trust.

26 U.S.C. § 904(d)(3) (eff. to Feb. 16, 2009). Limitation on Credit.

. . .

(3) Look-thru in case of controlled foreign corporations.--

> (A) In general.--Except as otherwise provided in this paragraph, dividends, interest, rents, and royalties received or accrued by the taxpayer from a controlled foreign corporation in which the taxpayer is a United States shareholder shall not be treated as passive category income.
>
> (B) Subpart F inclusions.--Any amount included in gross income under section 951(a)(1)(A) shall be treated as passive category income to the extent the amount so included is attributable to passive category income.
>
> (C) Interest, rents, and royalties.--Any interest, rent, or royalty which is received or accrued from a controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as passive category income to the extent it is properly allocable (under regulations prescribed by the Secretary) to passive category income of the controlled foreign corporation.
>
> (D) Dividends.--Any dividend paid out of the earnings and profits of any controlled foreign corporation in which the taxpayer is a United States shareholder shall be treated as passive category income in proportion to the ratio of--
>
> > (i) the portion of the earnings and profits attributable to passive category income, to
> > (ii) the total amount of earnings and profits.
>
> (E) Look-thru applies only where subpart F applies.--If a controlled foreign corporation meets the requirements of section 954(b)(3)(A) (relating to de minimis rule) for any taxable year, for purposes of this paragraph, none of its foreign base company

income (as defined in section 954(a) without regard to section 954(b)(5)) and none of its gross insurance income (as defined in section 954(b)(3)(C)) for such taxable year shall be treated as passive category income, except that this sentence shall not apply to any income which (without regard to this sentence) would be treated as financial services income. Solely for purposes of applying subparagraph (D), passive income of a controlled foreign corporation shall not be treated as passive category income if the requirements of section 954(b)(4) are met with respect to such income.

(F) Coordination with high-taxed income provisions.--

(i) In determining whether any income of a controlled foreign corporation is passive category income, subclause (II) of paragraph (2)(B)(iii) shall not apply.
(ii) Any income of the taxpayer which is treated as passive category income under this paragraph shall be so treated notwithstanding any provision of paragraph (2); except that the determination of whether any amount is high-taxed income shall be made after the application of this paragraph.

(G) Dividend.--For purposes of this paragraph, the term 'dividend' includes any amount included in gross income in section 951(a)(1)(B). Any amount included in gross income under section 78 to the extent attributable to amounts included in gross income in section 951(a)(1)(A) shall not be treated as a dividend but shall be treated as included in gross income under section 951(a)(1)(A).

(H) Look-thru applies to passive foreign investment company inclusion.--If--

(i) a passive foreign investment company is a controlled foreign corporation, and
(ii) the taxpayer is a United States shareholder in such controlled foreign corporation,
any amount included in gross income under section 1293 shall be treated as income in a separate category to the

extent such amount is attributable to income in such category.

. . . .

26 U.S.C. § 951 (eff. from Dec. 29, 2007 to Dec. 21, 2017). Amounts included in gross income of United States shareholders.

(a) Amounts included.--

(1) In general.--If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends--

(A) the sum of--

(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year,

(ii) his pro rata share (determined under section 955(a)(3) as in effect before the enactment of the Tax Reduction Act of 1975) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year, and

(iii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations for such year; and

(B) the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

(2) Pro rata share of subpart F income.--The pro rata share referred to in paragraph (1)(A)(i) in the case of any United States shareholder is the amount--

(A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

(B) the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year.

For purposes of subparagraph (B), any gain included in the gross income of any person as a dividend under section 1248 shall be treated as a distribution received by such person with respect to the stock involved.

(3) Limitation on pro rata share of previously excluded subpart F income withdrawn from investment.--For purposes of paragraph (1)(A)(iii), the pro rata share of any United States shareholder of the previously excluded subpart F income of a controlled foreign corporation withdrawn from investment in foreign base company shipping operations shall not exceed an amount--

(A) which bears the same ratio to his pro rata share of such income withdrawn (as determined under section 955(a)(3)) for the taxable year, as

(B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

(b) United States shareholder defined.--For purposes of this subpart, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

(c) Coordination with passive foreign investment company provisions.--If, but for this subsection, an amount would be included in the gross income of a United States shareholder for any taxable year both under subsection (a)(1)(A)(i) and under section 1293 (relating to current taxation of income from certain passive foreign investment companies), such amount shall be included in the gross income of such shareholder only under subsection (a)(1)(A).

(b) United States shareholder defined.--For purposes of this title, the term "United States shareholder" means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.

(c) Coordination with passive foreign investment company provisions.--If, but for this subsection, an amount would be included in the gross income of a United States shareholder for

any taxable year both under subsection (a)(1)(A)(i) and under section 1293 (relating to current taxation of income from certain passive foreign investment companies), such amount shall be included in the gross income of such shareholder only under subsection (a)(1)(A).

26 U.S.C. § 951 (eff. from Jan. 1, 2005 to Dec. 28, 2007). Amounts included in gross income of United States shareholders.

(a) Amounts included.--

(1) In general.--If a foreign corporation is a controlled foreign corporation for an uninterrupted period of 30 days or more during any taxable year, every person who is a United States shareholder (as defined in subsection (b)) of such corporation and who owns (within the meaning of section 958(a)) stock in such corporation on the last day, in such year, on which such corporation is a controlled foreign corporation shall include in his gross income, for his taxable year in which or with which such taxable year of the corporation ends--

(A) the sum of--

(i) his pro rata share (determined under paragraph (2)) of the corporation's subpart F income for such year,
(ii) his pro rata share (determined under section 955(a)(3) as in effect before the enactment of the Tax Reduction Act of 1975) of the corporation's previously excluded subpart F income withdrawn from investment in less developed countries for such year, and
(iii) his pro rata share (determined under section 955(a)(3)) of the corporation's previously excluded subpart F income withdrawn from foreign base company shipping operations for such year; and

(B) the amount determined under section 956 with respect to such shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).

(2) Pro rata share of subpart F income.--The pro rata share referred to in paragraph (1)(A)(i) in the case of any United States shareholder is the amount--

(A) which would have been distributed with respect to the stock which such shareholder owns (within the meaning of section 958(a)) in such corporation if on the last day, in its taxable year, on which the corporation is a controlled foreign corporation it had distributed pro rata to its shareholders an amount (i) which bears the same ratio to its subpart F income for the taxable year, as (ii) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year, reduced by

(B) the amount of distributions received by any other person during such year as a dividend with respect to such stock, but only to the extent of the dividend which would have been received if the distribution by the corporation had been the amount (i) which bears the same ratio to the subpart F income of such corporation for the taxable year, as (ii) the part of such year during which such shareholder did not own (within the meaning of section 958(a)) such stock bears to the entire year.

For purposes of subparagraph (B), any gain included in the gross income of any person as a dividend under section 1248 shall be treated as a distribution received by such person with respect to the stock involved.

(3) Limitation on pro rata share of previously excluded subpart F income withdrawn from investment.--For purposes of paragraph (1)(A)(iii), the pro rata share of any United States shareholder of the previously excluded subpart F income of a controlled foreign corporation withdrawn from investment in foreign base company shipping operations shall not exceed an amount--

(A) which bears the same ratio to his pro rata share of such income withdrawn (as determined under section 955(a)(3)) for the taxable year, as

(B) the part of such year during which the corporation is a controlled foreign corporation bears to the entire year.

(b) United States shareholder defined.--For purposes of this subpart, the term “United States shareholder” means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

(c) Foreign trade income not taken into account.--

(1) In general.--The foreign trade income of a FSC and any deductions which are apportioned or allocated to such income shall not be taken into account under this subpart.

(2) Foreign trade income.--For purposes of this subsection, the term “foreign trade income” has the meaning given such term by section 923(b), but does not include section 923(a)(2) nonexempt income (within the meaning of section 927(d)(6)).

(d) Coordination with passive foreign investment company provisions.--If, but for this subsection, an amount would be included in the gross income of a United States shareholder for any taxable year both under subsection (a)(1)(A)(i) and under section 1293 (relating to current taxation of income from certain passive foreign investment companies), such amount shall be included in the gross income of such shareholder only under subsection (a)(1)(A).

26 U.S.C. § 956 (eff. Dec. 29, 2007 to Mar. 22, 2018) Investment of earnings in United States property.

(a) General rule.--In the case of any controlled foreign corporation, the amount determined under this section with respect to any United States shareholder for any taxable year is the lesser of--

(1) the excess (if any) of--

(A) such shareholder's pro rata share of the average of the amounts of United States property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of such taxable year, over

(B) the amount of earnings and profits described in section 959(c)(1)(A) with respect to such shareholder, or

(2) such shareholder's pro rata share of the applicable earnings of such controlled foreign corporation.

The amount taken into account under paragraph (1) with respect to any property shall be its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

(b) Special rules.--

(1) Applicable earnings.--For purposes of this section, the term “applicable earnings” means, with respect to any controlled foreign corporation, the sum of--

(A) the amount (not including a deficit) referred to in section 316(a)(1) to the extent such amount was accumulated in prior taxable years, and

(B) the amount referred to in section 316(a)(2),

but reduced by distributions made during the taxable year and by earnings and profits described in section 959(c)(1).

(2) Special rule for U.S. property acquired before corporation is a controlled foreign corporation.--In applying subsection (a) to any taxable year, there shall be disregarded any item of United States property which was acquired by the controlled foreign corporation before the first day on which such corporation was treated as a controlled foreign corporation. The aggregate amount of property disregarded under the preceding sentence shall not exceed the portion of the applicable earnings of such controlled foreign corporation which were accumulated during periods before such first day.

(3) Special rule where corporation ceases to be controlled foreign corporation.--If any foreign corporation ceases to be a controlled foreign corporation during any taxable year--

(A) the determination of any United States shareholder's pro rata share shall be made on the basis of stock owned (within the meaning of section 958(a)) by such shareholder on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation,

(B) the average referred to in subsection (a)(1)(A) for such taxable year shall be determined by only taking into account quarters ending on or before such last day, and

(C) in determining applicable earnings, the amount taken into account by reason of being described in paragraph (2) of section 316(a) shall be the portion of the amount so described which is allocable (on a pro rata basis) to the part of such year during which the corporation is a controlled foreign corporation.

(c) United States property defined.--

(1) In general.--For purposes of subsection (a), the term “United States property” means any property acquired after December 31, 1962, which is--

(A) tangible property located in the United States;

(B) stock of a domestic corporation;

(C) an obligation of a United States person; or

(D) any right to the use in the United States of--

(i) a patent or copyright,
(ii) an invention, model, or design (whether or not patented),
(iii) a secret formula or process, or
(iv) any other similar right,

which is acquired or developed by the controlled foreign corporation for use in the United States.

(2) Exceptions.--For purposes of subsection (a), the term “United States property” does not include--

(A) obligations of the United States, money, or deposits with--

(i) any bank (as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)), without regard to subparagraphs (C) and (G) of paragraph (2) of such section), or
(ii) any corporation not described in clause (i) with respect to which a bank holding company (as defined by section 2(a) of such Act) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation;

(B) property located in the United States which is purchased in the United States for export to, or use in, foreign countries;

(C) any obligation of a United States person arising in connection with the sale or processing of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person had the sale or processing transaction been made between unrelated persons;

(D) any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States;

(E) an amount of assets of an insurance company equivalent to the unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business attributable to contracts which are not contracts described in section 953(a)(1);

(F) the stock or obligations of a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation, nor a domestic corporation, 25 percent or more of the total combined voting power of which, immediately after the acquisition of any stock in such domestic corporation by the controlled foreign corporation, is owned, or is considered as being owned, by such United States shareholders in the aggregate;

(G) any movable property (other than a vessel or aircraft) which is used for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or under such waters when used on the Continental Shelf of the United States;

(H) an amount of assets of the controlled foreign corporation equal to the earnings and profits accumulated after December 31, 1962, and excluded from subpart F income under section 952(b);

(I) deposits of cash or securities made or received on commercial terms in the ordinary course of a United States or foreign person's business as a dealer in securities or in commodities, but only to the extent such deposits are made or received as collateral or margin for (i) a securities loan, notional principal contract, options contract, forward contract, or futures contract, or (ii) any other financial transaction in which the Secretary determines that it is customary to post collateral or margin;

(J) an obligation of a United States person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities or commodities;

(K) securities acquired and held by a controlled foreign corporation in the ordinary course of its business as a dealer in securities if--

> (i) the dealer accounts for the securities as securities held primarily for sale to customers in the ordinary course of business, and
> (ii) the dealer disposes of the securities (or such securities mature while held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business; and

(L) an obligation of a United States person which--

(i) is not a domestic corporation, and
(ii) is not--

(I) a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation, or
(II) a partnership, estate, or trust in which the controlled foreign corporation, or any related person (as defined in section 954(d)(3)), is a partner, beneficiary, or trustee immediately after the acquisition of any obligation of such partnership, estate, or trust by the controlled foreign corporation.

For purposes of subparagraphs (I), (J), and (K), the term "dealer in securities" has the meaning given such term by section 475(c)(1), and the term "dealer in commodities" has the meaning given such term by section 475(e), except that such term shall include a futures commission merchant.

(3) Certain trade or service receivables acquired from related United States persons.--

(A) In general.--Notwithstanding paragraph (2) (other than subparagraph (H) thereof), the term "United States property" includes any trade or service receivable if--

(i) such trade or service receivable is acquired (directly or indirectly) from a related person who is a United States person, and
(ii) the obligor under such receivable is a United States person.

(B) Definitions.--For purposes of this paragraph, the term "trade or service receivable" and "related person" have the respective meanings given to such terms by section 864(d).

(d) Pledges and guarantees.--For purposes of subsection (a), a controlled foreign corporation shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a United States person if such controlled foreign corporation is a pledgor or guarantor of such obligations.

(e) Regulations.--The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to prevent the avoidance of the provisons1 of this section through reorganizations or otherwise.

26 U.S.C. § 956 (eff. Jan. 1, 2005 to Dec. 28, 2007). Investment of earnings in United States property.

(a) General rule.--In the case of any controlled foreign corporation, the amount determined under this section with respect to any United States shareholder for any taxable year is the lesser of--

(1) the excess (if any) of--

(A) such shareholder's pro rata share of the average of the amounts of United States property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of such taxable year, over

(B) the amount of earnings and profits described in section 959(c)(1)(A) with respect to such shareholder, or

(2) such shareholder's pro rata share of the applicable earnings of such controlled foreign corporation.

The amount taken into account under paragraph (1) with respect to any property shall be its adjusted basis as determined for purposes of computing earnings and profits, reduced by any liability to which the property is subject.

(b) Special rules.--

(1) Applicable earnings.--For purposes of this section, the term “applicable earnings” means, with respect to any controlled foreign corporation, the sum of--

(A) the amount (not including a deficit) referred to in section 316(a)(1) to the extent such amount was accumulated in prior taxable years, and

(B) the amount referred to in section 316(a)(2),
but reduced by distributions made during the taxable year and by earnings and profits described in section 959(c)(1).

(2) Special rule for U.S. property acquired before corporation is a controlled foreign corporation.--In applying subsection (a) to any taxable year, there shall be disregarded any item of United States property which was acquired by the controlled foreign corporation before the first day on which such corporation was treated as a controlled foreign corporation. The aggregate amount of property disregarded under the preceding sentence shall not exceed the portion of the applicable earnings of such controlled foreign corporation which were accumulated during periods before such first day.
(3) Special rule where corporation ceases to be controlled foreign corporation.--If any foreign corporation ceases to be a controlled foreign corporation during any taxable year--

(A) the determination of any United States shareholder's pro rata share shall be made on the basis of stock owned (within the meaning of section 958(a)) by such shareholder on the last day during the taxable year on which the foreign corporation is a controlled foreign corporation,

(B) the average referred to in subsection (a)(1)(A) for such taxable year shall be determined by only taking into account quarters ending on or before such last day, and

(C) in determining applicable earnings, the amount taken into account by reason of being described in paragraph (2) of section 316(a) shall be the portion of the amount so described which is allocable (on a pro rata basis) to the part of such year during which the corporation is a controlled foreign corporation.

(c) United States property defined.--

(1) In general.--For purposes of subsection (a), the term "United States property" means any property acquired after December 31, 1962, which is--

(A) tangible property located in the United States;

(B) stock of a domestic corporation;

(C) an obligation of a United States person; or

(D) any right to the use in the United States of--

(i) a patent or copyright,
(ii) an invention, model, or design (whether or not patented),
(iii) a secret formula or process, or
(iv) any other similar property right,

which is acquired or developed by the controlled foreign corporation for use in the United States.

(2) Exceptions.--For purposes of subsection (a), the term "United States property" does not include--

(A) obligations of the United States, money, or deposits with--

(i) any bank (as defined by section 2(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(c)), without regard to subparagraphs (C) and (G) of paragraph (2) of such section), or
(ii) any corporation not described in clause (i) with respect to which a bank holding company (as defined by section 2(a) of such Act) or financial holding company (as defined by section 2(p) of such Act) owns directly or indirectly more than 80 percent by vote or value of the stock of such corporation;

(B) property located in the United States which is purchased in the United States for export to, or use in, foreign countries;

(C) any obligation of a United States person arising in connection with the sale or processing of property if the amount of such obligation outstanding at no time during the taxable year exceeds the amount which would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person had the sale or processing transaction been made between unrelated persons;

(D) any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States;

(E) an amount of assets of an insurance company equivalent to the unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business attributable to contracts which are not contracts described in section 953(a)(1);

(F) the stock or obligations of a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation, nor a domestic corporation, 25 percent or more of the total combined voting power of which, immediately after the acquisition of any stock in such domestic corporation by the controlled foreign corporation, is owned, or is considered as being owned, by such United States shareholders in the aggregate;

(G) any movable property (other than a vessel or aircraft) which is used for the purpose of exploring for, developing, removing, or transporting resources from ocean waters or under such waters when used on the Continental Shelf of the United States;

(H) an amount of assets of the controlled foreign corporation equal to the earnings and profits accumulated after

December 31, 1962, and excluded from subpart F income under section 952(b);

(I) to the extent provided in regulations prescribed by the Secretary, property which is otherwise United States property which is held by a FSC and which is related to the export activities of such FSC;

(J) deposits of cash or securities made or received on commercial terms in the ordinary course of a United States or foreign person's business as a dealer in securities or in commodities, but only to the extent such deposits are made or received as collateral or margin for (i) a securities loan, notional principal contract, options contract, forward contract, or futures contract, or (ii) any other financial transaction in which the Secretary determines that it is customary to post collateral or margin;

(K) an obligation of a United States person to the extent the principal amount of the obligation does not exceed the fair market value of readily marketable securities sold or purchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of its business by a United States or foreign person which is a dealer in securities or commodities;

(L) securities acquired and held by a controlled foreign corporation in the ordinary course of its business as a dealer in securities if--

(i) the dealer accounts for the securities as securities held primarily for sale to customers in the ordinary course of business, and
(ii) the dealer disposes of the securities (or such securities mature while held by the dealer) within a period consistent with the holding of securities for sale to customers in the ordinary course of business; and

(M) an obligation of a United States person which--

(i) is not a domestic corporation, and
(ii) is not--

(I) a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation, or
(II) a partnership, estate, or trust in which the controlled foreign corporation, or any related person (as defined in section 954(d)(3)), is a partner, beneficiary, or trustee immediately after the acquisition of any obligation of such partnership, estate, or trust by the controlled foreign corporation.

For purposes of subparagraphs (J), (K), and (L), the term "dealer in securities" has the meaning given such term by section 475(c)(1), and the term "dealer in commodities" has the meaning given such term by section 475(e), except that such term shall include a futures commission merchant.

(3) Certain trade or service receivables acquired from related United States persons.--

(A) In general.--Notwithstanding paragraph (2) (other than subparagraph (H) thereof), the term "United States property" includes any trade or service receivable if--

(i) such trade or service receivable is acquired (directly or indirectly) from a related person who is a United States person, and
(ii) the obligor under such receivable is a United States person.

(B) Definitions.--For purposes of this paragraph, the term "trade or service receivable" and "related person" have the respective meanings given to such terms by section 864(d).

(d) Pledges and guarantees.--For purposes of subsection (a), a controlled foreign corporation shall, under regulations prescribed by the Secretary, be considered as holding an obligation of a United States person if such controlled foreign corporation is a pledgor or guarantor of such obligation.

(e) Regulations.--The Secretary shall prescribe such regulations as may be necessary to carry out the purposes of this section, including regulations to prevent the avoidance of the provisions of this section through reorganizations or otherwise.

26 U.S.C. § 959(a) (eff. to Dec. 21, 2017). Exclusion from gross income of previously taxed earnings and profits.

(a) Exclusion from gross income of United States persons.--For purposes of this chapter, the earnings and profits of a foreign corporation attributable to amounts which are, or have been, included in the gross income of a United States shareholder under section 951(a) shall not, when--

> (1) such amounts are distributed to, or
>
> (2) such amounts would, but for this subsection, be included under section 951(a)(1)(B) in the gross income of,

such shareholder (or any other United States person who acquires from any person any portion of the interest of such United States shareholder in such foreign corporation, but only to the extent of such portion, and subject to such proof of the identity of such interest as the Secretary may by regulations prescribe) directly or indirectly through a chain of ownership described under section 958(a), be again included in the gross income of such United States shareholder (or of such other United States person). The rules of subsection (c) shall apply for purposes of paragraph (1) of this subsection and the rules of subsection (f) shall apply for purposes of paragraph (2) of this subsection.

. . . .

26 U.S.C. § 960(a) (eff. to Aug. 9, 2010). Special rules for foreign tax credit.

(a) Taxes paid by a foreign corporation.--

(1) Deemed paid credit.--For purposes of subpart A of this part, if there is included under section 951(a) in the gross income of a domestic corporation any amount attributable to earnings and profits of a foreign corporation which is a member of a qualified group (as defined in section 902(b)) with respect to the domestic corporation, then, except to the extent provided in regulations, section 902 shall be applied as if the amount so included were a dividend paid by such foreign corporation (determined by applying section 902(c) in accordance with section 904(d)(3)(B)).

(2) Taxes previously deemed paid by domestic corporation.--If a domestic corporation receives a distribution from a foreign corporation, any portion of which is excluded from gross income under section 959, the income, war profits, and excess profits taxes paid or deemed paid by such foreign corporation to any foreign country or to any possession of the United States in connection with the earnings and profits of such foreign corporation from which such distribution is made shall not be taken into account for purposes of section 902, to the extent such taxes were deemed paid by a domestic corporation under paragraph (1) for any prior taxable year.

(3) Taxes paid by foreign corporation and not previously deemed paid by domestic corporation.--Any portion of a distribution from a foreign corporation received by a domestic corporation which is excluded from gross income under section 959(a) shall be treated by the domestic corporation as a dividend, solely for purposes of taking into account under section 902 any income, war profits, or excess profits taxes paid to any foreign country or to any possession of the United States, on or with respect to the accumulated profits of such foreign corporation from which such

distribution is made, which were not deemed paid by the domestic corporation under paragraph (1) for any prior taxable year.

. . . .

26 U.S.C. § 1248(a) (eff. to Dec. 21, 2017). Gain from certain sales or exchanges of stock in certain foreign corporations.

(a) General rule.--If--

> (1) a United States person sells or exchanges stock in a foreign corporation, and
>
> (2) such person owns, within the meaning of section 958(a), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale or exchange when such foreign corporation was a controlled foreign corporation (as defined in section 957),

then the gain recognized on the sale or exchange of such stock shall be included in the gross income of such person as a dividend, to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock sold or exchanged was held by such person while such foreign corporation was a controlled foreign corporation. For purposes of this section, a United States person shall be treated as having sold or exchanged any stock if, under any provision of this subtitle, such person is treated as realizing gain from the sale or exchange of such stock.

. . . .

26 U.S.C. § 6501. Limitations on assessment and collection.

. . .

(e) Substantial omission of items.--Except as otherwise provided in subsection (c)--

(1) Income taxes.--In the case of any tax imposed by subtitle A--

. . .

(C) Constructive dividends.-- If the taxpayer omits from gross income an amount properly includible therein under section 951(a), the tax may be assessed, or a proceeding in court for the collection of such tax may be done without assessing, at any time within 6 years after the return was filed.

. . . .

26 U.S.C. § 7806. Construction of title.

(a) Cross references.--The cross references in this title to other portions of the title, or other provisions of law, where the word "see" is used, are made only for convenience, and shall be given no legal effect.

(b) Arrangement and classification.--No inference, implication, or presumption of legislative construction shall be drawn or made by reason of the location or grouping of any particular section or provision or portion of this title, nor shall any table of contents, table of cross references, or similar outline, analysis, or descriptive matter relating to the contents of this title be given any legal effect. The preceding sentence also applies to the sidenotes and ancillary tables contained in the various prints of this Act before its enactment into law.

26 C.F.R. § 1.338-8(h)(4)(i). Asset and stock consistency.

(4) Certain distributions—(i) General rule. In the case of a target affiliate that is a controlled foreign corporation, paragraph (g) of this section applies with respect to the target affiliate by treating any reference to a dividend to which section 243(a)(3) applies as a reference to any amount taken into account under § 1.1502–32 in determining the basis of target stock that is—
(A) A dividend;
(B) An amount treated as a dividend under section 1248 (or that would have been so treated but for section 1291); or
(C) An amount included in income under section 951(a)(1)(B).

. . . .

26 C.F.R. § 1.385-3(c)(3)(i)(C)(3)(ii). Transactions in which debt proceeds are distributed or that have a similar effect.

(ii) Dividend. For purposes of paragraph (c)(3)(i)(C)(3)(i) of this section, the term dividend has the meaning specified in section 316, including the portion of gain recognized under section 1248 that is treated as a dividend and deemed dividends under section 367(b) and the regulations thereunder. In addition, the term dividend includes inclusions with respect to stock (for example, inclusions under sections 951(a) and 1293).

. . . .

26 C.F.R. § 1.865-2(d)(2). Loss with respect to stock.

(2) Dividend recapture amount. A dividend recapture amount is a dividend (except for an amount treated as a dividend under section 78), an inclusion described in section 951(a)(1)(A)(i) (but only to the extent attributable to a dividend (including a dividend under section 964(e)(1)) included in the earnings of a controlled foreign corporation (held directly or indirectly by the person recognizing the loss) that is included in foreign personal holding company income under section 954(c)(1)(A)) and an inclusion described in section 951(a)(1)(B).

. . . .

26 C.F.R. § 1.904-5(m)(4). Look-through rules as applied to controlled foreign corporations and other entities.

. . .

(4) Dividends—(i) Look-through rule for controlled foreign corporations. Any dividend paid or accrued out of the earnings and profits of any controlled foreign corporation, shall be treated as income in a separate category in proportion to the ratio of the portion of earnings and profits attributable to income in such category to the total amount of earnings and profits of the controlled foreign corporation. For purposes of this paragraph, the term “dividend” includes any amount included in gross income under section 951(a)(1)(B) as a pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.
. . . .

26 C.F.R. § 1.956-1 (eff. to June 23, 2008). Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(a) In general. Section 956(a)(1) and paragraph (b) of this section provide rules for determining the amount of a controlled foreign corporation's earnings invested in United States property at the close of any taxable year. Such amount is the aggregate amount invested in United States property to the extent such amount would have constituted a dividend if it had been distributed on such date. Subject to the provisions of section 951(a)(4) and the regulations thereunder, a United States shareholder of a controlled foreign corporation is required to include in his gross income his pro rata share, as determined in accordance with paragraph (c) of this section, of the controlled foreign corporation's increase for any taxable year in earnings invested in United States property but only to the extent such share is not excludable from his gross income under the provisions of section 959(a)(2) and the regulations thereunder.

(b) Amount of a controlled foreign corporation's investment of earnings in United States property—(1) Dividend limitation. The amount of a controlled foreign corporation's earnings invested at the close of its taxable year in United States property is the aggregate amount of such property held, directly or indirectly, by such corporation at the close of its taxable year to the extent such amount would have constituted a dividend under section 316 and §§ 1.316–1 and 1.316–2 (determined after the application of section 955(a)) if it had been distributed on such closing day. For purposes of this subparagraph, the determination of whether an amount would have constituted a dividend if distributed shall be made without regard to the provisions of section 959(d) and the regulations thereunder.

(2) Aggregate amount of United States property. For purposes of determining an increase in earnings invested in United States property for any taxable year beginning after December 31, 1975,

the aggregate amount of United States property held by a controlled foreign corporation at the close of—

(i) Any taxable year beginning after December 31, 1975, and
(ii) The last taxable year beginning before January 1, 1976 does not include stock or obligations of a domestic corporation described in section 956(b)(2)(F) or movable property described in section 956(b)(2)(G).

(3) Treatment of earnings and profits. For purposes of making the determination under subparagraph (1) of this paragraph as to whether an amount of investment would have constituted a dividend if distributed at the close of any taxable year of a controlled foreign corporation, earnings and profits of the controlled foreign corporation shall be considered not to include any amounts which are attributable to—

(i) Amounts which have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2)) and have not been distributed, or
(ii)(a) Amounts which are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or

(b) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subparagraph apply only in determining the limitation on a controlled foreign corporation's increase in earnings invested in United States property. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(4) [Reserved]

(c) Shareholder's pro rata share of increase—(1) General rule. A United States shareholder's pro rata share of a controlled foreign corporation's increase for any taxable year in earnings invested in United States property is the amount determined by subtracting the shareholder's pro rata share of—

(i) The controlled foreign corporation's earnings invested in United States property at the close of its preceding taxable year, as determined under paragraph (b) of this section, reduced by amounts paid by such corporation during such preceding taxable year to which section 959(c)(1) and the regulations thereunder apply, from his pro rata share of
(ii) The controlled foreign corporation's earnings invested in United States property at the close of its current taxable year, as determined under paragraph (b) of this section.

(2) Illustration. The application of this paragraph may be illustrated by the following examples:
Example 1. A is a United States shareholder and direct owner of 60 percent of the only class of stock of R Corporation, a controlled foreign corporation during the entire period here involved. Both A and R Corporation use the calendar year as a taxable year. Corporation R's aggregate investment in United States property on December 31, 1964, which would constitute a dividend (as determined under paragraph (b) of this section) if distributed on such date is $150,000. During the taxable year 1964, R Corporation distributed $50,000 to which section 959(c)(1) applies. Corporation R's aggregate investment in United States property on December 31, 1965, is $250,000; and R Corporation's current and accumulated earnings and profits on such date (determined as provided in paragraph (b) of this section) are $225,000. A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property is $75,000, determined as follows:

(i) Aggregate investment in United States property on December 31, 1965 ....$250,000

(ii) Current and accumulated earnings and profits on December 31, 1965 225,000

(iii) Amount of earnings invested in United States property on December 31, 1965, which would constitute a dividend if distributed on such date (lesser of item (i) or item (ii))...225,000

(iv) Aggregate investment in United States property on December 31, 1964, which would constitute a dividend if distributed on such date..$150,000

Less: Amounts distributed during 1964 to which sec. 959(c)(1) applies.............50,000..................100,000

(v) R Corporation's increase for 1965 in earnings invested in United States property (item (iii) minus item (iv)).....125,000

(vi) A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property (item (v) times 60 percent) 75,000

Example 2. The facts are the same as in example 1, except that R Corporation's current and accumulated earnings and profits on December 31, 1965, are $100,000 instead of $225,000. Accordingly, even through R Corporation's aggregate investment in United States property on December 31, 1965, of $250,000 exceeds the net amount ($100,000) taken into account under subparagraph (1)(i) of this paragraph as of December 31, 1964, by $150,000, there is no increase for taxable year 1965 in earnings invested in United States property because of the dividend limitation of paragraph (b)(1) of this section. Corporation R's aggregate investment in United States property on December 31, 1966, is unchanged ($250,000). Corporation R's current and accumulated earnings and profits on December 31, 1966, are $175,000, and, as a consequence, its aggregate investment in United States property which would constitute a dividend if distributed on that

date is $175,000. Corporation R pays no amount during 1965 to which section 959(c)(1) applies. Corporation R's increase for the taxable year 1966 in earnings invested in United States property is $75,000, and A's pro rata share of that amount is $45,000 ($75,000 times 60 percent).

(d) Date and basis of determinations. The determinations made under paragraph (c)(1)(i) of this section with respect to the close of the preceding taxable year of a controlled foreign corporation and under paragraph (c)(1)(ii) with respect to the close of the current taxable year of such controlled foreign corporation, for purposes of determining the United States shareholder's pro rata share of such corporation's increased investment of earnings in United States property for the current taxable year, shall be made as of the last day of the current taxable year of such corporation but on the basis of stock owned, within the meaning of section 958(a) and the regulations thereunder, by such United States shareholder on the last day of the current taxable year of the foreign corporation on which such corporation is a controlled foreign corporation. See the last sentence of section 956(a)(2). The application of this paragraph may be illustrated from the following example:

Example. Domestic corporation M owns 60 percent of the only class of stock of A Corporation, a controlled foreign corporation during the entire period here involved. Both M Corporation and A Corporation use the calendar year as a taxable year. Corporation A's investment of earnings in United States property at the close of the taxable year 1963 is $100,000, as determined under paragraph (b) of this section, and M Corporation includes its pro rata share of such amount ($60,000) in gross income for its taxable year 1963. On June 1, 1964, M Corporation acquires an additional 25 percent of A Corporation's outstanding stock from a person who is not a United States person as defined in section 957(d). Corporation A's investment of earnings in United States property at the close of the taxable year 1964, as determined under paragraph (b) of this section, is unchanged ($100,000). Corporation A pays no amount during 1963 to which section 959(c)(1) applies. Corporation M is not required, by reason of the acquisition in 1964 of A Corporation's stock, to include an additional amount in its gross income with respect to A Corporation's investment of earnings in United States property even though the earnings invested in United States property

by A Corporation attributable to the stock acquired by M Corporation were not previously taxed. The determination made under paragraph (c)(1)(i) of this section as well as the determination made under paragraph (c)(1)(ii) of this section with respect to A Corporation's investment for 1964 of earnings in United States property are made on the basis of stock owned by M Corporation (85 percent) at the close of 1964.

(e) Amount attributable to property—(1) General rule. Except as provided in subparagraph (2) of this paragraph, for purposes of paragraph (b)(1) of this section the amount taken into account with respect to any United States property shall be its adjusted basis, as of the applicable determination date, reduced by any liability (other than a liability described in subparagraph (3) of this paragraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items at such time. A liability in excess of the adjusted basis of the property which is subject to such liability shall not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability.

(2) Rule for pledges and guarantees. For purposes of this section the amount taken into account with respect to any pledge or guarantee described in paragraph (c)(1) of § 1.956–2 shall be the unpaid principal amount on the applicable determination date of the obligation with respect to which the controlled foreign corporation is a pledgor or guarantor.

(3) Excluded charges. For purposes of subparagraph (1) of this paragraph, a specific charge created with respect to any item of

property principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's investment of earnings in United States property will not be recognized; whether a specific charge is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of § 1.954–1.

(4) Statement required. If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes United States property on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

26 C.F.R. § 1.956-1 (eff. June 24, 2008 to June 23, 2011). Shareholder's pro rata share of a controlled foreign corporation's increase in earnings invested in United States property.

(a) In general. Section 956(a)(1) and paragraph (b) of this section provide rules for determining the amount of a controlled foreign corporation's earnings invested in United States property at the close of any taxable year. Such amount is the aggregate amount invested in United States property to the extent such amount would have constituted a dividend if it had been distributed on such date. Subject to the provisions of section 951(a)(4) and the regulations thereunder, a United States shareholder of a controlled foreign corporation is required to include in his gross income his pro rata share, as determined in accordance with paragraph (c) of this section, of the controlled foreign corporation's increase for any taxable year in earnings invested in United States property but only to the extent such share is not excludable from his gross income under the provisions of section 959(a)(2) and the regulations thereunder.

(b) Amount of a controlled foreign corporation's investment of earnings in United States property—(1) Dividend limitation. The amount of a controlled foreign corporation's earnings invested at the close of its taxable year in United States property is the aggregate amount of such property held, directly or indirectly, by such corporation at the close of its taxable year to the extent such amount would have constituted a dividend under section 316 and §§ 1.316–1 and 1.316–2 (determined after the application of section 955(a)) if it had been distributed on such closing day. For purposes of this subparagraph, the determination of whether an amount would have constituted a dividend if distributed shall be made without regard to the provisions of section 959(d) and the regulations thereunder.

(2) Aggregate amount of United States property. For purposes of determining an increase in earnings invested in United States property for any taxable year beginning after December 31, 1975, the aggregate amount of United States property held by a controlled foreign corporation at the close of—

(i) Any taxable year beginning after December 31, 1975, and
(ii) The last taxable year beginning before January 1, 1976 does not include stock or obligations of a domestic corporation described in section 956(b)(2)(F) or movable property described in section 956(b)(2)(G).

(3) Treatment of earnings and profits. For purposes of making the determination under subparagraph (1) of this paragraph as to whether an amount of investment would have constituted a dividend if distributed at the close of any taxable year of a controlled foreign corporation, earnings and profits of the controlled foreign corporation shall be considered not to include any amounts which are attributable to—

(i) Amounts which have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 951(a)(1)(B) (or which would have been so included but for section 959(a)(2)) and have not been distributed, or
(ii)(a) Amounts which are included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) or would be so included under such section but for the fact that such amounts were distributed to such shareholder during the taxable year, or
(b) Amounts which, for any prior taxable year, have been included in the gross income of a United States shareholder of such controlled foreign corporation under section 551(b) and have not been distributed.

The rules of this subparagraph apply only in determining the limitation on a controlled foreign corporation's increase in earnings invested in United States property. See section 959 and the regulations thereunder for limitations on the exclusion from gross income of previously taxed earnings and profits.

(4) [Reserved]

(c) Shareholder's pro rata share of increase—(1) General rule. A United States shareholder's pro rata share of a controlled foreign corporation's increase for any taxable year in earnings invested in United States property is the amount determined by subtracting the shareholder's pro rata share of—

> (i) The controlled foreign corporation's earnings invested in United States property at the close of its preceding taxable year, as determined under paragraph (b) of this section, reduced by amounts paid by such corporation during such preceding taxable year to which section 959(c)(1) and the regulations thereunder apply, from his pro rata share of
> (ii) The controlled foreign corporation's earnings invested in United States property at the close of its current taxable year, as determined under paragraph (b) of this section.

(2) Illustration. The application of this paragraph may be illustrated by the following examples:

Example 1. A is a United States shareholder and direct owner of 60 percent of the only class of stock of R Corporation, a controlled foreign corporation during the entire period here involved. Both A and R Corporation use the calendar year as a taxable year. Corporation R's aggregate investment in United States property on December 31, 1964, which would constitute a dividend (as determined under paragraph (b) of this section) if distributed on such date is $150,000. During the taxable year 1964, R Corporation distributed $50,000 to which section 959(c)(1) applies. Corporation R's aggregate investment in United States property on December 31, 1965, is $250,000; and R Corporation's current and accumulated earnings and profits on such date (determined as provided in paragraph (b) of this section) are $225,000. A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property is $75,000, determined as follows:

(i) Aggregate investment in United States property on December 31, 1965..$250,000

(ii) Current and accumulated earnings and profits on December 31, 1965……………………………………………………………………225,000

(iii) Amount of earnings invested in United States property on December 31, 1965, which would constitute a dividend if distributed on such date (lesser of item (i) or item (ii))…………………………225,000

(iv) Aggregate investment in United States property on December 31, 1964, which would constitute a dividend if distributed on such date ………..$150,000

Less: Amounts distributed during 1964 to which sec. 959(c)(1) applies………………………………………..50,000…………100,000

(v) R Corporation's increase for 1965 in earnings invested in United States property (item (iii) minus item (iv))………………………125,000

(vi) A's pro rata share of R Corporation's increase for 1965 in earnings invested in United States property (item (v) times 60 percent)….75,000

Example 2. The facts are the same as in example 1, except that R Corporation's current and accumulated earnings and profits on December 31, 1965, are $100,000 instead of $225,000. Accordingly, even through R Corporation's aggregate investment in United States property on December 31, 1965, of $250,000 exceeds the net amount ($100,000) taken into account under subparagraph (1)(i) of this paragraph as of December 31, 1964, by $150,000, there is no increase for taxable year 1965 in earnings invested in United States property because of the dividend limitation of paragraph (b)(1) of this section. Corporation R's aggregate investment in United States property on December 31, 1966, is unchanged ($250,000). Corporation R's current and accumulated earnings and profits on December 31, 1966, are $175,000, and, as a consequence, its aggregate investment in United States property which would constitute a dividend if distributed on that date is $175,000. Corporation R pays no amount during 1965 to which section 959(c)(1) applies. Corporation R's increase for the taxable year 1966 in earnings invested in United States property is $75,000, and A's pro rata share of that amount is $45,000 ($75,000 times 60 percent).

(d) Date and basis of determinations. The determinations made under paragraph (c)(1)(i) of this section with respect to the close of the preceding taxable year of a controlled foreign corporation and under paragraph (c)(1)(ii) with respect to the close of the current taxable year of such controlled foreign corporation, for purposes of determining the United States shareholder's pro rata share of such corporation's increased investment of earnings in United States property for the current taxable year, shall be made as of the last day of the current taxable year of such corporation but on the basis of stock owned, within the meaning of section 958(a) and the regulations thereunder, by such United States shareholder on the last day of the current taxable year of the foreign corporation on which such corporation is a controlled foreign corporation. See the last sentence of section 956(a)(2). The application of this paragraph may be illustrated from the following example:

Example. Domestic corporation M owns 60 percent of the only class of stock of A Corporation, a controlled foreign corporation during the entire period here involved. Both M Corporation and A Corporation use the calendar year as a taxable year. Corporation A's investment of earnings in United States property at the close of the taxable year 1963 is $100,000, as determined under paragraph (b) of this section, and M Corporation includes its pro rata share of such amount ($60,000) in gross income for its taxable year 1963. On June 1, 1964, M Corporation acquires an additional 25 percent of A Corporation's outstanding stock from a person who is not a United States person as defined in section 957(d). Corporation A's investment of earnings in United States property at the close of the taxable year 1964, as determined under paragraph (b) of this section, is unchanged ($100,000). Corporation A pays no amount during 1963 to which section 959(c)(1) applies. Corporation M is not required, by reason of the acquisition in 1964 of A Corporation's stock, to include an additional amount in its gross income with respect to A Corporation's investment of earnings in United States property even though the earnings invested in United States property by A Corporation attributable to the stock acquired by M Corporation were not previously taxed. The determination made under paragraph (c)(1)(i) of this section as well as the determination made under paragraph (c)(1)(ii) of this section with respect to A Corporation's

investment for 1964 of earnings in United States property are made on the basis of stock owned by M Corporation (85 percent) at the close of 1964.

(e) Amount attributable to property—(1) General rule. Except as provided in subparagraph (2) of this paragraph, for purposes of paragraph (b)(1) of this section the amount taken into account with respect to any United States property shall be its adjusted basis, as of the applicable determination date, reduced by any liability (other than a liability described in subparagraph (3) of this paragraph) to which such property is subject on such date. To be taken into account under this subparagraph, a liability must constitute a specific charge against the property involved. Thus, a liability evidenced by an open account or a liability secured only by the general credit of the controlled foreign corporation will not be taken into account. On the other hand, if a liability constitutes a specific charge against several items of property and cannot definitely be allocated to any single item of property, the liability shall be apportioned against each of such items of property in that ratio which the adjusted basis of such item on the applicable determination date bears to the adjusted basis of all such items at such time. A liability in excess of the adjusted basis of the property which is subject to such liability shall not be taken into account for the purpose of reducing the adjusted basis of other property which is not subject to such liability. See § 1.956–1T(e)(6) for a special rule for determining amounts attributable to United States property acquired as the result of certain nonrecognition transactions.

(2) Rule for pledges and guarantees. For purposes of this section the amount taken into account with respect to any pledge or guarantee described in paragraph (c)(1) of § 1.956–2 shall be the unpaid principal amount on the applicable determination date of the obligation with respect to which the controlled foreign corporation is a pledgor or guarantor.

(3) Excluded charges. For purposes of subparagraph (1) of this paragraph, a specific charge created with respect to any item of property principally for the purpose of artificially increasing or decreasing the amount of a controlled foreign corporation's

investment of earnings in United States property will not be recognized; whether a specific charge is created principally for such purpose will depend upon all the facts and circumstances of each case. One of the factors that will be considered in making such a determination with respect to a loan is whether the loan is from a related person, as defined in section 954(d)(3) and paragraph (e) of § 1.954–1.

(4) Statement required. If for purposes of this section a United States shareholder of a controlled foreign corporation reduces the adjusted basis of property which constitutes United States property on the ground that such property is subject to a liability, he shall attach to his return a statement setting forth the adjusted basis of the property before the reduction and the amount and nature of the reduction.

(e)(5), (e)(6) [Reserved]. For further guidance, see § 1.956–1T(e)(5) and (e)(6).

(f) Effective/applicability dates. (1) Paragraph (e)(5) of this section is effective June 14, 1988, with respect to investments made on or after June 14, 1988. Paragraph (e)(6) of this section applies to nonrecognition property acquired in exchanges occurring on or after June 24, 2008.

26 C.F.R. § 1.956-2 (eff. to July 2, 2008). Definition of United States property.

(a) Included property—(1) In general. For purposes of section 956(a) and § 1.956–1, United States property is (except as provided in paragraph (b) of this section) any property acquired (within the meaning of paragraph (d)(1) of this section) by a foreign corporation (whether or not a controlled foreign corporation at the time) during any taxable year of such foreign corporation beginning after December 31, 1962, which is—

(i) Tangible property (real or personal) located in the United States;

(ii) Stock of a domestic corporation;

(iii) An obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)); or

(iv) Any right to the use in the United States of—

(a) A patent or copyright,

(b) An invention, model, or design (whether or not patented),

(c) A secret formula or process, or

(d) Any other similar property right, which is acquired or developed by the foreign corporation for use in the United States by any person. Whether a right described in this subdivision has been acquired or developed for use in the United States by any person is to be determined from all the facts and circumstances of each case. As a general rule, a right actually used principally in the United States will be considered to have been acquired or developed for use in the United States in the absence of affirmative evidence showing that the right was not so acquired or developed for such use.

(2) Illustrations. The application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation R uses as a taxable year a fiscal year ending on June 30. Corporation R acquires on June 1, 1963, and holds on June 30, 1963, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States. Corporation R's aggregate investment in United States property at the close of its taxable year ending June 30, 1963, is zero since the property which is acquired on June 1, 1963, is not acquired during a taxable year of R Corporation beginning after December 31, 1962. Assuming no change in R Corporation's aggregate investment in United States property during its taxable year ending June 30, 1964, R Corporation's increase in earnings invested in United States property for such taxable year is zero.

Example 2. Foreign corporation S uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable year 1965. Corporation S is not a controlled foreign corporation at any time during its taxable years 1963 and 1964. Corporation S owns on December 31, 1964, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States which it acquires during taxable years beginning after December 31, 1962. Corporation S's aggregate investment in United States property on December 31, 1964, is $100,000. Corporation S's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956–1) as of December 31, 1964, are in excess of $100,000. Assuming no change in S Corporation's aggregate investment in United States property during its taxable year 1965, S Corporation's increase in earnings invested in United States property for such taxable year is zero.

Example 3. Foreign corporation T uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable years 1963, 1964, and 1966. At December 31, 1964, T Corporation's investment in United States property is $100,000. Corporation T is not a controlled foreign corporation at any time during its taxable year 1965 in which it acquires $25,000 of tangible property (not described in section 956(b)(2)) located in the United States. On December 31, 1965, T

Corporation holds the United States property of $100,000 which it held on December 31, 1964, and, in addition, the United States property acquired in 1965. Corporation T's aggregate investment in United States property at December 31, 1965, is $125,000. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956–1) as of December 31, 1965, are in excess of $125,000, and T Corporation pays no amount during 1965 to which section 959(c)(1) applies. Assuming no change in T Corporation's aggregate investment in United States property during its taxable year 1966, T Corporation's increase in earnings invested in United States property for such taxable year is zero.

(3) Property owned through partnership. For purposes of section 956, if a controlled foreign corporation is a partner in a partnership that owns property that would be United States property, within the meaning of paragraph (a)(1) of this section, if owned directly by the controlled foreign corporation, the controlled foreign corporation will be treated as holding an interest in the property equal to its interest in the partnership and such interest will be treated as an interest in United States property. This paragraph (a)(3) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(b) Exceptions—(1) Excluded property. For purposes of section 956(a) and paragraph (a) of this section, United States property does not include the following types of property held by a foreign corporation:

(i) Obligations of the United States.

(ii) Money.

(iii) Deposits with persons carrying on the banking business, unless the deposits serve directly or indirectly as a pledge or guarantee within the meaning of paragraph (c) of this section. See paragraph (e)(2) of § 1.956–1.

(iv) Property located in the United States which is purchased in the United States for export to, or use in, foreign countries. For

purposes of this subdivision, property to be used outside the United States will be considered property to be used in a foreign country. Whether property is of a type described in this subdivision is to be determined from all the facts and circumstances in each case. Property which constitutes export trade assets within the meaning of section 971(c)(2) and paragraph (c)(3) of § 1.971–1 will be considered property of a type described in this subdivision.

(v) Any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) arising in connection with the sale or processing of property if the amount of such obligation outstanding at any time during the taxable year of the foreign corporation does not exceed an amount which is ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person, or, if the sale or processing transaction occurs between related persons, would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person if such persons were unrelated persons. Whether the amount of an obligation described in this subdivision is ordinary and necessary is to be determined from all the facts and circumstances in each case.

(vi) Any aircraft, railroad rolling stock, vessel, motor vehicle, or container used in the transportation of persons or property in foreign commerce and used predominantly outside the United States. Whether transportation property described in this subdivision is used in foreign commerce and predominantly outside the United States is to be determined from all the facts and circumstances in each case. As a general rule, such transportation property will be considered to be used predominantly outside the United States if 70 percent or more of the miles traversed (during the taxable year at the close of which a determination is made under section 956(a)(2)) in the use of such property are traversed outside the United States or if such

property is located outside the United States 70 percent of the time during such taxable year.

(vii) An amount of assets described in paragraph (a) of this section of an insurance company equivalent to the unearned premiums or reserves which are ordinary and necessary for the proper conduct of that part of its insurance business which is attributable to contracts other than those described in section 953(a)(1) and the regulations thereunder. For purposes of this subdivision, a reserve will be considered ordinary and necessary for the proper conduct of an insurance business if, under the principles of paragraph (c) of § 1.953–4, such reserve would qualify as a reserve required by law. See paragraph (d)(3) of § 1.954–2 for determining, for purposes of this subdivision, the meaning of insurance company and of unearned premiums.

(viii) For taxable years beginning after December 31, 1975, the voting or nonvoting stock or obligations of an unrelated domestic corporation. For purposes of this subdivision, an unrelated domestic corporation is a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation making the investment, nor a corporation 25 percent or more of whose total combined voting power of all classes of stock entitled to vote is owned or considered as owned (within the meaning of section 958(b)) by United States shareholders of the controlled foreign corporation making the investment. The determination of whether a domestic corporation is an unrelated corporation is made immediately after each acquisition of stock or obligations by the controlled foreign corporations.

(ix) For taxable years beginning after December 31, 1975, movable drilling rigs or barges and other movable exploration and exploitation equipment (other than a vessel or an aircraft) when used on the Continental Shelf (as defined in section 638) of the United States in the exploration for, development, removal, or transportation of natural resources from or under ocean waters. Property used on the Continental Shelf includes property located

in the United States which is being constructed or is in storage or in transit within the United States for use on the Continental Shelf. In general, the type of property which qualifies for the exception under this subdivision includes any movable property which would be entitled to the investment credit if used outside the United States in certain geographical areas of the Western Hemisphere pursuant to section 48(a)(2)(B)(x) (without reference to sections 49 and 50).

(x) An amount of—

> (a) A controlled foreign corporation's assets described in paragraph (a) of this section equivalent to its earnings and profits which are accumulated after December 31, 1962, and are attributable to items of income described in section 952(b) and the regulations thereunder, reduced by the amount of
>
> (b) The earnings and profits of such corporation which are applied in a taxable year of such corporation beginning after December 31, 1962, to discharge a liability on property, but only if the liability was in existence at the close of such corporation's taxable year immediately preceding its first taxable year beginning after December 31, 1962, and the property would have been United States property if it had been acquired by such corporation immediately before such discharge.

For purposes of this subdivision, distributions made by such corporation for any taxable year shall be considered first made out of earnings and profits for such year other than earnings and profits referred to in (a) of this subdivision.

(2) Statement required. If a United States shareholder of a controlled foreign corporation excludes any property from the United States property of such controlled foreign corporation on the ground that section 956(b)(2) applies to such excluded property, he shall attach to his return a statement setting forth,

by categories described in paragraph (a)(1) of this section, the amount of United States property of the controlled foreign corporation and, by categories described in subparagraph (1) of this paragraph, the amount of such property which is excluded.

(c) Treatment of pledges and guarantees—(1) General rule. Except as provided in subparagraph (4) of this paragraph, any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) with respect to which a controlled foreign corporation is a pledgor or guarantor shall be considered for purposes of section 956(a) and paragraph (a) of this section to be United States property held by such controlled foreign corporation.

(2) Indirect pledge or guarantee. If the assets of a controlled foreign corporation 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 will be considered a pledgor or guarantor of that obligation. For this purpose the pledge of stock of a controlled foreign corporation will be considered as the indirect pledge of the assets of the corporation if at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business. This paragraph (c)(2) applies only to pledges and guarantees which are made after September 8, 1980. For purposes of this paragraph (c)(2) a refinancing shall be considered as a new pledge or guarantee.

(3) Illustrations. The following examples illustrate the application of this paragraph (c):

Example 1. A, a United States person, borrows $100,000 from a bank in foreign country X on December 31, 1964. On the same date controlled foreign corporation R pledges its assets as security for A's performance

of A's obligation to repay such loan. The place at which or manner in which A uses the money is not material. For purposes of paragraph (b) of § 1.956–1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of § 1.956–1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example 2. The facts are the same as in example 1, except that R Corporation participates in the transaction, not by pledging its assets as security for A's performance of A's obligation to repay the loan, but by agreeing to buy for $100,000 at maturity the note representing A's obligation if A does not repay the loan. Separate arrangements are made with respect to the payment of the interest on the loan. The agreement of R Corporation to buy the note constitutes a guarantee of A's obligation. For purposes of paragraph (b) of § 1.956–1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of § 1.956–1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example 3. A, a United States person, borrows $100,000 from a bank on December 10, 1981, pledging 70 percent of the stock of X, a controlled foreign corporation, as collateral for the loan. A and X use the calendar year as their taxable year, in the loan agreement, among other things, A agrees not to cause or permit X Corporation to do any of the following without the consent of the bank:

(a) Borrow money or pledge assets, except as to borrowings in the ordinary course of business of X Corporation;

(b) Guarantee, assume, or become liable on the obligation of another, or invest in or lend funds to another;

(c) Merge or consolidate with any other corporation or transfer shares of any controlled subsidiary;

(d) Sell or lease (other than in the ordinary course of business) or otherwise dispose of any substantial part of its assets;

(e) Pay or secure any debt owing by X Corporation to A; and

(f) Pay any dividends, except in such amounts as may be required to make interest or principal payments on A's loan from the bank.

A retains the right to vote the stock unless a default occurs by A. Under paragraph (c)(2) of this section, the assets of X Corporation serve indirectly as security for A's performance of A's obligation to repay the loan and X Corporation will be considered a pledgor or guarantor with respect to that obligation. For purposes of paragraph (b) of § 1.956–1, X Corporation will be considered to hold A's obligation to repay the bank $100,000 and under paragraph (e)(2) of § 1.956–1, the amount taken into account in computing X Corporation's aggregate investment in United States property on December 31, 1981, is the unpaid principal amount of the obligation on that date.

(4) Special rule for certain conduit financing arrangements. The rule contained in subparagraph (1) of this paragraph shall not apply to a pledge or a guarantee by a controlled foreign corporation to secure the obligation of a United States person if such United States person is a mere conduit in a financing arrangement. Whether the United States person is a mere conduit in a financing arrangement will depend upon all the facts and circumstances in each case. A United States person will be considered a mere conduit in a financing arrangement in a case in which a controlled foreign corporation pledges stock of its subsidiary corporation, which is also a controlled foreign corporation, to secure the obligation of such United States person, where the following conditions are satisfied:

(i) Such United States person is a domestic corporation which is not engaged in the active conduct of a trade or business and has no substantial assets other than those arising out of its relending

of the funds borrowed by it on such obligation to the controlled foreign corporation whose stock is pledged; and

(ii) The assets of such United States person are at all times substantially offset by its obligation to the lender.

(d) Definitions—(1) Meaning of "acquired"—(i) Applicable rules. For purposes of this section—

(a) Property shall be considered acquired by a foreign corporation when such corporation acquires an adjusted basis in the property;

(b) Property which is an obligation of a United States person with respect to which a controlled foreign corporation is a pledgor or guarantor (within the meaning of paragraph (c) of this section) shall be considered acquired when the corporation becomes liable as a pledgor or guarantor or is otherwise considered a pledgor or guarantor (within the meaning of paragraph (c)(2) of this section); and

(c) Property shall not be considered acquired by a foreign corporation if—

(1) Such property is acquired in a transaction in which gain or loss would not be recognized under this chapter to such corporation if such corporation were a domestic corporation;
(2) The basis of the property acquired by the foreign corporation is the same as the basis of the property exchanged by such corporation; and
(3) The property exchanged by the foreign corporation was not United States property (as defined in paragraph (a)(1) of this section) but would have been such property if it had been acquired by such corporation immediately before such exchange.

(ii) Illustrations. The application of this subparagraph may be illustrated by the following examples:

Example 1. Foreign corporation R uses the calendar year as a taxable year and acquires before January 1, 1963, stock of domestic corporation M having as to R Corporation an adjusted basis of $10,000. The stock of M Corporation is not United States property of R Corporation on December 31, 1962, since it is not acquired in a taxable year of R Corporation beginning on or after January 1, 1963. On June 30, 1963, R Corporation sells the M Corporation stock for $15,000 in cash and expends such amount in acquiring stock of domestic corporation N which has as to R Corporation an adjusted basis of $15,000. For purposes of determining R Corporation's aggregate investment in United States property on December 31, 1963, R Corporation has, by virtue of acquiring the stock of N Corporation, acquired $15,000 of United States property.

Example 2. Foreign corporation S, a controlled foreign corporation for the entire period here involved, uses the calendar year as a taxable year and purchases for $100,000 on December 31, 1963, tangible property (not described in section 956(b)(2)) located in the United States and having a remaining estimated useful life of 10 years, subject to a mortgage of $80,000 payable in 5 annual installments. The property constitutes United States property as of December 31, 1963, and the amount taken into account for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of § 1.956–1 is $20,000. No depreciation is sustained with respect to the property during the taxable year 1963. During the taxable year 1964, S Corporation pays $16,000 on the mortgage and sustains $10,000 of depreciation with respect to the property. As of December 31, 1964, the amount taken into account with respect to the property for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of § 1.956–1 is $26,000, computed as follows:

Cost of property $100,000

Less: Reserve for depreciation 10,000

Adjusted basis of property....................................90,000

Less: Liability to which property is subject:
Gross amount of mortgage $80,000
Payment during 1964 16,000
64,000
Amount taken into account (12–31–64)...............................26,000

Example 3. Controlled foreign corporation T uses the calendar year as a taxable year and acquires on December 31, 1963, $10,000 of United States property not described in section 956(b)(2); no depreciation is sustained with respect to the property during 1963. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956–1) as of December 31, 1963, are in excess of $10,000, and T Corporation's United States shareholders include in their gross income under section 951(a)(1)(B) their pro rata share of T Corporation's increase ($10,000) for 1963 in earnings invested in United States property. On January 1, 1964, T Corporation acquires an additional $10,000 of United States property not described in section 956(b)(2). Each of the two items of property has an estimated useful life of 5 years, and T Corporation sustains $4,000 of depreciation with respect to such properties during its taxable year 1964. Corporation T's current and accumulated earnings and profits as of December 31, 1964, exceed $16,000, determined as provided in paragraph (b) of § 1.956–1. Corporation T pays no amounts during 1963 to which section 959(c)(1) applies. Corporation T's investment of earnings in United States property at December 31, 1964, is $16,000, and its increase for 1964 in earnings invested in United States property is $6,000.

Example 4. Foreign corporation U uses the calendar year as a taxable year and acquires before January 1, 1963, stock in domestic corporation M having as to U Corporation an adjusted basis of $10,000. On December 1, 1964, pursuant to a statutory merger described in section 368(a)(1), M Corporation merges into domestic corporation N, and U Corporation receives on such date one share of stock in N Corporation, the surviving corporation, for each share of stock it held in M Corporation. Pursuant to section 354 no gain or loss is recognized to U Corporation, and pursuant to section 358 the basis of the property received (stock of N Corporation) is the same as that of the property exchanged (stock of M Corporation). Corporation U is not considered for

purposes of section 956 to have acquired United States property by reason of its receipt of the stock in N Corporation.

Example 5. The facts are the same as in example 4, except that U Corporation acquires the stock of M Corporation on February 1, 1963, rather than before January 1, 1963. For purposes of determining U Corporation's aggregate investment in United States property on December 31, 1963, U Corporation has, by virtue of acquiring the stock of M Corporation, acquired $10,000 of United States property. Corporation U pays no amount during 1963 to which section 959(c)(1) applies. The reorganization and resulting acquisition on December 1, 1964, by U Corporation of N Corporation's stock also represents an acquisition of United States property; however, assuming no other change in U Corporation's aggregate investment in United States property during 1964, U Corporation's increase for such year in earnings invested in United States property is zero.

(2) [Reserved]

26 C.F.R. § 1.956-2 (eff. July 3, 2008 to May 5, 2011). Definition of United States property.

(a) Included property—(1) In general. For purposes of section 956(a) and § 1.956–1, United States property is (except as provided in paragraph (b) of this section) any property acquired (within the meaning of paragraph (d)(1) of this section) by a foreign corporation (whether or not a controlled foreign corporation at the time) during any taxable year of such foreign corporation beginning after December 31, 1962, which is—

(i) Tangible property (real or personal) located in the United States;

(ii) Stock of a domestic corporation;

(iii) An obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)); or

(iv) Any right to the use in the United States of—

(a) A patent or copyright,

(b) An invention, model, or design (whether or not patented),

(c) A secret formula or process, or

(d) Any other similar property right, which is acquired or developed by the foreign corporation for use in the United States by any person. Whether a right described in this subdivision has been acquired or developed for use in the United States by any person is to be determined from all the facts and circumstances of each case. As a general rule, a right actually used principally in the United States will be considered to have been acquired or developed for use in the United States in the absence of affirmative evidence showing that the right was not so acquired or developed for such use.

(2) Illustrations. The application of the provisions of this paragraph may be illustrated by the following examples:

Example 1. Foreign corporation R uses as a taxable year a fiscal year ending on June 30. Corporation R acquires on June 1, 1963, and holds on June 30, 1963, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States. Corporation R's aggregate investment in United States property at the close of its taxable year ending June 30, 1963, is zero since the property which is acquired on June 1, 1963, is not acquired during a taxable year of R Corporation beginning after December 31, 1962. Assuming no change in R Corporation's aggregate investment in United States property during its taxable year ending June 30, 1964, R Corporation's increase in earnings invested in United States property for such taxable year is zero.

Example 2. Foreign corporation S uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable year 1965. Corporation S is not a controlled foreign corporation at any time during its taxable years 1963 and 1964. Corporation S owns on December 31, 1964, $100,000 of tangible property (not described in section 956(b)(2)) located in the United States which it acquires during taxable years beginning after December 31, 1962. Corporation S's aggregate investment in United States property on December 31, 1964, is $100,000. Corporation S's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956–1) as of December 31, 1964, are in excess of $100,000. Assuming no change in S Corporation's aggregate investment in United States property during its taxable year 1965, S Corporation's increase in earnings invested in United States property for such taxable year is zero.

Example 3. Foreign corporation T uses the calendar year as a taxable year and is a controlled foreign corporation for its entire taxable years 1963, 1964, and 1966. At December 31, 1964, T Corporation's investment in United States property is $100,000. Corporation T is not a controlled foreign corporation at any time during its taxable year 1965 in which it acquires $25,000 of tangible property (not described in section 956(b)(2)) located in the United States. On December 31, 1965, T

Corporation holds the United States property of $100,000 which it held on December 31, 1964, and, in addition, the United States property acquired in 1965. Corporation T's aggregate investment in United States property at December 31, 1965, is $125,000. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956–1) as of December 31, 1965, are in excess of $125,000, and T Corporation pays no amount during 1965 to which section 959(c)(1) applies. Assuming no change in T Corporation's aggregate investment in United States property during its taxable year 1966, T Corporation's increase in earnings invested in United States property for such taxable year is zero.

(3) Property owned through partnership. For purposes of section 956, if a controlled foreign corporation is a partner in a partnership that owns property that would be United States property, within the meaning of paragraph (a)(1) of this section, if owned directly by the controlled foreign corporation, the controlled foreign corporation will be treated as holding an interest in the property equal to its interest in the partnership and such interest will be treated as an interest in United States property. This paragraph (a)(3) applies to taxable years of a controlled foreign corporation beginning on or after July 23, 2002.

(b) Exceptions—(1) Excluded property. For purposes of section 956(a) and paragraph (a) of this section, United States property does not include the following types of property held by a foreign corporation:

(i) Obligations of the United States.

(ii) Money.

(iii) Deposits with persons carrying on the banking business, unless the deposits serve directly or indirectly as a pledge or guarantee within the meaning of paragraph (c) of this section. See paragraph (e)(2) of § 1.956–1.

(iv) Property located in the United States which is purchased in the United States for export to, or use in, foreign countries. For

purposes of this subdivision, property to be used outside the United States will be considered property to be used in a foreign country. Whether property is of a type described in this subdivision is to be determined from all the facts and circumstances in each case. Property which constitutes export trade assets within the meaning of section 971(c)(2) and paragraph (c)(3) of § 1.971–1 will be considered property of a type described in this subdivision.

(v) Any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) arising in connection with the sale or processing of property if the amount of such obligation outstanding at any time during the taxable year of the foreign corporation does not exceed an amount which is ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person, or, if the sale or processing transaction occurs between related persons, would be ordinary and necessary to carry on the trade or business of both the other party to the sale or processing transaction and the United States person if such persons were unrelated persons. Whether the amount of an obligation described in this subdivision is ordinary and necessary is to be determined from all the facts and circumstances in each case.

(vi) [Reserved]. For further guidance, see § 1.956–2T(b)(1)(vi).

(vii) An amount of assets described in paragraph (a) of this section of an insurance company equivalent to the unearned premiums or reserves which are ordinary and necessary for the proper conduct of that part of its insurance business which is attributable to contracts other than those described in section 953(a)(1) and the regulations thereunder. For purposes of this subdivision, a reserve will be considered ordinary and necessary for the proper conduct of an insurance business if, under the principles of paragraph (c) of § 1.953–4, such reserve would qualify as a reserve required by law. See paragraph (d)(3) of § 1.954–2 for determining, for

purposes of this subdivision, the meaning of insurance company and of unearned premiums.

(viii) For taxable years beginning after December 31, 1975, the voting or nonvoting stock or obligations of an unrelated domestic corporation. For purposes of this subdivision, an unrelated domestic corporation is a domestic corporation which is neither a United States shareholder (as defined in section 951(b)) of the controlled foreign corporation making the investment, nor a corporation 25 percent or more of whose total combined voting power of all classes of stock entitled to vote is owned or considered as owned (within the meaning of section 958(b)) by United States shareholders of the controlled foreign corporation making the investment. The determination of whether a domestic corporation is an unrelated corporation is made immediately after each acquisition of stock or obligations by the controlled foreign corporations.

(ix) For taxable years beginning after December 31, 1975, movable drilling rigs or barges and other movable exploration and exploitation equipment (other than a vessel or an aircraft) when used on the Continental Shelf (as defined in section 638) of the United States in the exploration for, development, removal, or transportation of natural resources from or under ocean waters. Property used on the Continental Shelf includes property located in the United States which is being constructed or is in storage or in transit within the United States for use on the Continental Shelf. In general, the type of property which qualifies for the exception under this subdivision includes any movable property which would be entitled to the investment credit if used outside the United States in certain geographical areas of the Western Hemisphere pursuant to section 48(a)(2)(B)(x) (without reference to sections 49 and 50).

(x) An amount of—

> (a) A controlled foreign corporation's assets described in paragraph (a) of this section equivalent to its earnings and

profits which are accumulated after December 31, 1962, and are attributable to items of income described in section 952(b) and the regulations thereunder, reduced by the amount of

(b) The earnings and profits of such corporation which are applied in a taxable year of such corporation beginning after December 31, 1962, to discharge a liability on property, but only if the liability was in existence at the close of such corporation's taxable year immediately preceding its first taxable year beginning after December 31, 1962, and the property would have been United States property if it had been acquired by such corporation immediately before such discharge.

For purposes of this subdivision, distributions made by such corporation for any taxable year shall be considered first made out of earnings and profits for such year other than earnings and profits referred to in (a) of this subdivision.

(2) Statement required. If a United States shareholder of a controlled foreign corporation excludes any property from the United States property of such controlled foreign corporation on the ground that section 956(b)(2) applies to such excluded property, he shall attach to his return a statement setting forth, by categories described in paragraph (a)(1) of this section, the amount of United States property of the controlled foreign corporation and, by categories described in subparagraph (1) of this paragraph, the amount of such property which is excluded.

(c) Treatment of pledges and guarantees—(1) General rule. Except as provided in subparagraph (4) of this paragraph, any obligation (as defined in paragraph (d)(2) of this section) of a United States person (as defined in section 957(d)) with respect to which a controlled foreign corporation is a pledgor or guarantor shall be considered for purposes of section 956(a) and paragraph (a) of this section to be United States property held by such controlled foreign corporation.

(2) Indirect pledge or guarantee. If the assets of a controlled foreign corporation 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 will be considered a pledgor or guarantor of that obligation. For this purpose the pledge of stock of a controlled foreign corporation will be considered as the indirect pledge of the assets of the corporation if at least 66 2/3 percent of the total combined voting power of all classes of stock entitled to vote is pledged and if the pledge of stock is accompanied by one or more negative covenants or similar restrictions on the shareholder effectively limiting the corporation's discretion with respect to the disposition of assets and the incurrence of liabilities other than in the ordinary course of business. This paragraph (c)(2) applies only to pledges and guarantees which are made after September 8, 1980. For purposes of this paragraph (c)(2) a refinancing shall be considered as a new pledge or guarantee.

(3) Illustrations. The following examples illustrate the application of this paragraph (c):

Example 1. A, a United States person, borrows $100,000 from a bank in foreign country X on December 31, 1964. On the same date controlled foreign corporation R pledges its assets as security for A's performance of A's obligation to repay such loan. The place at which or manner in which A uses the money is not material. For purposes of paragraph (b) of § 1.956–1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of § 1.956–1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example 2. The facts are the same as in example 1, except that R Corporation participates in the transaction, not by pledging its assets as security for A's performance of A's obligation to repay the loan, but by agreeing to buy for $100,000 at maturity the note representing A's

obligation if A does not repay the loan. Separate arrangements are made with respect to the payment of the interest on the loan. The agreement of R Corporation to buy the note constitutes a guarantee of A's obligation. For purposes of paragraph (b) of § 1.956–1, R Corporation will be considered to hold A's obligation to repay the bank $100,000, and, under the provisions of paragraph (e)(2) of § 1.956–1, the amount taken into account in computing R Corporation's aggregate investment in United States property on December 31, 1964, is the unpaid principal amount of the obligation on that date ($100,000).

Example 3. A, a United States person, borrows $100,000 from a bank on December 10, 1981, pledging 70 percent of the stock of X, a controlled foreign corporation, as collateral for the loan. A and X use the calendar year as their taxable year, in the loan agreement, among other things, A agrees not to cause or permit X Corporation to do any of the following without the consent of the bank:

(a) Borrow money or pledge assets, except as to borrowings in the ordinary course of business of X Corporation;

(b) Guarantee, assume, or become liable on the obligation of another, or invest in or lend funds to another;

(c) Merge or consolidate with any other corporation or transfer shares of any controlled subsidiary;

(d) Sell or lease (other than in the ordinary course of business) or otherwise dispose of any substantial part of its assets;

(e) Pay or secure any debt owing by X Corporation to A; and

(f) Pay any dividends, except in such amounts as may be required to make interest or principal payments on A's loan from the bank.

A retains the right to vote the stock unless a default occurs by A. Under paragraph (c)(2) of this section, the assets of X Corporation serve indirectly as security for A's performance of A's obligation to repay the loan and X Corporation will be considered a pledgor or guarantor with

respect to that obligation. For purposes of paragraph (b) of § 1.956–1, X Corporation will be considered to hold A's obligation to repay the bank $100,000 and under paragraph (e)(2) of § 1.956–1, the amount taken into account in computing X Corporation's aggregate investment in United States property on December 31, 1981, is the unpaid principal amount of the obligation on that date.

(4) Special rule for certain conduit financing arrangements. The rule contained in subparagraph (1) of this paragraph shall not apply to a pledge or a guarantee by a controlled foreign corporation to secure the obligation of a United States person if such United States person is a mere conduit in a financing arrangement. Whether the United States person is a mere conduit in a financing arrangement will depend upon all the facts and circumstances in each case. A United States person will be considered a mere conduit in a financing arrangement in a case in which a controlled foreign corporation pledges stock of its subsidiary corporation, which is also a controlled foreign corporation, to secure the obligation of such United States person, where the following conditions are satisfied:

(i) Such United States person is a domestic corporation which is not engaged in the active conduct of a trade or business and has no substantial assets other than those arising out of its relending of the funds borrowed by it on such obligation to the controlled foreign corporation whose stock is pledged; and
(ii) The assets of such United States person are at all times substantially offset by its obligation to the lender.

(d) Definitions—(1) Meaning of "acquired"—(i) Applicable rules. For purposes of this section—

(a) Property shall be considered acquired by a foreign corporation when such corporation acquires an adjusted basis in the property;

(b) Property which is an obligation of a United States person with respect to which a controlled foreign corporation is a pledgor or guarantor (within the meaning of paragraph (c) of this section)

shall be considered acquired when the corporation becomes liable as a pledgor or guarantor or is otherwise considered a pledgor or guarantor (within the meaning of paragraph (c)(2) of this section); and

(c) Property shall not be considered acquired by a foreign corporation if—

(1) Such property is acquired in a transaction in which gain or loss would not be recognized under this chapter to such corporation if such corporation were a domestic corporation;
(2) The basis of the property acquired by the foreign corporation is the same as the basis of the property exchanged by such corporation; and
(3) The property exchanged by the foreign corporation was not United States property (as defined in paragraph (a)(1) of this section) but would have been such property if it had been acquired by such corporation immediately before such exchange.

(ii) Illustrations. The application of this subparagraph may be illustrated by the following examples:

Example 1. Foreign corporation R uses the calendar year as a taxable year and acquires before January 1, 1963, stock of domestic corporation M having as to R Corporation an adjusted basis of $10,000. The stock of M Corporation is not United States property of R Corporation on December 31, 1962, since it is not acquired in a taxable year of R Corporation beginning on or after January 1, 1963. On June 30, 1963, R Corporation sells the M Corporation stock for $15,000 in cash and expends such amount in acquiring stock of domestic corporation N which has as to R Corporation an adjusted basis of $15,000. For purposes of determining R Corporation's aggregate investment in United States property on December 31, 1963, R Corporation has, by virtue of acquiring the stock of N Corporation, acquired $15,000 of United States property.

Example 2. Foreign corporation S, a controlled foreign corporation for the entire period here involved, uses the calendar year as a taxable year and purchases for $100,000 on December 31, 1963, tangible property (not described in section 956(b)(2)) located in the United States and having a remaining estimated useful life of 10 years, subject to a mortgage of $80,000 payable in 5 annual installments. The property constitutes United States property as of December 31, 1963, and the amount taken into account for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of § 1.956–1 is $20,000. No depreciation is sustained with respect to the property during the taxable year 1963. During the taxable year 1964, S Corporation pays $16,000 on the mortgage and sustains $10,000 of depreciation with respect to the property. As of December 31, 1964, the amount taken into account with respect to the property for purposes of determining the aggregate amount of S Corporation's investment in United States property under paragraph (b) of § 1.956–1 is $26,000, computed as follows:

Cost of property $100,000

Less: Reserve for depreciation 10,000

Adjusted basis of property..................................90,000

Less: Liability to which property is subject:
Gross amount of mortgage $80,000
Payment during 1964 16,000
64,000
Amount taken into account (12–31–64)..............................26,000

Example 3. Controlled foreign corporation T uses the calendar year as a taxable year and acquires on December 31, 1963, $10,000 of United States property not described in section 956(b)(2); no depreciation is sustained with respect to the property during 1963. Corporation T's current and accumulated earnings and profits (determined as provided in paragraph (b) of § 1.956–1) as of December 31, 1963, are in excess of $10,000, and T Corporation's United States shareholders include in their gross income under section 951(a)(1)(B) their pro rata share of T

Corporation's increase ($10,000) for 1963 in earnings invested in United States property. On January 1, 1964, T Corporation acquires an additional $10,000 of United States property not described in section 956(b)(2). Each of the two items of property has an estimated useful life of 5 years, and T Corporation sustains $4,000 of depreciation with respect to such properties during its taxable year 1964. Corporation T's current and accumulated earnings and profits as of December 31, 1964, exceed $16,000, determined as provided in paragraph (b) of § 1.956–1. Corporation T pays no amounts during 1963 to which section 959(c)(1) applies. Corporation T's investment of earnings in United States property at December 31, 1964, is $16,000, and its increase for 1964 in earnings invested in United States property is $6,000.

Example 4. Foreign corporation U uses the calendar year as a taxable year and acquires before January 1, 1963, stock in domestic corporation M having as to U Corporation an adjusted basis of $10,000. On December 1, 1964, pursuant to a statutory merger described in section 368(a)(1), M Corporation merges into domestic corporation N, and U Corporation receives on such date one share of stock in N Corporation, the surviving corporation, for each share of stock it held in M Corporation. Pursuant to section 354 no gain or loss is recognized to U Corporation, and pursuant to section 358 the basis of the property received (stock of N Corporation) is the same as that of the property exchanged (stock of M Corporation). Corporation U is not considered for purposes of section 956 to have acquired United States property by reason of its receipt of the stock in N Corporation.

Example 5. The facts are the same as in example 4, except that U Corporation acquires the stock of M Corporation on February 1, 1963, rather than before January 1, 1963. For purposes of determining U Corporation's aggregate investment in United States property on December 31, 1963, U Corporation has, by virtue of acquiring the stock of M Corporation, acquired $10,000 of United States property. Corporation U pays no amount during 1963 to which section 959(c)(1) applies. The reorganization and resulting acquisition on December 1, 1964, by U Corporation of N Corporation's stock also represents an acquisition of United States property; however, assuming no other change in U Corporation's aggregate investment in United States

property during 1964, U Corporation's increase for such year in earnings invested in United States property is zero.

(2) [Reserved]

(e) [Reserved]. For further guidance, see § 1.956–2T(e).

26 C.F.R. § 1.1411-10(c), (g). Controlled foreign corporations and passive foreign investment companies.

. . .

(c) Calculation of net investment income—(1) Dividends. For purposes of section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i), net investment income is calculated by taking into account the amount of dividends described in this paragraph (c)(1).

> (i) Distributions of previously taxed earnings and profits—(A) Rules when an election under paragraph (g) of this section is not in effect with respect to the shareholder—(1) General rule. Except as otherwise provided in this paragraph (c)(1)(i), with respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, a distribution of earnings and profits that is not treated as a dividend for chapter 1 purposes under section 959(d) or section 1293(c) is a dividend for purposes of section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i) if the distribution is attributable to amounts that are or have been included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) in a taxable year beginning after December 31, 2012. Solely, for this purpose, distributions of earnings and profits attributable to amounts that are or have been included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) are considered first attributable to those earnings and profits, if any, derived from the current taxable year, and then from prior taxable years beginning with the most recent prior taxable year, and with respect to amounts included under section 951(a), without regard to whether the earnings and profits are described in section 959(c)(1) or section 959(c)(2).

. . .

(g) Election with respect to CFCs and QEFs—(1) Effect of election. If an election under paragraph (g) of this section is made with respect to a CFC or QEF, amounts included in gross income for chapter 1 purposes under section 951(a) or section 1293(a)(1)(A) with respect to the CFC or

QEF in taxable years beginning with the taxable year for which the election is made are treated as net investment income for purposes of § 1.1411–4(a)(1)(i), and amounts included in gross income under section 1293(a)(1)(B) with respect to the QEF in taxable years beginning with the taxable year for which the election is made are taken into account in calculating net gain attributable to the disposition of property under § 1.1411–4(a)(1)(iii). See paragraphs (c)(1)(i)(B) and (c)(1)(i)(C) of this section for the effect of this election on certain distributions of previously taxed earnings and profits.

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General Information

Court	United States Court of Appeals for the Third Circuit; United States Court of Appeals for the Third Circuit
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